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June 30, 2020

VIA EMAIL to comments@fdic.gov

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20249

Re: Comments on the Proposed Rule: Parent Companies of Industrial Banks and Industrial Loan Companies (RIN 3064-AF31)

To Whom It May Concern:

We appreciate the opportunity to comment on the FDIC's proposed rulemaking ("Proposed Rule").[1] As you know, the Proposed Rule requires certain conditions and commitments for deposit insurance applications, changes in control, and mergers involving FDIC-insured industrial banks, industrial loan companies and similar entities that are subsidiaries of companies not subject to consolidated supervision by the Federal Reserve Board ("FRB").

We are submitting this comment letter on behalf of Finance Enterprises, Ltd. and its wholly-owned subsidiary, Finance Factors Limited ("Finance Factors"). Finance Factors is a non-member industrial loan company ("ILC") based in Honolulu, Hawaii. Founded in 1952, Finance Factors is one of the oldest ILCs in the country. Of the ILCs still in existence, it has been FDIC-insured the longest, since 1984. It is also a minority depository institution ("MDI"), meeting both definitions to qualify for MDI status, with 51 percent or more of its voting stock owned by minority individuals, and with the majority of its board of directors (and staff) being minority and the community it serves being predominantly minority. As such, Finance Factors provides underserved areas with products and services that may not be available elsewhere. As of March 30, 2020, Finance Factors had total assets of approximately $596 million, making it the second smallest bank based in Hawaii.

[1] Parent Companies of Industrial Banks and Industrial Loan Companies, 85 Fed. Reg. 17,771, at 17,771 n.2. (proposed March 31, 2020) (to be codified at 12 C.F.R. pt. 354) [hereinafter *Proposed Rule*].

Hawaii is a uniquely insular banking market – no Hawaiian banks have branches in the continental U.S., and no U.S. continental banks have branches in Hawaii. Therefore, regulatory compliance costs tend to affect Hawaiian banks disproportionally because Hawaiian banks have fewer opportunities to increase and diversify their revenue streams as compared with U.S. continental banks.

We understand that the stated purpose of the Proposed Rule is to (i) codify existing practices utilized by the FDIC to supervise industrial banks and their parent companies, (ii) to mitigate undue risk to the Deposit Insurance Fund ("DIF") that may otherwise be presented in the absence of Federal consolidated supervision of an industrial bank and its parent company, and (iii) to ensure that the parent company that owns or controls an industrial bank serves as a source of financial strength for the industrial bank, consistent with section 38A of the Federal Deposit Insurance Act ("FDIA").[2]

We agree with the principles underlying the Proposed Rule with respect to future charters and large institutions. However, we disagree with the Proposed Rule's necessity with respect to its application (or potential application) to existing institutions or with respect to institutions with less than $1 billion in total assets. Retroactive application of the Proposed Rule to existing institutions would be unnecessary, inequitable and a divergence from historical practices. Additionally, the costs associated with complying with the Proposed Rule would be a comparatively greater burden on community banks and would outweigh any purported benefit, especially given that the FDIC has sufficient supervisory and enforcement tools to apply the substantive requirements of the Proposed Rule on a case-by-case basis.

This letter responds to primarily to question one set forth in the Proposed Rule. In sum,

(i) The Proposed Rule should not apply retroactively;
(ii) If the Proposed Rule will apply retroactively, it should only apply to parent companies of industrial banks with over $1 billion in total assets; and
(iii) The Proposed Rule should not apply in the event of a reorganization, merger or change in control if the industrial bank already exists and is below $1 billion in total assets.

We would appreciate confirmation of these views as part of the final rulemaking associated with the Proposed Rule.

Question 1: Should the proposed rule apply only prospectively, that is, to industrial banks that become a subsidiary of a parent company that is a Covered Company? Or should the proposed rule also apply to all industrial banks that, as of the effective date, are a subsidiary of a parent that is not subject to Federal consolidated supervision by the FRB? What are the concerns with each approach?

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[2] *Id*. at 17,771-72.

Comment:

The Proposed Rule should only apply prospectively. Specifically, industrial bank charters and activities that pre-date the Proposed Rule are not part of the "evolution" seen by the current FDIC administration. Existing industrial banks are seasoned, lower risk franchises, especially Finance Factors, which was founded in 1952. It would be inequitable to apply new conditions and commitments on parent companies of industrial banks that have not voluntarily engaged in transactions such as mergers or changes in control altering their historic structure.

The FDIC justifies the Proposed Rule due to the "continuing evolution of the industrial bank charter."[3] However, the industrial bank charter has not evolved. The definition of "industrial banks," as provided in the Proposed Rule, are entities excluded from the definition of "bank" in the Bank Holding Company Act ("BHCA"),[4] which by definition is a charter available in a limited number of states, with authorized activities as defined by those chartering states as of March 5, 1987. With such limitations, it is unclear what evolution is referenced as the geographic footprint and nature of activities is limited. Further, while it has been seven years since the moratorium on industrial bank charters ended in July 2013, the charters of the 23 industrial banks in existence as of the Proposed Rule all pre-date 2008.[5] As noted in the Proposed Rule, until the two recent charter approvals of Nelnet and Square, only four industrial bank charters were granted in the last 20 years.[6] Moreover, between 2017 and 2019, the FDIC only received nine industrial bank deposit insurance applications and one change in control application.[7] The FDIC estimates the Proposed Rule would apply to four filings per year by companies seeking to establish or acquire an industrial bank.[8] The "continuing" evolution is also unclear because the number of industrial banks has declined from 58 in 2007 to 23 in 2020.[9]

Further, and as noted in the Proposed Rule, only two industrial banks failed during the financial crisis.[10] These failures were referenced within the Proposed Rule as "small industrial banks that did not present circumstances raising concern with respect to industrial banks proposed prior to the crisis."[11] The limited number of failures further calls into question the necessity for the Proposed Rule, but also underscores that retroactive applicability is not needed.

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[3] *Id.* at 17,772.

[4] *Id*. at 17,771 n.2.

[5] *Id*. at 17,773.

[6] *Id*.

[7] *Id*.

[8] *Id*. at 17,780.

[9] *Id*. at 17,773.

[10] *Id*.

[11] *Id*. at 17,776.

While there has not been a significant historic evolution of the industrial bank charter since 2007, even after the end of the moratorium in July 2013, perhaps the FDIC's noted evolution "has less to do with their size and scope and more to do with who owns them—or wants to,"[12] which is what led to the 2007 FDIC moratorium on deposit insurance applications and what drove the previous FDIC notice of proposed rulemaking in 2007[13] after Wal-Mart and Home Depot sought industrial bank charters.[14]

The current Proposed Rule also comes after the two recent FDIC approvals of deposit insurance for Nelnet and Square. Because the FDIC's cited "evolution" appears to start with these recent approvals, the Proposed Rule should go no further back in time than those. To the extent the Proposed Rule is adopted, it should only apply prospectively, as those are the companies seeking an industrial bank charter to "operate unique business models"[15] or have "diversified business operations and activities that would not otherwise be permissible for BHCs under the BHCA and applicable regulations."[16]

It would be inequitable to apply the Proposed Rule retroactively to entities that have previously been granted industrial bank charters and during the process of obtaining deposit insurance were assessed and examined for their risk by the FDIC, including with respect to their parent companies. There would be no added benefit to depositors or the DIF by applying the Proposed Rule retroactively to those parent companies that have already demonstrated the ability to serve as a source of strength to their subsidiaries. Additionally, this would be inequitable for entities that strategically entered into transactions or engaged in activities in order to receive the benefits offered by the industrial bank charter at the time of such transaction, most of which were decades ago. Such retroactive application could lead to economic uncertainty due to the deprivation of notice to entities of the Proposed Rule's application.

The inequities of a retroactive rule would be further exacerbated because the FDIC has sufficient supervisory tools to monitor parent companies of industrial banks. The FDIC's existing practice is to tailor conditions as appropriate to the institution and the parent company, as described in more detail later in this letter. Rulemaking resulting from the FDIC's historically tailored approach is not a clarification or codification of an existing rule that would allow for retroactive application of a consistently applied existing practice.[17] Nor is it, as provided in the Administrative

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[12] Federal Reserve Bank of Saint Louis, Industrial Loan Companies Come Out of the Shadows, REGIONAL ECONOMIST (July 1, 2007), https://www.stlouisfed.org/publications/regional-economist/july-2007/industrial-loan-companies-come-out-of-the-shadows.

[13] Industrial Bank Subsidiaries of Financial Companies, 72 Fed. Reg. 5,217 (proposed February 5, 2007).

[14] *Proposed Rule*, *supra* note 1, at 17,774.

[15] *Id*. at 17,776.

[16] *Id*.

[17] In the *Matter of Lodavina Grosnickle* (Release No. ID-441; Administrative Proceeding File No. 3-14408; November 10, 2011, citing *SEC v. First Pacific Bancorp*, 142 F.3d 1186 (9th Cir. 1998), wherein the Court considered the newly-

Procedure Act, being done in connection with "interpretative rules and statements of policy."[18] The FDIC's prior treatment of parent companies of industrial banks has not been consistent, nor is the Proposed Rule an interpretative rule or statement of policy as the Proposed Rule would have the force and effect of law.[19] Further, if the Proposed Rule was in fact a means to

- "codify existing practices utilized by the FDIC to supervise industrial banks and their parent companies,"[20]
- "codify the FDIC's informal standards,"[21]
- "codify certain supervisory requirements,"[22] or
- to generally "codify the FDIC's current supervisory processes and policies,"[23]

as provided in numerous instances in the Proposed Rule, such rulemaking authority would not require notice or publication as provided in the Administrative Procedure Act.[24]

In fact, the scope of the Proposed Rule is far broader than a clarification or codification of existing practices or procedures. First, the FDIC's existing practice, which is consistent with its supervisory and enforcement authority granted by 12 USC §1831o-1(b), has been conducted on a

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created officer and director bar of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Penny Stock Act). The Court in *First Pacific Bancorp* applied the bar retroactively, noting that the Penny Stock Act "merely codified the equitable authority to impose [an] officer and director bar which the courts already possessed and exercised." *Id*. at 1193 n. 8. The Court in *Grosnickle,* noted "Dodd-Frank lacks an express retroactivity provision, and 'normal rules of [statutory] construction do not reveal Congress' intent regarding retroactivity" (citing *Pezza v. Investors Capital Corp.*, 767 F. Supp. 2.d. 225 (D. Mass 2011)). In *Grosnickle*, the Court did not uphold the associational bar against Grosnickle as it related to municipal advisors because "before Dodd-Frank's enactment there was no associational bar or similar provision with respect to municipal advisors," as it was not an existing practice. *Grosnickle*, at 10.

[18] 5 U.S.C. § 553(d)(2).

[19] Todd Garvey. *A Brief Overview of Rulemaking and Judicial Review*. Congressional Research Service (March 27, 2017) (Rules that carry the force and effect of law are known as legislative rules. These rules are to be distinguished from non-legislative rules, such as interpretive rules and policy statements, which lack the force and effect of law. *See, e.g.*, *Appalachian Power Co. v. EPA, 208 F.3d 1015, 1020, (D.C. Cir. 2000)* ("Only 'legislative rules' have the force and effect of law ... A 'legislative rule' is one the agency has duly promulgated in compliance with the procedures laid down in the statute or in the Administrative Procedure Act."); *Nat'l Mining Ass'n v. McCarthy, 758 F.3d 243, 250 (D.C. Cir. 2014)* ("Legislative rules have the 'force and effect of law' and may be promulgated only after public notice and comment.")).

[20] *Proposed Rule*, *supra* note 1, at 17,772.

[21] *Id*.

[22] *Id*. at 17,776.

[23] *Id*.

[24] 5 U.S.C. § 553(b)(A) (providing that general notice of proposed rulemaking must be published in the Federal Register except for "*interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice…*" so long as notice or hearing is not required by statute). There is no statutory notice or hearing required by statute based on the legal authority provided in the Proposed Rule.

case-by-case basis derived from the risks presented by the application or entity.[25] The current procedure of the FDIC is tailored and not uniformly applied to the parent companies of industrial banks, while the Proposed Rule seeks to standardize and generally apply conditions and commitments to the parent companies of industrial banks, which is not an existing practice. Second, conditions imposed in writing in connection with FDIC action typically expire, either by their terms or by further FDIC action. The Proposed Rule would apply conditions in perpetuity.[26] Accordingly, it would be inequitable to apply the Proposed Rule retroactively.

Despite the foregoing position that the Proposed Rule should not apply retroactively, in the event the Proposed Rule will apply retroactively, it should only apply to parent companies of industrial banks with over $1 billion in total assets as smaller institutions by virtue of their size pose less risk to the DIF. As of December 31, 2019, there were 23 industrial banks, with $141 billion in aggregate total assets and a majority of the 23 industrial banks had over $1 billion in total assets.[27] As of December 31, 2019, there were a total of 5,177 FDIC-insured institutions with $18.645 trillion in total assets,[28] industrial banks had $141 billion in total assets, which constituted only 0.756% of the total assets of all FDIC-insured institutions. Given that institutions with less than $1 billion in total assets constitute less than a majority of industrial banks and industrial banks themselves are only 0.756% of the total assets of all FDIC-insured institutions, combined with the disproportionately higher regulatory burden on smaller institutions for compliance with little to no meaningful impact in risk mitigation to the DIF, we take the position that the $1 billion threshold is reasonable. This is further underscored by evidence that industrial banks perform better than all other FDIC institutions, and have lower troubled asset ratios than all FDIC-insured institutions.[29] It is also important to note evidence that parent companies of industrial banks have served as stronger sources of strength than bank holding companies that are subject to consolidated FRB supervision. In the 2012 GAO Report regarding BHCA exempt institutions ("2012 GAO Report"), the GAO noted that the parent companies of industrial banks did function as a source of strength and that the capitalization of the parent companies of industrial banks was higher than bank holding companies.[30]

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[25] *See* Federal Deposit Insurance Corporation, Deposit Insurance Applications Procedures Manual, 1.1-1, 1.1-2 (2019) (providing that "…staff will process each application in a fair, objective, timely and forward-looking manner that considers each applicant's specific risk attributes and any mitigating elements") [hereinafter *Applications Procedures Manual*].

[26] *Proposed Rule*, *supra* note 1, at 17,785.

[27] *Proposed Rule*, *supra* note 1, at 17,773.

[28] FDIC. *Statistics at a Glance as of December 31, 2019*.
https://www.fdic.gov/bank/statistical/stats/2019dec/industry.pdf

[29] Barth, James R. and Sun, Yanfei. *A New Look at the Performance of Industrial Loan Corporations*. Utah Center for Financial Services – The University of Utah (Jan. 2008).

[30] U.S. Gov't Accountability Office, GAO-12-160, Bank Holding Company Act: Characteristics and Regulation of Exempt Institutions and the Implications of Removing the Exemptions (Jan. 2012) [hereinafter *2012 GAO Report*] at 23.

This calls into question the necessity and the rationale for the Proposed Rule. The 2012 GAO Report states as follows:

> To assess whether these holding companies could be a source of strength to the financial institution, we analyzed the capitalization of holding companies for ILCs and credit card banks. On average, the holding companies of ILCs and credit card banks we analyzed had higher ratios of equity-to-total assets over the 5-year period than bank holding companies...The higher ratio shows that these holding companies had a higher, stronger cushion against losses that might occur. The average equity-to-total assets ratios for limited-purpose credit card banks remained above 20 percent over the period. In comparison, the average equity-to-total assets ratio of bank holding companies with total assets of more than $500 million that were required to file financial data with the Federal Reserve remained below 10 percent during the same period.[31]

Additionally, the impact of the regulatory burden is significantly higher on smaller institutions, especially because a number of the commitments noted in the Proposed Rule will apply in perpetuity, and accordingly will disproportionately affect smaller institutions with no meaningful risk mitigation to the DIF. Further, by virtue of being FDIC-insured depository institutions, these smaller industrial banks are already subject to regulation and supervision by the FDIC.[32] The additional layer of requirements, as provided in the Proposed Rule, is unduly burdensome with little to no clear benefits in reducing risk to the DIF.

Further, the Proposed Rule should not apply in any case, either prospectively or retroactively, when the parent company of an industrial bank engages in (i) a reorganization, merger or change in control, (ii) the industrial bank is a pre-existing industrial bank, and (iii) the total assets of the industrial bank are below $1 billion. As provided above, entities with less than $1 billion in total assets will provide no meaningful risk exposure to the DIF. Given Finance Factor's small size and demonstrated track record of successful operations, the risk to the DIF is even further limited. The FDIC already has sufficient powers to ensure the acquiring parent company will continue to serve as a source of strength.[33] Further, any internal reorganization of a parent company of an industrial bank, such as internal housekeeping measures, should not subject the parent company to the application of the Proposed Rule. Finally, in connection with a merger or change in control, the FDIC would have the opportunity to review the facts and circumstances of the transaction as part of

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[31] *Id.*

[32] 12 U.S.C. §1831o-1(b).

[33] *Id.*

the regulatory application review process and could impose on a case-by-case basis some or all of the substantive requirements of the Proposed Rule as conditions imposed in writing.

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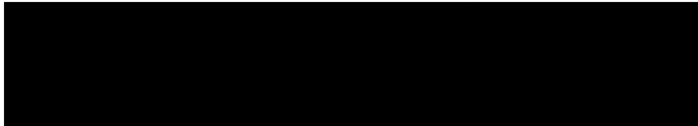
We appreciate the opportunity to submit these comments in connection with the Proposed Rule. Should you wish to discuss any of the above or desire any clarification, please contact Carleton Goss at cgoss@huntonak.com (214-468-3330).

Sincerely,



CC: Alana Peacott-Ricardos, Compliance Officer, Bank Secrecy Act Officer, and Associate General Counsel, Finance Factors