CSBS SINCE 1902

CONFERENCE OF STATE BANK SUPERVISORS

June 1st, 2020

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN 3064-AF31

Re: *Proposed Rule: Parent Companies of Industrial Banks and Industrial Loan Companies.*

Dear Sir,

The Conference of State Bank Supervisors ("CSBS")[1] appreciates the opportunity to comment on the notice of proposed rulemaking issued by the Federal Deposit Insurance Corporation (the "FDIC") titled "Parent Companies of Industrial Banks and Industrial Loan Companies". The proposed rule seeks to codify practices utilized by the agency to supervise ILCs and industrial banks (both referred to for the purposes of this letter as "industrial banks") and their parent companies who are *not* subject to consolidated supervision by the Federal Reserve Board.

CSBS believes there is significant value in making the FDIC's policies and procedures for assessing deposit insurance applications, change of control requests, and mergers related to industrial banks and their parent companies transparent to future applicants and the broader public. However, CSBS is concerned that the FDIC is moving towards a further federalization of corporate governance oversight by placing *permanent* limitations on the ability of industrial banks to make certain governance decisions without prior approval from the FDIC. Given that the industrial bank charter is a lawful option under state and federal law, the FDIC should not create new requirements that place this viable state-charter option at a disadvantage compared to other options available to non-bank firms seeking to offer bank products and services to consumers.

In light of these concerns, CSBS requests that the FDIC:

- Place reasonable time bounds on restricted corporate governance activities (listed in Section 345.5) to ensure that industrial banks, once out of de novo status, can exercise flexibility in corporate governance decisions.
- Provide clarity regarding what constitutes a "material change" in an industrial banks business plan.
- For continuing commitments related to capital and liquidity, provide a cure period in the event that an industrial bank or its parent company is initially compliant but falls below agreed upon levels.

[1] CSBS is the nationwide organization of state banking and financial regulators from all 50 states, American Samoa, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands. CSBS supports the state banking agencies by serving as a forum for policy and supervisory process development, by facilitating regulatory coordination on a state-to-state and state-to-federal basis, and by facilitating state implementation of policy through training, educational programs, and exam resource development.

- Provide clarity regarding the intersection of the FDIC's capital rules with commitments to maintain specific capital levels in written agreements.
- Explain the rationale for making one class of CEBA exempted institutions subject to the rule but not other classes of exempted institutions.

The sections that follow contain contextual information regarding the role of state regulators in chartering and supervising industrial banks, information regarding state regulators' historical support for the industrial bank charter, and descriptions of our concerns with the proposed rule.

States are the sole chartering authority of industrial banks and supervise them and their parent companies jointly with the FDIC

Industrial banks have been chartered and supervised by the states since their inception in 1910, and the FDIC did not become involved in regulating them until 1982, when the Garn-St.Germain Depository Institutions Act made industrial banks eligible for FDIC deposit insurance.[2] In the past, as many as 40 states chartered or licensed depository and/or non-depository industrial banks. Today, only 6 states have the authority under state *and* federal law to charter industrial banks.

The decrease is attributable to passage of the Competitive Equality Banking Act (CEBA) of 1987, which changed the Bank Holding Company Act (BHCA) definition of "bank" to include any institution that was FDIC insured. This meant any new industrial banks would be defined as a bank and thus would be precluded from having non-financial ownership. CEBA exempted industrial banks and their parent companies from the Bank Holding Company Act if they received a charter from one of the states eligible to issue industrial bank charters (and where FDIC deposit insurance was required) at the time the law was enacted. Under CEBA, seven states were allowed to grandfather existing industrial banks and to charter new industrial banks. That number dropped to six when Colorado's last industrial bank became inactive in 2009 and the state repealed its industrial bank statute. The remaining states that can charter industrial banks that fall under the BHC exemption include Utah, Nevada[3], Minnesota, Indiana, Hawaii, and California. There are now 23 active industrial banks, with the majority (14) in Utah.[4]

While, in the past, there were substantive differences between the permissible activities of commercial banks and industrial banks, FDIC-insured industrial banks are now permitted to engage in the same activities as other insured depository institutions.[5] The primary remaining difference between commercial banks and industrial banks is that the parent companies of industrial banks can engage in nonbanking commercial operations, whereas bank holding companies are restricted by the BHCA to engaging in activities "closely related to banking". Six of the 23 active industrial banks are owned by commercial parents.[6]

State and Federal regulators apply a variety of requirements and oversight functions to address the unique considerations that stem from commercial ownership of a financial institution. For the purposes of this letter, our explanation of state oversight functions focuses on Utah, considering they supervise the majority of existing and newly chartered industrial banks. The process for obtaining an industrial bank

[2] FDIC Supervisory Insights Journal. Summer 2004. "The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective." Page 4. Available here.
[3] Nevada does not directly charter industrial banks but relies on the Nevada Thrift Companies Act
[4] The FDIC approved deposit insurance applications for Square LLC and Nelnet Bank on March 18th, 2020. Both will be headquartered in Utah. Once active, there will be 25 industrial banks with 16 in Utah.
[5] With one exception being the inability of industrial banks to accept demand deposits.
[6] "A New Look at the Performance of Industrial Loan Companies." James R. Barth and Yanfei Sun. Auburn University. January 2018. Page 16. Available here.

charter begins with an application to the banking department under the relevant sections of the state's code and an application for insurance of deposits with the FDIC.[7] In reviewing an application and business plan for approval, the Utah Department of Financial Institutions gives weight to the following factors, among others:

1. The character, reputation, and financial standing of the organizer
2. The organizers have the resources (source of capital) to support an IB.
3. Selection of a board of directors, the majority of who, must be outside, unaffiliated individuals, and some who are residents of the state.
4. The establishment of an organization within the state where autonomous decision-making authority and responsibilities reside with the board and management such that they are in control of the IB's activities and direction
5. A management team that has a track record, the knowledge, expertise, and experience in operating a depository institution in a regulated environment
6. Management that is independent of the parent
7. A bona fide business plan and purpose for the existence of an industrial bank, in which deposit taking is an integral component, including three years pro forma projections and supporting detail
8. FDIC deposit insurance.

States may also take steps to consider the impact on competition when evaluating a charter application. This analysis seeks to determine that new entrants into the marketplace will not have a detrimental impact upon existing financial institutions.

Operating industrial banks are supervised by state regulators for strict compliance with the Federal Reserve's restrictions on transactions with affiliates (Reg. W) and extensions of credit to insiders (Reg. O).[8] Like commercial banks, they are subject to safety and soundness examinations by the state and FDIC. Parent companies of Utah based industrial banks are inspected every three years, unless conditions warrant more frequent contact. The FDIC is invited to participate and often joins the state examiners on parent company inspections. Other states have similar authority to conduct examinations of industrial bank affiliates.[9] Industrial banks are also subject to examinations under the Community Reinvestment Act as well as regular compliance, Bank Secrecy Act, and Information Technology exams.

The FDIC has specific authorities that are sufficient to ensure that industrial banks and their commercial parent companies do not pose an undue risk to the deposit insurance fund. Pursuant to section 10(b)(4) of the FDI Act, the FDIC has the authority to examine the affairs of any industrial bank affiliate, including the parent company. In addition, the Dodd-Frank Act changed the Federal Deposit Insurance Act to require parent companies to act as sources of financial strength for industrial banks—and the proposed rule will codify this requirement.[10]

The FDIC also has full authority to advance enforcement actions against an industrial bank's affiliated entities, which includes any director, officer, employee, or controlling stockholder, and can also include

[7] See Section 7-1-704 of Utah Code
[8] One difference is that cross guarantee liabilities does not apply to industrial banks and golden parachute restrictions apply to the institution but not the parent company. However, 2004 FDIC OIG report noted that cross-guarantee authority would make no significant difference unless two or more ILCs are owned by a parent and one fails (available here.)
[9] The Lexis Practice Advisor Journal Fall 2019 Edition. "Industrial Loan Companies." John Popeo. Available here.
[10] See Section 616 of the Dodd-Frank Act and subsection (d) of Section 38A of the FDI Act or 12 U.S.C. 1831*o*-1(d).

any independent contractor (attorney, appraiser, or accountant) who knowing or recklessly engages in misconduct.[11]

In addition, the FDIC is empowered, in the course of its supervisory activities, to issue subpoenas and to take and preserve testimony under oath, as long as the documentation or information sought relates to the affairs or ownership of the insured industrial bank. Therefore, any entity that affects the industrial banks affairs or ownership may be subpoenaed and required to produce documents.

State regulators believe the joint supervisory approach to supervising industrial banks with the FDIC has been effective, and industrial banks with commercial parents do not present an outsized safety and soundness risk.

Former FDIC Chairman Donald Powell, noted at a 2003 CSBS event, "the FDIC believes the ILC charter, per se, poses no greater safety and soundness risk than other charters….further, the firewalls and systems of governance safeguarding ILCs from misuse by their parent companies are, in many cases, more stringent than what exists in many affiliates of bank holding companies."[12] Overall, the small footprint of industrial banks, capital requirements imposed on them, and supervision of the bank and parent company by the state and FDIC ensure they do not pose a threat to banking industry stability.

CSBS has historically supported the industrial bank charter

One of the great benefits of the state banking system is that it allows for the existence of many different types of financial institutions and choices of charter type. States are engines for experimentation and industrial banks are excellent examples of the creativity and flexibility of the state banking system. For fintech firms that want to have a national presence and are willing to truly become a bank and take on all of the commitments and responsibilities that come with a bank charter, the option of an industrial bank charter is a lawful and reasonable one.

State banking regulators have a mandate to ensure safety and soundness and consumer protection, but also to foster local economic development. While states are well served by chartering and supporting local, community-based institutions, residents of a state also benefit from the operations of banks (state or national) with a regional or national footprint. Industrial banks have been significant drivers of economic development in states like Utah, where they have provided high quality and high paying jobs to residents in the state. Other states are looking for similar economic benefits. For example, California is currently working to change their law (which allows for industrial bank charters but restricts the ability of their parent companies to engage in commercial activity) to allow for some commercial ownership of industrial banks.[13]

Industrial banks do not pose unique risks to consumers. Any bank, whether a commercial bank or an industrial bank, can export interest rates, and there is nothing special about industrial banks which makes them more susceptible to third-party lending arrangements or partnerships. States and the FDIC *both* view

[11] 12 U.S.C.S. § 1813(u)
[12] "The ILC and the Reconstruction of U.S. Banking." Mehrsa Baradaran, SMU Law Review, Volume 63, 2010. Page 1162. Available here. Also available here.
[13] "California encouraging ILC charters as fintechs increasingly seek bank charters". S&P Global Market Intelligence. Feb 28th, 2020, Available here.

unfavorably entities that partner with a state bank with the sole goal of evading a lower interest rate established under the law of the entity's licensing states.[14]

CSBS does not support the application of *permanent* restrictions on corporate governance decision making for industrial banks

CSBS supports the FDIC's effort to increase transparency regarding deposit insurance applications, changes in control, or mergers related to industrial banks and commercial parents. Codifying existing requirements (such as the source of strength requirement in the FDI Act) and practices (such as the imposition of capital and liquidity maintenance agreements) will help to ensure that prospective applicants and the public understand regulatory requirements and supervisory expectations. However, state regulators who oversee industrial banks are concerned that section 354.5 of the proposed rule imposes *permanent* restrictions on corporate governance activities of covered industrial banks and their parent companies without demonstrating that existing state and federal controls are insufficient to prevent conflicts of interest between industrial banks and commercial ownership.

Specifically, section 354.5 of the proposed rule would place permanent restrictions on the ability of covered industrial banks to make material changes in their business plan[15], add or replace board members, hire new employees for senior roles, or enter into contracts for material services with the parent company. Previous conditions requiring no change in an industrial banks Board or management without prior approval from the FDIC have typically expired at the end of the industrial banks de novo period.[16] These conditions have generally aligned with time-bounded restrictions put in place by the states. For example, Utah does not allow any change in the executive officers or board of directors as submitted in an industrial bank's application without the prior approval of the State Commissioner for a period of 3 years after the industrial bank commences operations. In addition, the state requires the industrial bank to operate within the parameters of a 3-year pro-forma business plan submitted with the application, and any significant deviation from the plan must have prior written approval from the Commissioner. The bank's board of directors is also required to meet a minimum of eight times a year for at least the first two years of operation. These conditions have proven to be successful in supervising de novo industrial banks. Other states authorized to charter industrial banks have similar requirements.

Federal regulators should not create more expansive and permanent restrictions that prevent industrial banks that have been successful during their de novo period from being flexible in corporate decision making. If the FDIC moves forward with the proposal, they should place reasonable time-bounds on the proposed restricted activities listed in Section 354.5. The FDIC should retain the flexibility to evaluate deposit insurance applications on a case-by-case basis and apply ongoing restrictions only if absolutely necessary.

There are areas in which additional clarity regarding the written commitments described in section 354.4 would help to increase understanding of regulatory requirements and supervisory expectations. Specifically, clarity is needed regarding the applicability of (CALMA imposed or other written) capital commitments to the well-capitalized criteria in Part 324 of the FDICs regulations and possible consequences of such applicability on brokered deposit restrictions under PCA. Given that current

[14] "FDIC Proposes New Rule Clarifying Federal Interest Rate Authority." Press Release, November 19, 2019. Available here.

[15] Further clarity should be provided regarding what would constitute a "material change."

[16] FDIC Deposit Insurance Applications Procedures Manual Supplement—Applications from Non-Bank and Non-Community Bank Applicants, Section D: "Approval Conditions" notes: "Most non-standard conditions do not exceed the three-year de novo period." Page 10.

CALMA agreements in place require industrial banks to maintain levels of capital well above those required by the agencies to be considered "well-capitalized", the FDIC should provide clarity regarding the regulatory consequences of falling below levels agreed upon in the written commitment. In no circumstance should an industrial bank be rendered "less-than well capitalized" if it were to drop below agreed upon levels but whose capital levels remain well above levels mandated by the agency's capital rules. In addition, the FDIC should consider providing a cure period for industrial banks whose capital or liquidity ratios fall below agreed upon levels but remain above levels that would trigger restrictions under the PCA framework.

It would also be beneficial for the FDIC to explain its rationale for applying the proposed rule to industrial banks and their parents but not to other CEBA exempted entities such as credit card banks, which often have commercial (department store etc.) ownership.

Conclusion

As previously noted, CSBS believes the industrial bank charter should be a viable option for entities that want to have a national presence and are willing to truly become a bank and take on all of the commitments and responsibilities that come with a bank charter. The FDIC should not layer additional corporate governance restrictions on top of existing state standards that serve well to limit the risks posed by commercial ownership of an insured industrial bank. Coordinated supervision of industrial banks by state supervisors and the FDIC continues to work well. CSBS and state regulators who charter and supervise industrial banks would be willing and eager to consult with the FDIC regarding any concerns highlighted in this letter.

Sincerely,

John Ryan
President & CEO