

Pathway opens for non-financial and fintech companies to obtain *de novo* industrial bank charters

On March 17th, 2020, the Federal Deposit Insurance Corporation (FDIC) released a notice of proposed rulemaking (NPR) seeking comment on a proposed rule that would require certain conditions and commitments for approval or non-objection to certain filings involving an industrial bank or industrial loan corporation (ILC) provided the parent company is not subject to consolidated oversight by the Federal Reserve Board (FRB).¹ The developments open the door for additional non-financial companies and fintech companies to enter regulated financial services, and provides a clearer path to not being subject to the FRB's oversight. "This proposal would ensure that parent companies serve as a source of strength for their industrial bank subsidiaries," said FDIC Chairman Jelena McWilliams.²

On March 18th, 2020, the FDIC approved separate applications by payment company Square Inc and student loan servicer Nelnet Inc to become *de novo* industrial banks, the first time the agency has granted such licenses in over a decade.² FDIC Chairman McWilliams stated the following on the approvals: "Nelnet [and Square] satisfied each of the statutory factors required for approval, subject to certain conditions. One of the conditions would require the proposed bank[s] to maintain levels of capital that are significantly higher than typical FDIC-insured banks."³

Proposed rule key takeaways

The proposed rule:

- Establishes requirements for deposit insurance applications involving an ILC and a covered company (the parent company);
- Captures grandfathered ILCs following a change in control, merger, or grant of deposit insurance
- Applies significant restrictive commitments on the Covered Company in addition to requiring the Covered Company to enter into written agreements with both the FDIC and the subsidiary industrial bank;
- Adds the possibility that a controlling shareholder of the Covered Company also join the written agreement, limiting the ability of a company to limit the reach of the written agreement;
- Provides a pathway, by rule, for ILCs to receive deposit insurance, which did not previously exist;
- Promotes transparency, relative to previous requirements that could vary and were not transparent;
- Does not include an expiration of the commitments, and therefore certain changes, including changes to the ILC's business model, will require FDIC approval;
- Requires additional reporting (e.g. submission of an annual report describing the Covered Company's operations and activities);
- Raises the bar for independent directors by limiting the Covered Company's direct or indirect representation, likely impact the size of boards and mix of directors;

- Codifies Capital and Liquidity Maintenance Agreement (CLMA) as a requirement, including specific actions that are more explicit as to the support the Covered Company needs to provide on an ongoing basis;
- Codifies the ability of the FDIC to require the elements captured in a recovery plan up to the point of receivership; and,
- Provides the FDIC more flexibility to impose additional restrictions.

Approval order – requirement comparison

Category	Square	Nelnet	Level of Difference
Written agreement	<ul style="list-style-type: none"> CLMA and a Parent Company Agreement (PCA) 	<ul style="list-style-type: none"> CLMA and a Parent Company Agreement (PCA) 	None
Reporting and recordkeeping	<ul style="list-style-type: none"> Parent company must consent to examination, reporting, recordkeeping Books and records shall be maintained under the control and direction of authorized Bank officials and available for review by the FDIC 	<ul style="list-style-type: none"> Parent company must consent to examination, reporting, recordkeeping Books and records shall be maintained under the control and direction of authorized Bank officials and available for review by the FDIC 	None
Governance and background check requirement	<ul style="list-style-type: none"> Full disclosure to all proposed directors of the Bank of the facts concerning the interest of any insider in any transactions being effected or contemplated Appoint a Chief Risk Officer and a Chief Operating Officer Bank directors or senior executive officers must complete background checks, including Interagency Biographical and Financial Reports for any senior executive officer with a written description of mentioned details (salary, benefits etc.) to the FDIC 	<ul style="list-style-type: none"> Full disclosure to all proposed directors of the Bank of the facts concerning the interest of any insider in any transactions being effected or contemplated 	High
Independent validations	<ul style="list-style-type: none"> Independent Public Accountant must audit the Bank's financial statements annually for at least the first three years of operation and submit the reports to the FDIC Document and conduct full-scope independent validations of all models subject to the satisfaction of the FDIC 	<ul style="list-style-type: none"> Independent Public Accountant must audit the Bank's financial statements annually for at least the first three years of operation and submit the reports to the FDIC Document and conduct full-scope independent validations of all models subject to the satisfaction of the FDIC 	None
Capital and Liquidity Maintenance Agreement (CLMA)	<ul style="list-style-type: none"> 20% leverage ratio at all times Third-party line of credit for the benefit of the Bank acceptable to the FDIC Purchase any loan from the Bank at the greater of the cost basis or fair market value Establish and maintain a \$50 million reserve deposit at an unaffiliated, third-party insured depository institution that the Bank could draw upon in the event that Square fails to provide sufficient funds Submit an annual business plan to the FDIC for review and approval 	<ul style="list-style-type: none"> 12% leverage ratio at all times Contribute sufficient capital should the Bank's leverage ratio drop below the required minimum Provide financial support to ensure that the Bank can meet its short-term and long-term liquidity needs Establish and maintain a \$40 million deposit account at the Bank that would be accessible to the Bank in the event that Nelnet fails to provide sufficient funds 	High
Material changes in the plan	<ul style="list-style-type: none"> Notify the Regional Director of any proposed major deviation or material change from the Business Plan 	<ul style="list-style-type: none"> Notify the Regional Director of any proposed major deviation or material change from the Business Plan 	None
Compliance management system (CMS)	<ul style="list-style-type: none"> The Compliance Program shall include: <ul style="list-style-type: none"> (a) policies and procedures (b) training program (c) an internal CMS monitoring process that is designed to detect and promptly correct compliance weaknesses within the Bank and any service providers (d) Consumer complaint monitoring process (e) independent audit coverage A third party to review and provide periodic reports concerning the effectiveness of the complaint response system and if any material concerns are identified 	<ul style="list-style-type: none"> The Compliance Program shall: <ul style="list-style-type: none"> (a) ensure that all activities related to service providers comply with all applicable consumer protection laws, including any implementing rules and regulations (b) Consumer complaint monitoring process 	Moderate
Others		<ul style="list-style-type: none"> Submit any proposed contracts, leases, or agreements relating to construction or rental of permanent quarters to the Regional Director All assets purchased from affiliates in connection with the formation of the Bank comply with the prohibition on the purchase of low quality assets in Section 23 of Reg W 	High

Square and Nelnet's approval orders contain material differences between the governance, capital and compliance requirements. The differences show that regulators will increase the severity of the requirements based on the level of business model risk and dependency on the parent they perceive in the business model. It shows the range of calibration that may occur as applicants head towards the approval path – specifically the design calls that need to be made by institutions as they approach the FDIC.

Considerations for ILC applications and beyond

The regulatory requirements and expectations for access to FDIC insured deposits and the banking system include robust financial, governance, risk management, and compliance capabilities that mitigate risks to the federal safety net and potential harm to consumers. Nonfinancial and fintech companies interested in pursuing an ILC should consider the following components as part of their ILC application:

- Risk assessments;
- Well-designed governance framework, including a board of directors and committees to provide oversight;
- Records, systems, and controls, including risk oversight, compliance risk management program, and anti-money laundering program;
- Financial management, including financial and capital projections;
- Monitoring adherence to the business plan and revising the plan if needed;
- Alternative business strategy, including contingency plans and recovery/exit strategies;
- Impact of the CLMA along with capital and liquidity requirements;
- Reach of the FDIC into the Covered Company (e.g. examination on relevant services provided to ILC); and,
- Prior notice commitments for changes to business model, etc.

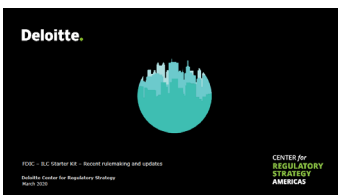
All of these capabilities will be tested by examiners potentially prior to approval and through post-approval exams, to verify that the company's operations are fully aligned with supervisory expectations. After approval, organizational management needs to operationalize the bank while regulators seek to better understand whether what was illustrated in the business plan application is backed by solid plans, infrastructure, and people. Regulators will be looking to see whether the bank has an understanding of the required level of risk management, governance, and infrastructure is to open the doors on day one.

Additional materials

In Deloitte's point of view publication from last year, "[So, you want to be a bank](#)," we described the specific strategic considerations and options financial technology companies should consider when deciding whether or not to "join them" rather than "beat them," and what the actual journey for entry into the banking system may entail. In Deloitte's follow-up, "[So, you want approval to become a bank](#)," we dive deeper into what it takes to move from a desire to acquire a banking license to meeting the explicit and implicit price of admission for entry and getting the "all clear" from regulators.

The attached presentation serves as a reference pack, summarizing the FDIC's recent activity regarding ILCs and overall industry impact to help prepare future bank charter applicants accordingly.

Click the icon below to access the presentation:



Endnotes

1. Federal Deposit Insurance Corporation, "FDIC Seeks Comment on Proposal to Ensure Safety and Soundness of Industrial Banks" accessed March 18th, 2020 at <https://www.fdic.gov/news/news/press/2020/pr20031a.pdf>
2. Federal Deposit Insurance Corporation, "Statement by FDIC Chairman Jelena McWilliams on the Notice of Proposed Rulemaking: Parent companies of industrial banks and industrial loan companies; FDIC Board Meeting" accessed March 18th, 2020 at <https://www.fdic.gov/news/news/speeches/spmar1720.html>
3. Federal Deposit Insurance Corporation, "Statement by FDIC Chairman Jelena McWilliams on Nelnet Bank" accessed March 18th, 2020 at <https://www.fdic.gov/news/news/speeches/spmar1820a.html>

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