Industrial Loan Companies: Are They Back in Vogue?

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Attorneys at Law

March 21, 2018 | Webinar

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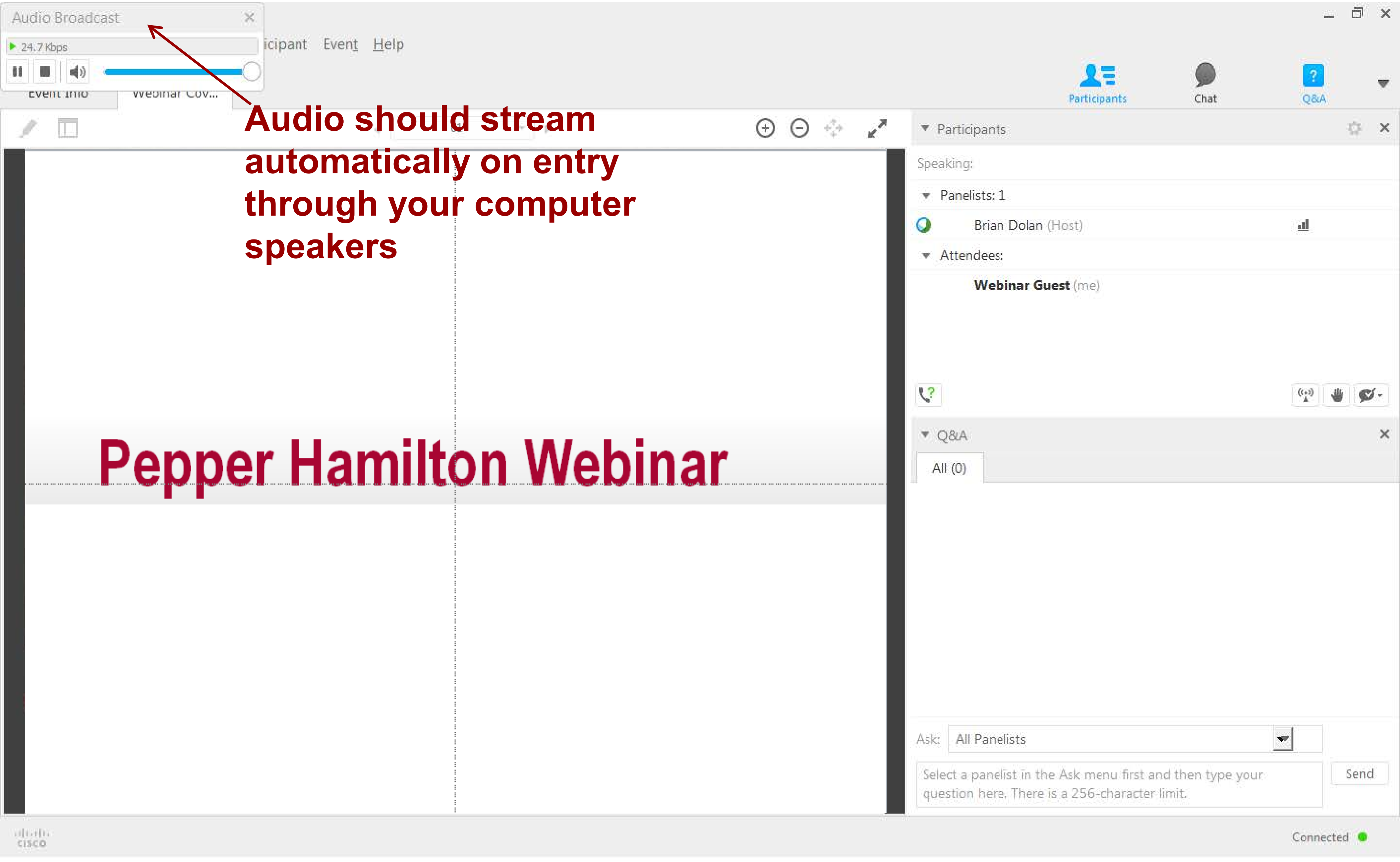

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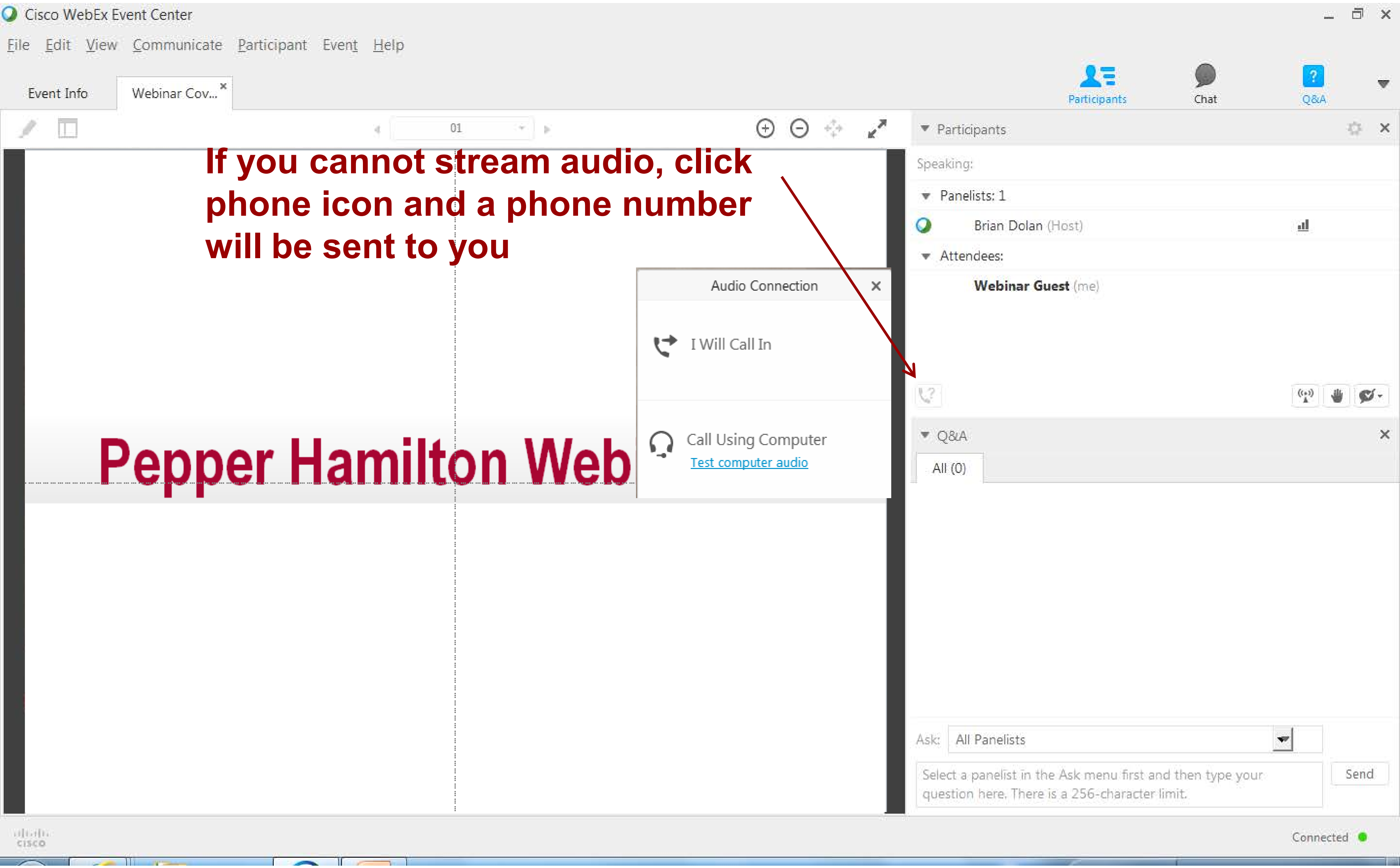

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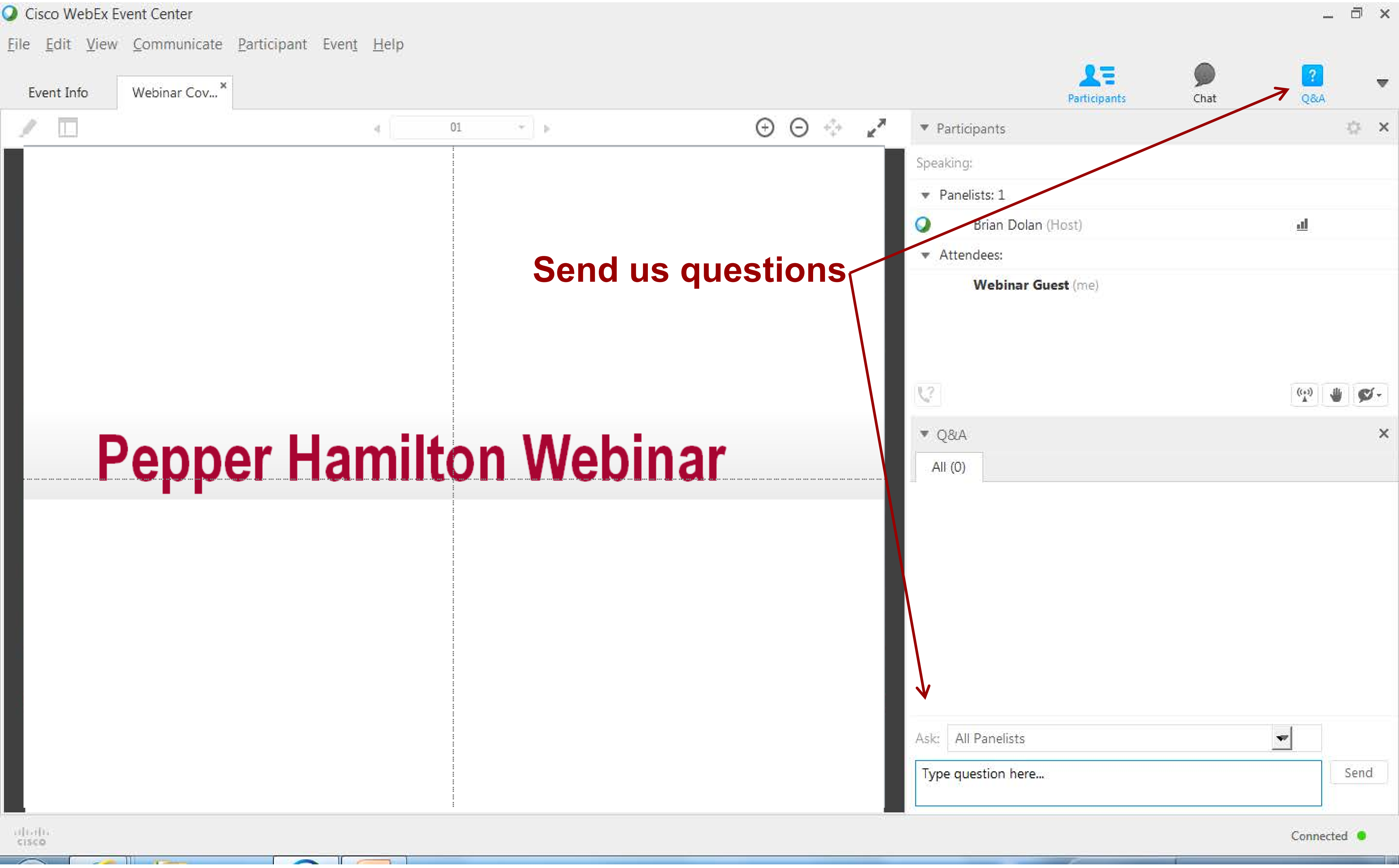
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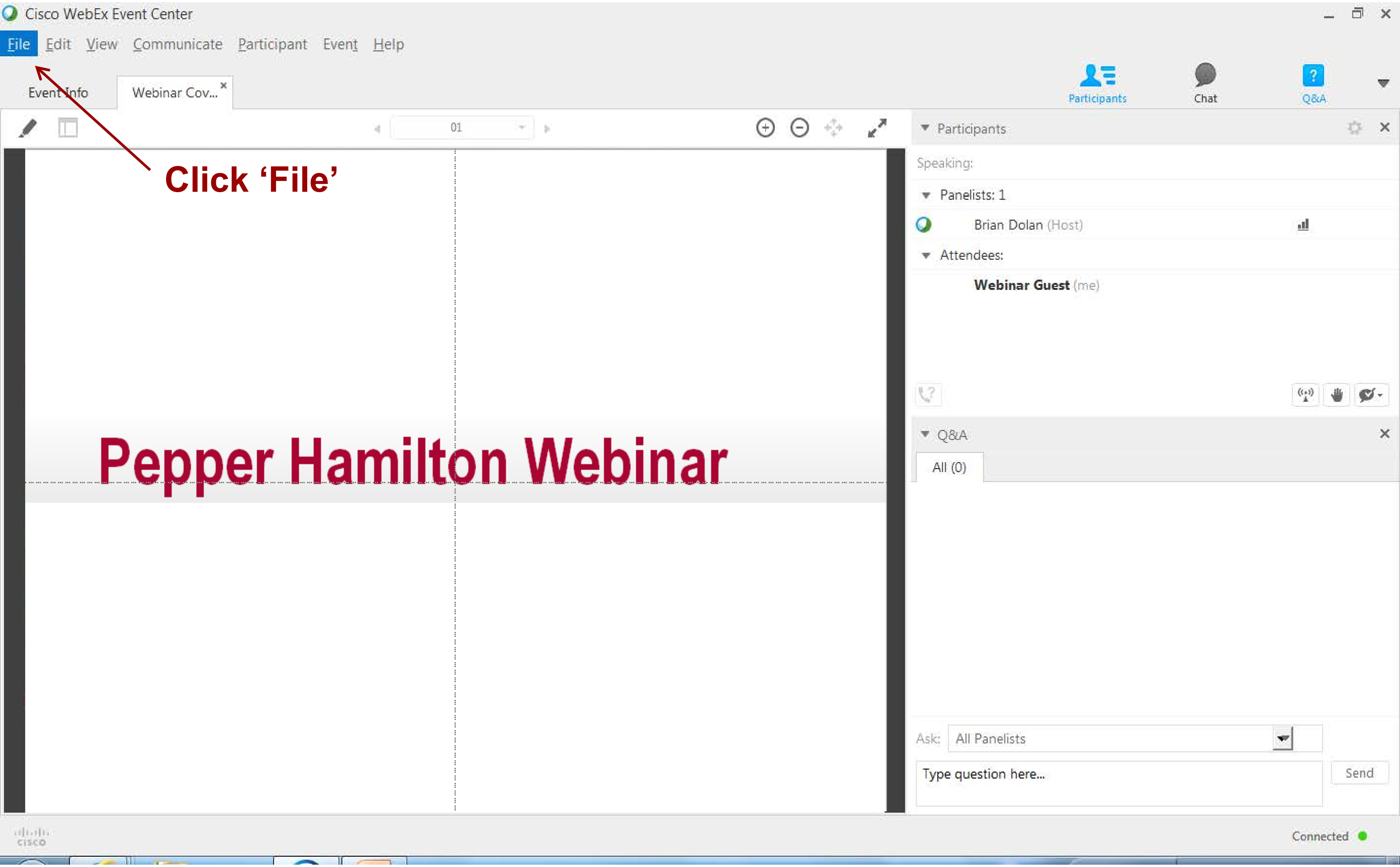

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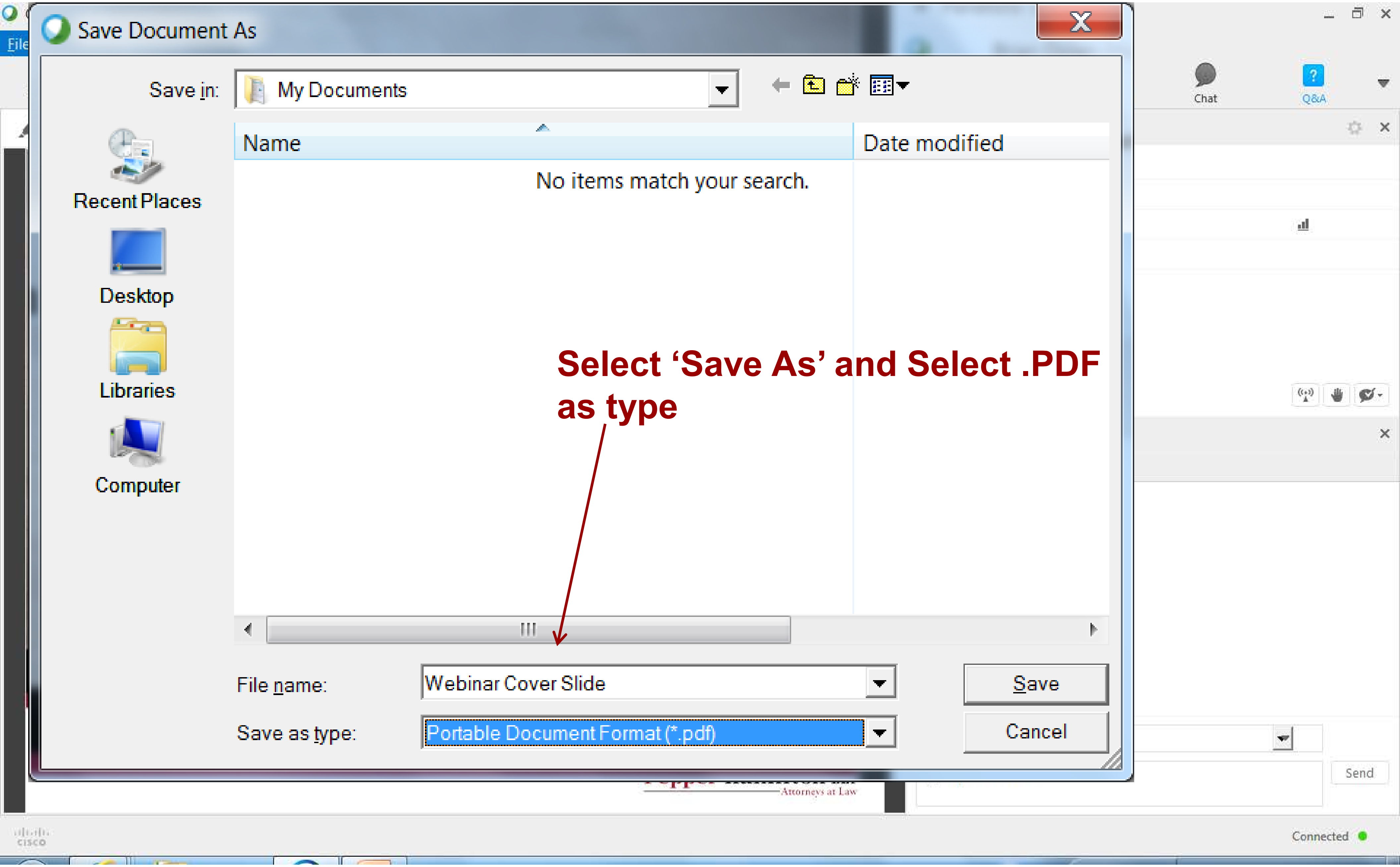

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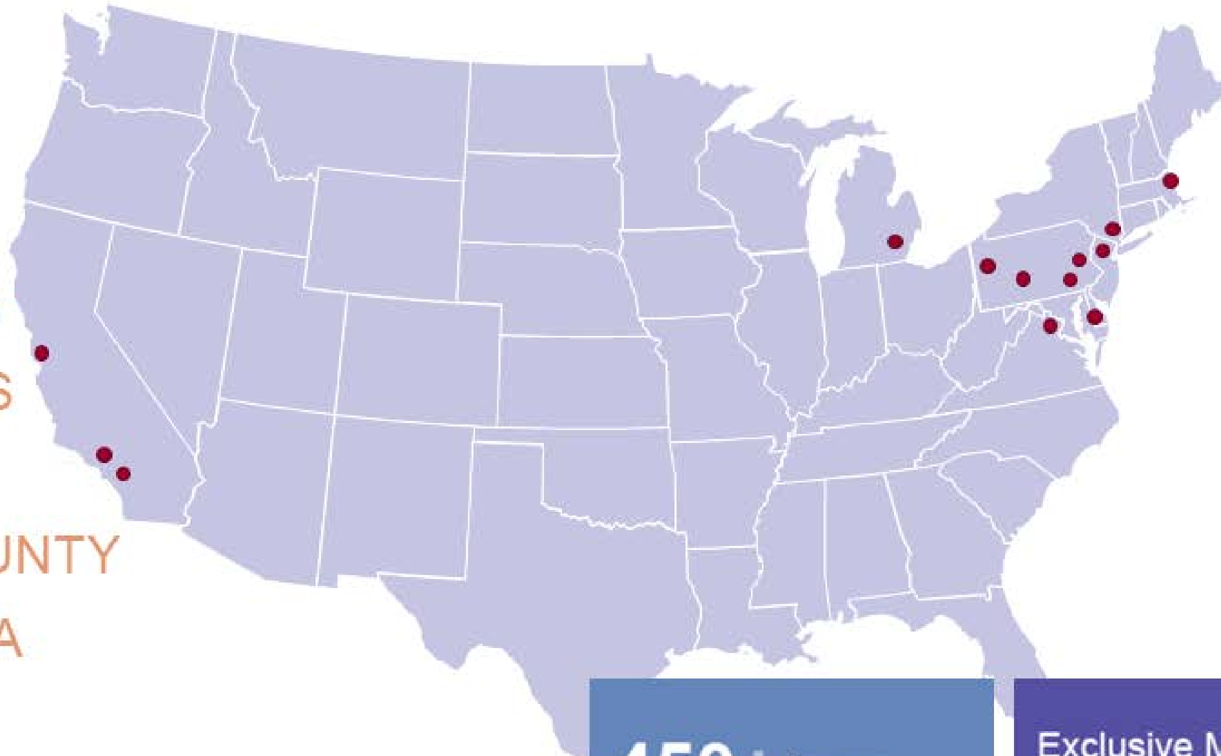

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We will be starting at 12pm ET. There is currently no audio until we start.

Welcome and Introduction

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Richard P. Eckman

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- A finance and transactional lawyer and from 2003 to 2015 was chairman of the firm's Financial Services Practice Group
- Transactional practice focuses on representing financial institutions, corporations and other entities in complex financing transactions, including mergers and acquisitions, asset securitizations and other lending and venture transactions
- Represents many financial institutions and lenders in a broad array of areas, including commercial lending, consumer finance, mortgage banking, insurance, trust matters, outsourcing and operational issues.

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- Leader of the Consumer Financial Services and Bank Regulatory Practice Group
- Practice focuses on representing financial institutions, corporations and other entities in mortgage banking and consumer financial services issues
- Regularly counsels clients on compliance with state and federal laws affecting mortgage lending and servicing activities
- Former executive director and compliance counsel for the residential mortgage and lending businesses at Morgan Stanley.

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Special Counsel, Financial Services Practice Group

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- Extensive experience in consumer lending, safety and soundness, and anti-money laundering. His work in consumer and regulatory compliance at large financial institutions has been marked by innovations that resulted in fundamental structural changes to existing firm-wide compliance activities, including with respect to regulatory change management, risk assessments, and vendor management.
- Prior to Pepper, experience includes working at the U.S. Office of the Comptroller of the Currency (OCC), Morgan Stanley Discover, JPMorgan Chase Card Services and Citibank.

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- Focuses his practice on banking, securities and corporate law matters
- Has represented dozens of clients before the federal bank regulatory agencies, the U.S. Securities and Exchange Commission, and various state banking and securities regulators across the country
- Prior to Pepper, was counsel with the Office of the Comptroller of the Currency in New York, where he negotiated enforcement documents, participated in bank examinations, coordinated action with Federal Reserve and FDIC staff, and provided advice regarding supervision of banks, federal branches and agencies, and trust banks.

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Welcome and Introduction

Industrial Loan Companies

What Is It?

Industrial loan companies and industrial banks (collectively, ILCs) are FDIC-supervised financial institutions that they can be owned by commercial firms without becoming subject to the Bank Holding Company Act (BHCA)

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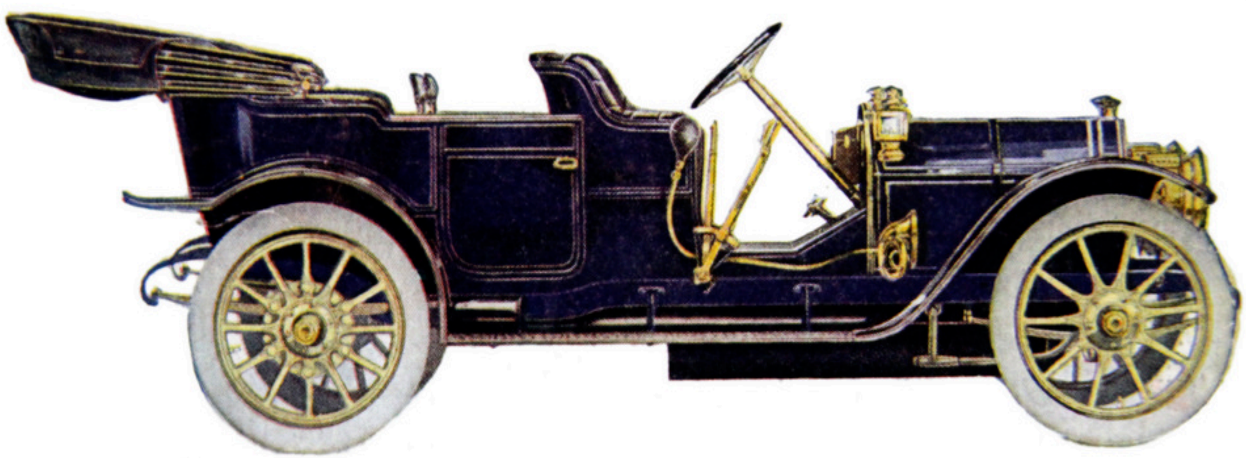
Industrial Loan Companies

What Is It?

ILCs first appeared in the early 1900s. They were small, state-chartered institutions that made uncollateralized loans to low- and moderate-income workers who couldn't get such loans from banks. State laws at the time generally prohibited ILCs from accepting deposits, so they funded themselves by issuing certificates of investment or indebtedness, dubbed thrift certificates.



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Industrial Loan Companies

What Is It?

ILCs became eligible for deposit insurance under the Garn-St. Germain Depository Institutions Act of 1982. The Competitive Equality Banking Act (CEBA) of 1987 broadened the definition of a bank under the BHCA to include any FDIC-insured institution. A handful of states grandfathered their ILCs.

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Utah Industrial Bank Charter

- Pitney Bowes Bank, Inc.
- UBS Bank USA
- USAA Financial Services Corp.
- Sallie Mae Bank
- American Express Centurion Bank
- BMW Bank of North America
- Comenity Capital Bank (Alliance Data Systems)

Utah Industrial Bank Charter

- In March 2004, Utah law was amended to change the name Industrial Loan Corporation to Industrial Bank
- Utah Industrial Banks are authorized to make all kinds of consumer and commercial loans and to accept federally insured deposits, but not demand deposits if they have total assets greater than $100 million
- Utah Industrial Banks are subject to the same regulatory and supervisory oversight as other commercial banks

Utah Industrial Bank Charter

Main Advantages

- Not a "bank" for purposes of Bank Holding Company Act (BHCA)
- Federal preemption of state usury laws
- Exemption from state lender licensing laws
- Exemption from state money service business (MSB) laws
- Reduced cost of funding due to access to the Federal Reserve discount window and ability to accept deposits
- Access to Federal Reserve payment systems
- Ability to become a member of the major Card Associations (Visa, MasterCard, etc.) and engage in card issuing or acquiring activities
- Supervision by only the Utah Department of Financial Institutions and the FDIC versus a multitude of state regulators

Utah Industrial Bank Charter

Main Advantages (Continued)

- A bank charter signifies financial stability and inspires confidence in potential customers, investors, and third-party partners
- Ability to "leverage" the bank's ability to export its interest rate, participate in payment associations, or perform clearing and settlement activities by contracting with third parties
- FDIC regulation allows banks to satisfy their legal requirement to be "engaged in the business of taking deposits" by maintaining a single deposit in the amount of at least $500,000

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Utah Industrial Bank Charter

Main Disadvantages

- A mono-line lender's chances of being approved may be slim despite the FDIC's recent assurances that it is open to considering Industrial Loan Bank applications following a moratorium on industrial charters that expired in 2013
- Although it is technically permissible to have a single deposit in the amount of $500,000, the FDIC and the Utah DFI might not approve a business plan that calls for minimal deposits are solely brokered deposits
- Applicants must submit a detailed three-year business plan to the FDIC and Utah DFI, and cannot vary from that plan once the new bank is open for business without obtaining formal approval

Utah Industrial Bank Charter

Main Disadvantages (Continued)

- The bank's Tier 1 capital to assets ratio must remain not less than 8 percent throughout the first three years of operation, and minimum capital requirements may increase markedly if the bank's assets deteriorate:
  - Web Bank has a Tier 1 capital ratio of 19%
  - First Electronic Bank has a Tier 1 capital ratio of 29%
- The organizers, senior management, and directors must all include persons who have significant prior experience working in a regulated bank
- If the bank should fail, the FDIC may sue its directors and officers in their individual capacity (the FDIC brought claims against directors and officers in 39 percent of bank failures between 2007 and 2015)
- Members of the board and senior management will be expected to reside in the State of Utah

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Utah Industrial Bank Charter

Main Disadvantages (Continued)

- Banks are subject to the:
  - Risk-based capital regulations
  - Safety and soundness expectations (12 CFR 365, Appendix A and B)
  - Risk management expectations
  - Legal Lending Limits
  - Regulation W
  - Regulation O
  - Anti-money laundering requirements that exceed those for non-banks
  - Community Reinvestment Act
  - Volker Rule
  - Management Interlocks

Preparation and Exploratory Meetings

- Desire of a company to own and operate a bank without that company becoming a bank holding company. Need to conclude that the bank will:
  - Apply for and receive a charter from any one of the following states: California, Colorado, Hawaii, Indiana, Minnesota, Nevada and Utah;
  - Apply for and receive deposit insurance through the FDIC; and
  - Operate as an ILC with a main office and operations in the same state in which it is chartered.

Preparation and Exploratory Meetings

- Discussion of the extent to which the ILC will be "engaged in the business of receiving deposits other than trust funds". Federal law (12 U.S.C.§1815(a) requires an application to the FDIC and approval of the FDIC board of directors. FDIC regulations at 12 C.F.R. §303.14 state that the language quoted above requires one or more non-trust deposit accounts in the minimum aggregate amount of $500,000.

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Required Pre-Filing Meeting with FDIC and State Regulator

- The purpose, from the regulatory perspective:
  - Facilitate a comprehensive application that complies with applicable regulatory requirements;
  - Minimize delays in processing application;
  - Provide clarity to organizers about regulatory expectations and the application process; and
  - Learn about the organizing group and nature of the proposed activities.

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Required Pre-Filing Meeting with FDIC and State Regulator

- The purpose, from the organizers' perspective:
  - Learn what areas of the proposal raise regulatory concern;
  - Learn what areas of the proposal need further development;
  - Put something in writing before the regulators; and
  - Receive preliminary regulatory feedback:
    - learn about possible conditions;
    - learn what regulators consider to be the most important issues by listening to the nature of the questions asked by regulators; and
    - assess how Federal and state regulators will coordinate on filings (perhaps only one application will be needed), correspondence, and other matters.

What Factors Should the Application Address?

- Statutory factors:
  - Financial history and condition
  - Adequacy of the capital structure
  - Future earnings prospects
  - General character and fitness of management
  - Risk to the Deposit Insurance Fund
  - Convenience and needs of the community to be served
  - Whether the proposed corporate powers are consistent with the purposes of the Federal Deposit Insurance Act

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What Factors Should the Application Address?

- Management:
  - Interagency Biographical Financial Reports
  - Compensation and employment arrangements
  - Insider transactions
  - Stock benefit plans
  - Board of directors or managers (in theory, an ILC could be a limited liability company instead of a corporation)
- Capital:
  - Projected capital levels (including Tier 1 leverage ratio of at least 8%)
  - Projected capital sources
  - Types of proposed capital

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What Factors Should the Application Address?

- Convenience and Needs (Community Reinvestment Act)
- Premises and Fixed Assets
- Information Technology
- Other information:
  - Policies
  - Organizational expenses
  - Fidelity insurance

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What Factors Should the Application Address?

- Business Plan (three year):
  - Description of business
  - Marketing plan
  - Management plan
  - Records, systems and controls
  - Financial management plan
  - Monitoring and revising business plan
  - Financial projections

Timeline Related to Filing of the FDIC Application

- Within three days after filing, the FDIC acknowledges receipt and addresses the publication requirement
- Notice may be published before or after filing in the place where the main office and any branch will be located
- Within approximately 45 days after filing an application, the organizers will receive one of two letters from the FDIC:
  - The application is deemed to be substantially complete and has been accepted for processing, or
  - The application is deemed not to be substantially complete, with the letter setting forth one or more questions that organizers are expected to answer, in writing, within 30 days.

Substantially Complete Application

- When an application is "substantially complete":
  - When the FDIC has the information necessary to consider each of the applicable statutory factors and any other regulatory requirements.
  - In practice, this is when all questions raised by the application are answered to the satisfaction of the FDIC and the business plan is deemed acceptable. Thus, all issues must be resolved before an application will be deemed to be substantially complete.

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Substantially Complete Application

- The application is not formally processed by FDIC, with the statutory factors and other activities not “considered,” until the application is deemed substantially complete.
- Within 60 days of a determination of substantial completion, a field investigation is completed, with any additional concerns communicated to the organizers.

Additional Considerations

- Within 30 days after the field examination is completed, the FDIC seeks written concurrence of the organizers with any proposed non-standard conditions and then finalizes the FDIC recommendation for action on the application. Standard conditions do not require the express written concurrence of the organizers.
- Any application for an ILC charter is, from the FDIC perspective, a request to charter a “non-bank bank” and is unique.

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Additional Considerations

- FDIC policy provides that applications to obtain FDIC insurance by an ILC warrant heightened scrutiny and require FDIC-Washington, D.C. approval, in addition to FDIC regional and field office approval.
- Deposit Insurance cannot be granted without the issuance of a written order, which order will include all applicable standard and non-standard conditions.

Standard Conditions

- **This is a summary of most of the FDIC standard conditions for approval that apply for the first three years of ILC operation:**
  - The ILC must obtain all necessary and final approvals from the appropriate state authority;
  - If the transaction does not take effect within a specified time period, or unless, in the meantime, a request for an extension of time has been approved, then the consent granted expires at the end of the specified time period;
  - That until the conditional commitment of the FDIC becomes effective, the FDIC may alter, suspend or withdraw its commitment should any interim development warrant such action;

Standard Conditions

- In the case of a merger transaction, including a corporate reorganization, the proposed transaction may not be consummated before the 30th calendar day (or shorter time period as may be prescribed by the FDIC with the concurrence of the U.S. Department of Justice) after the date of the order approving the merger transaction.
- The ILC will provide a specific amount of initial paid-in capital;
- The Tier 1 capital to assets leverage ratio (as defined in FDIC capital regulations and guidance) will be maintained at not less than eight percent throughout the first three years of operation and that an adequate allowance for loan and lease losses will be provided;

Standard Conditions

- Any changes in proposed management or proposed ownership to the extent of 10% or more of stock, including new acquisitions of or subscriptions to 10% or more of stock must be approved by the FDIC prior to the ILC opening for business;
- The ILC will adopt an accrual accounting system for maintaining its books;
- Where applicable, deposit insurance will not become effective until the ILC has been granted a charter as an ILC, has authority to conduct the business of an ILC, and its establishment and operation as an ILC have been fully approved by the appropriate state supervisor;

Standard Conditions

- Where deposit insurance is granted to an interim institution formed or organized solely to facilitate a related transaction, deposit insurance will only become effective in conjunction with consummation of the related transaction;
- Where applicable, the ILC has submitted any proposed contracts, leases, or agreements relating to construction or rental of permanent offices to the appropriate FDIC regional director for review and comment;

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Standard Conditions

- Where applicable, full disclosure has been made to all proposed directors and stockholders of the facts concerning the interest of any current or proposed insider in any transactions being effected or then contemplated, including the identity of the parties to the transaction and the terms and costs involved.
  - An insider is (i) a director, officer, or incorporator of the ILC, (ii) a shareholder who directly or indirectly controls 10 or more percent of any class of the ILC's outstanding voting stock, or (iii) the associates or interests of any person in (i) or (ii) above;
- The person(s) selected to serve as the principal operating officer(s) must be acceptable to the appropriate FDIC regional director;

Standard Conditions

- The ILC will have adequate fidelity coverage;
- The ILC will obtain an audit of its financial statements by an independent public accountant annually for at least the first three years after deposit insurance is effective and submit to the appropriate FDIC office (i) a copy of the audited annual financial statements and the independent public auditor's report thereon within 90 days after the end of the ILC’s fiscal year, (ii) a copy of any other reports by the independent auditor (including any management letters) within 15 days after their receipt by the ILC, and (iii) written notification within 15 days after a change in the ILC’s independent auditor;

Standard Conditions

- The ILC will operate within the parameters of the business plan submitted to the FDIC. During the first three years of operation, the ILC will notify the regional director of the FDIC of any proposed major deviation or material change from the submitted plan 60 days <u>before</u> consummation of the change; and
- In cases where the business plan provides for only an intercompany or similar deposit, then the following additional standard condition is imposed: The ILC will acquire prior to the effective date of deposit insurance and continue to maintain the requisite deposits to be "engaged in the business of receiving deposits other than trust funds".

Non-Standard Conditions

- **Non-standard conditions include, but are not limited to, these areas:**
  - The ILC must develop and implement a CRA plan acceptable to the FDIC,
  - The ILC must provide prior notification of any plans to establish a loan production office,
  - FDIC must provide prior approval before the ILC may change its business plan, enter into employment agreements or stock options plans, adopt or revise operating policies, or add or change directors or officers.
  -

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Non-Standard Conditions

- The ILC must have in place safeguards against the risks posed by its parent company so that the FDIC may determine whether the ILC will be able to effectively monitor and control the relationship between the ILC and its parent company, including in the areas of corporate relationships, management authority and independence, and the FDIC can monitor and control that relationship.

  - Note: non-standard conditions may be imposed to exceed the three-year de novo period, for any length of time deemed necessary by the FDIC to mitigate risk.

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FDIC UPDATES

- Recent testimony on January 23, 2018 from the proposed new chair of FDIC, Jelena McWilliams, suggests that FDIC may be more amenable to providing FDIC insurance to ILCs

- 2/8/18 – Senate Banking Committee approved nomination by a vote of 24 to 1 to a six (6) year term. Not surprisingly, Sen. Elizabeth Warren (D-Mass) was the only panel member to vote against Ms. McWilliams

- McWilliams background - EVP Chief Legal Officer of Fifth Third Bank in Cincinnati. Full Senate confirmation appears likely

- Former Chairman Martin Gruenberg is deciding whether to continue to serve on FDIC Board for the remainder of 2018. Term as Chair officially ended in November but term as a member continues until end of the year

- FDIC still has pending an application by Square for an ILC charter. Will FDIC advance Square's application? What is the impact on other FINTECH charters and ILC charters more generally?

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Questions & Answers

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