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The Coronavirus Economic Stabilization Act of 2020 Provides Relief to Financial Institutions

Overview: In addition to providing numerous forms of fiscal stimulus and relief to businesses and individuals, the Coronavirus Aid, Relief, and Economic Security Act (“CARES Act) includes several provisions intended to give financial institutions increased flexibility to assist their customers during the current coronavirus pandemic.

Debt Guarantee Authority

One of the features of the Dodd-Frank Act authorizes the FDIC to create a program to guarantee obligations of solvent insured depository institutions, subject to certain conditions and restrictions, during times of severe economic distress. Under this authority, the FDIC created the Temporary Liquidity Guarantee Program (“TLGP”), which existed from 2008 to 2012. Section 4008 of the CARES Act authorizes the FDIC to create such a program during the current coronavirus pandemic in order to guarantee noninterest-bearing demand deposit accounts above the current insurance limit of $250,000 per depositor. Although the FDIC is now permitted to fully guarantee such deposit accounts, it is not required to do so. At this time the FDIC has made no announcement about implementing such a program, but it can be expected that a program functionally similar to the TLGP may be forthcoming. Because any liquidity guaranty program adopted under the CARES Act must terminate no later than December 31, 2020, it seems likely that the FDIC will move fast to implement a program.

Temporary Lending Limit Waiver

Section 4011 of the CARES Act grants the Office of the Comptroller of the Currency additional authority to exempt certain loans from the federal legal lending limits during the coronavirus emergency. Under federal law and regulations, national banks and their domestic operating subsidiaries are prohibited from making excessive loans to one person or to related persons who are financially dependent. The OCC may establish different limits (or exemptions) by regulation. The CARES Act has temporarily amended the law in two significant ways. First, it expressly exempts from the lending limits loans or extensions of credit to “any nonbank financial company (as that term is defined in section 102 of the Financial Stability Act of 2010 (12 U.S.C. 5311)).” Second, it grants the OCC authority to
exempt any transaction or series of transactions from the lending limits by the issuance of an order. This new order authority should allow for expedited limited-purpose exemptions, which in turn will enable national banks to offer credit assistance to customers in distress due to the coronavirus pandemic. These changes will only be effective until either December 31, 2020, or the termination of the President’s declaration of the pandemic as a national emergency, whichever occurs first.

Temporary Relief For Community Banks

Section 4012 of the CARES Act provides temporary regulatory relief to certain qualifying banks. The Economic Growth, Regulatory Relief, and Consumer Protection Act (“EGRRCPA”) authorized the federal banking regulators to establish by regulation a simplified leverage ratio calculation for banks with assets of less than $10 billion and which meet certain risk profile criteria (“Qualifying Community Banks”). The federal banking regulators subsequently adopted regulations establishing a simplified leverage ratio of 9% of total assets applicable to Qualifying Community Banks (the “Community Bank Leverage Ratio”). The CARES Act expressly requires the federal banking regulators to issue an interim final rule that lowers the Community Bank Leverage Ratio to 8% and provides a reasonable grace period for Qualifying Community Banks to satisfy the ratio after they fall below it. That rule was issued by federal financial regulators on April 6. During the grace period, a Qualifying Community Bank will be presumed to satisfy the capital and leverage requirements of the EGRRCPA. The rule that the CARES Act requires regulators to adopt will be effective only from the date issued until either December 31, 2020, or the termination of the national emergency declaration, whichever occurs first. However, under the interim final rule, community banks will have until January 1, 2022 before the Community Bank Leverage Ratio is re-established at a rate greater than 9 percent. The rule aims to provide a transition period that will allow community banks “to focus on supporting lending to creditworthy households and businesses given the recent strains on the U.S. economy caused by the coronavirus.”

Temporary Relief From Troubled Debt Restructurings

Section 4013 of the CARES Act temporarily suspends the GAAP accounting rules related to loan modifications related to the COVID-19 pandemic. Specifically, the CARES Act allows a bank to restructure a debt owed by a borrower without having to categorize it as a troubled debt restructuring. Essentially, a bank would not be required to automatically write down the asset on its balance sheet and thereby reduce earnings or capital. The CARES Act expressly requires the federal banking regulators to defer to the financial institution’s judgment on whether to suspend the GAAP rules in this way. A bank that makes use of this relief under the CARES Act may only do so if the loan being modified was not more than 30 days past due as of December 31, 2019, and does not apply to any adverse impact on the credit of the borrower that is not related to the COVID-19 pandemic. This relief is only available for restructurings from March 1, 2020 until either December 31, 2020, or the termination of the national emergency declaration, whichever occurs first.

Optional Temporary Relief From Current Expected Credit Losses

Section 4014 of the CARES Act delays implementation of certain new accounting rules requiring Current Expected Credit Losses (“CECL”) estimation of certain potential loan losses. Specifically, the CARES Act provides, “Notwithstanding any other provision of law, no insured depository institution, bank holding company, or any affiliate thereof shall be required to comply with the Financial Accounting Standards Board Accounting Standards Update No. 2016–13 (‘Measurement of Credit Losses on Financial Instruments’), including the current expected credit losses methodology for estimating allowances for credit losses.” This relief is only available from the date the CARES Act was until either December 31, 2020, or the termination of the Coronavirus Emergency, whichever occurs first.
On the same day that the CARES Act was enacted, the federal banking regulators adopted an interim final rule which provides that banking organizations required to adopt CECL during the 2020 calendar year may delay an estimate of CECL’s impact on regulatory capital. On March 31, 2020, the federal banking regulators issued a joint statement on the interaction of Section 4014 of the CARES Act with this interim final rule.

FDIC Proposes New Rule For Approval of Industrial Loan Company Applications

Overview: This spring, the FDIC announced a proposed new rule regarding industrial banks and industrial loan companies (collectively “ILCs”). ILCs are state-chartered banks that are insured and supervised by the FDIC and can be owned by commercial entities that are not regulated by a federal banking agency. The proposed rule would codify the FDIC’s existing requirements for ILC applications, particularly with respect to parent companies of ILCs not subject to consolidated supervision by the Federal Reserve Board.

Background and Context

Generally, the FDIC applies the same regulatory requirements to ILCs as it does for any state-chartered bank that is not a member of the Federal Reserve system, based on the statutory factors set forth in the Federal Deposit Insurance Act. Traditionally, the FDIC has required ILC parent companies to enter into capital and liquidity maintenance agreements with the FDIC and the ILC applicant. According to the FDIC, “These agreements obligate the parent company to serve as a financial backstop by maintaining the industrial bank’s capital and liquidity at levels that the FDIC deems necessary for the safe and sound operation of the industrial bank.” The FDIC’s stated purpose for proposing the rule are that it would accomplish two goals:

1. Ensure that the parent of a covered industrial bank approved for deposit insurance would serve as the source of strength for the industrial bank; and
2. Provide transparency to future applicants and the broader public as to what the FDIC requires of parent companies of covered industrial banks.

The new rule would provide specificity and add clarity to these requirements.

Scope of the Proposed Rule

By its terms, the proposed rule would apply to both ILCs and their parent companies, subject to certain limitations. An ILC covered by the rule is any insured state bank that is an industrial bank, industrial loan company, or other similar institution excluded from the definition of “bank” under the Bank Holding Company Act. A parent company covered by the rule is defined as a “Covered Company,” which means any company that (i) is not subject to federal consolidated supervision by the Federal Reserve Board, and (ii) controls an ILC as a result of a change of control or merger pursuant to the Federal Deposit Insurance Act or because the ILC is granted deposit insurance. For these purposes, “control” of an ILC means (i) the power to directly or indirectly vote 25% or more of any class of voting shares of either the ILC itself or of any company that controls the ILC, or (ii) the power to direct the management or policies of the ILC.

Proposed Requirements

Under the proposed rule, a Covered Company would be expressly required to enter into written agreements with both the FDIC and the subsidiary ILC, pursuant to which the Covered Company must commit to eight obligations. Specifically, the Covered Company must:
• provide the FDIC with a list of all the Covered Company’s subsidiaries, which list must be updated annually;

• consent to the FDIC’s authority to examine the Covered Company and its subsidiaries;

• submit an annual report to the FDIC pertaining to the Covered Company and its subsidiaries, which includes information about the Covered Company’s financial condition, and such other reports as requested by the FDIC;

• maintain certain records the FDIC determines are necessary to assess risks to the ILC or the deposit insurance fund;

• perform or obtain an independent audit of each subsidiary ILC annually;

• limit the Covered Company’s representation any subsidiary ILC’s board of directors or managers to 25%;

• maintain the capital and liquidity of the subsidiary ILC at levels approved by the FDIC, and take such other actions as required by the FDIC to provide the ILC with sufficient capital and liquidity, including, if necessary, pledging assets, obtaining a letter of credit from a third-party institution, or indemnifying the ILC; and

• agree to certain tax allocation provisions with the ILC, which should include an express statement that an agency relationship exists between the Covered Company and the ILC with respect to tax assets generated by the ILC.

In addition to the eight specified commitments, the proposed rule would also authorize the FDIC to require certain additional commitments. First, the FDIC may require that a Covered Company and its subsidiary ILC implement a contingency plan subject to the FDIC’s approval that “sets forth, at a minimum, recovery actions to address significant financial or operational stress that could threaten the safe and sound operation of the industrial bank and one or more strategies for the orderly disposition of such industrial bank without the need for the appointment of a receiver or conservator.” Second, the FDIC may, at its sole discretion, require additional commitments from either the Covered Company or any individual who is a controlling shareholder of a Covered Company.

Proposed Restrictions

The proposed rule prohibits an ILC that is controlled by a Covered Company from taking the following five actions without prior written approval from the FDIC:

• making a material change to its business plan;

• adding or replacing a director, manager, or managing member;

• adding or replacing a senior executive officer;

• employing a senior executive officer who is associated in any manner with an affiliate of the ILC; or

• entering into any contract for services material to the operations of the ILC with the Covered Company or any of the Covered Company’s subsidiaries.
In addition to the specified restrictions, the FDIC would also have authority, at its sole discretion, to impose further restrictions on the activities or operations of the ILC.

**Outlook:** Public comments related to the proposed rule will be accepted until June 1, 2020. It should also be noted that right after the initial announcement of the proposed rule, the FDIC approved the deposit insurance applications for two fintech companies to create de novo industrial banks: Nelnet Bank and Square Financial Services. These events taken together suggest that the ILC structure may be a possible alternative to the OCC’s fintech charter for some businesses.

Congressional Democratic leaders strongly opposed the FDIC’s decision to move forward with the rulemaking along with the two approvals of deposit insurance. House Financial Services Committee Chairwoman Maxine Waters and Senate Banking Committee Ranking Member Sherrod Brown (D-OH) have long argued that grant ILC structures could weaken regulatory oversight, endanger consumer protection, and undermine the longstanding principle of ensuring that banking and commerce are not commingled. Both Waters and Brown urged the FDIC to refrain from moving forward with the proposed rulemaking in the midst of the coronavirus pandemic and will likely continue to raise loud objections to the rulemaking as it moves forward.

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