BankThink Why there's no need for the OCC's fintech charter

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The dictionary defines a MacGuffin as an object, event or character in a movie that serves to set and keep the plot in motion despite lacking intrinsic importance. The Maltese Falcon is the best example: a "priceless" statue coveted by the characters in the film, which drives the plot until it turns out to be made of lead.

It's a perfect metaphor for the Office of the Comptroller of the Currency's new fintech charter. For many fintechs, the OCC charter has been "the thing that dreams are made of" — highly coveted and sought-after way to get most of the benefits of a bank charter without the burdens. Unfortunately, it is turning out to be so unwieldy in practice that it now seems possible no one will ever actually apply for one. But, like the falcon in the movie, the very existence of the charter is setting forces in motion that could deliver critically needed changes to fintech and bank regulation.

I'll let you in on an open secret: There's no need for a fintech charter. The bank regulators have all the power they need to charter insured fintech banks that take deposits, have full payment system access and are subject to comprehensive regulation tailored to their specific business plans and risks. These insured fintech banks could deliver innovative services to consumers and businesses while maintaining safety and soundness. But the Federal Deposit Insurance Corp. — rooted in old concepts of banking — won't consider granting insurance to most potential fintech applicants. As a result, innovation is suffering, and new and creative businesses are failing to gain scale.

The OCC under Joseph Otting is now accepting fintech charter applications, but that's not the only way for firms to get access to the banking system. Bloomberg News

There are several reasons that the OCC's fintech charter is garnering so little traction. First, the charter contains most of the regulatory oversight of a full-service bank without the most important benefits. Fintech special-purpose national banks will be subject to bank capital, liquidity and financial inclusion commitments as well as all the rest of the bank compliance scheme.

But the most important benefit of the charter for potential fintech applicants — direct access to the Federal Reserve's payments system — isn't guaranteed. National banks, including fintech charter banks, are required to become members of the Federal Reserve System, and the Fed hasn't decided if that's a good idea. Just two weeks ago, a senior Fed official pointed out the "really difficult policy and interpretive issues the Federal Reserve is going to have to face," before granting membership to a fintech charter bank.

Second, there's the question of litigation risk: Both the New York State Department of Financial Services and the Conference of State Bank Supervisors have revived suits against the fintech charter, and there are others lined up behind them. Resolving those suits will require several years and at least one trip to the Supreme Court, and the answer could come out badly for the OCC and the fintechs. How many applicants will want to be part of that multiyear gamble?

Finally, there's the question of time, effort and money. Venture-backed companies only have a few years at most to build their customer base and achieve scale and profitability. How many of them are going to divert management time and energy to a potentially quixotic effort to secure a fintech charter?

A perfectly good alternative is available for fintechs which, if handled correctly by regulators, has few of the defects of the fintech charter — that's a full-service insured bank charter. Fintechs have traditionally been leery of entering the deposit-taking business, although it is hard to see why. For lending-focused fintechs, the availability of deposit insurance should be a boon to stability, profitability and customer retention. For payments-focused fintechs, deposit insurance would significantly increase their ability to hold and manage customer funds and provide many new avenues for growth and profit. Not every bank needs to be Bank of America.

The size of a fintech's deposit portfolio can be minimal or meaningful — it shouldn't matter. As for the rest of the requirements of a bank license — Bank Secrecy Act and anti-money- laundering requirements, consumer compliance, Community Reinvestment Act standards, cyber and other risk management, capital and liquidity management — all of those (other than CRA) are either directly or indirectly applied to fintechs today. And CRA-like obligations would come along with the OCC’s fintech charter anyway. Today’s fintechs are far more mature than those a few years back. They have already learned the hard lessons about risk management, compliance and money laundering in their interactions with customers and partner banks. There’s really not much more in an insured bank charter for a fintech to be afraid of.

There’s also a big added benefit. The objections of the banks and state regulators to “special treatment” for fintechs, unfair burdens on banks and the spread of preemption beyond regulated banks would be made moot by the granting of full-bank powers with deposit insurance, which would level the playing field in the way that both those groups have advocated. Litigation risk would go away.

The problem with this rosy picture is that the FDIC has been asleep at the innovation switch for far too long. It’s only a slight exaggeration to say that decades have passed since the FDIC approved a bank insurance application for any bank that wasn’t a plain vanilla, low-growth, locally focused community lender — what I call a “Bank of Middletown.”

There’s absolutely nothing in the FDIC’s mandate to prevent it from insuring all types of fintech specialty banks, which would then become subject to the full scope of current banking regulations. It’s working fine in the U.K. and EU, where newly chartered mobile/challenger/payments banks that “only" take deposits and do transaction and payments banking can add customers and develop broader lending strategies over time, in collaboration with regulators, without creating risk to the deposit insurer.

There's also nothing to prevent the FDIC (or the OCC or Fed or state regulators for that matter) from imposing higher levels of supervisory oversight and bespoke capital, liquidity and activities limitations on other types of insured fintechs as a way of making sure that no excessive risks are being taken with the insurance fund. Instead, the agency has just refused to process the nonstandard bank applications on vague risk-avoidance grounds. Even those applications it does accept are processed with painful slowness if they show any hint of an innovative approach (just ask Varo Money). This has to stop if we are going to encourage safe innovation in the financial services sphere.

It's time for a new direction at the FDIC. Under Chairman Jelena McWilliams there have been glimmers of a change in attitude toward innovative banking and fintech. Now that the OCC has started the story with its fintech charter MacGuffin, it's up to the FDIC to bring about a happy ending. All it will take is administrative muscle and political will, qualities that Chairman McWilliams seems to have in spades. The FDIC needs to use the powers it already has, publicly and with determination, to encourage, process and license insured fintech banks. The future depends on it.

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