BankThink How regulators besides the OCC can help fintechs

By Todd H. Baker

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The Office of the Comptroller of the Currency designed its fintech special-purpose national bank charter proposal with the best of intentions: to foster innovation in banking and economic growth, and provide alternatives for financial technology startups burdened by operating nationally under 50 different state regulatory regimes.

The OCC's proposal was also a reaction to the almost complete failure of the Federal Deposit Insurance Corp. to grant deposit insurance to innovative banks, and to the Federal Reserve's cramped reading of its own control regulations, which have inhibited venture capital and private equity investment in new types of technology-driven banking.

While the OCC introduced the new fintech charter with a great deal of fanfare, to date no one has announced plans to apply for one. Why? It turns out that there's a big catch with the fintech charter: A hornet's nest of unresolved legal, regulatory and political issues make applying for one a costly experiment with unclear value. But all is not lost.

Try, try again

These disruptors have withdrawn charter applications with the FDIC. They are expected to refile. Year of withdrawal in parentheses

- Nelnet: student lender (2018)
- Square: mobile point-of-sale (2018)
- Varo Money: mobile banking (2018)
- Social Finance: online lender (2017)

Now that the OCC has started the ball rolling, the FDIC and the Fed can act to fix roadblocks they themselves have created. Two policy changes will help achieve this: opening insured depository banking to fintechs and simplifying bank-control rules.

In many ways, the OCC's uninsured, non-deposit-taking national bank looked like an ideal vehicle for national fintech lenders and payments processors. It would be a national bank for all legal purposes, could export interest rates and fees nationally without concern for usury laws, and would generally be exempt from other state licensing requirements. Because an OCC fintech bank would not be considered an "insured bank," its controlling owners wouldn't be subject to the Bank Holding Company Act and could freely operate any type of nonfinancial businesses. Also, venture capital and private equity owners of a fintech bank wouldn't be subject to so-called Volcker Rule limits which otherwise would prevent them from investing.

The fintech charter didn't eliminate all of the costs of being a national bank, as charter recipients would become subject to bespoke capital and liquidity regulation and community reinvestment-type obligations. But all in all, it looked like a pretty good solution.

Yet the OCC fintech charter has a big "chicken and egg" problem. It turns out that until a fintech actually gets a fintech charter there's no way to begin to resolve the serious legal, regulatory and political issues that go to the heart of the charter's value and utility. And the issuance of a charter — itself a multi-year process — will be only the beginning, with years of litigation and political risk and no guarantee of a positive outcome. While I'm sure at some point someone will find a reason to take the plunge and apply for a fintech charter, it will take nerves of steel and a very deep pocketbook to pursue the game to its conclusion.

The issues that bedevil the fintech charter are complex. Let's start with the lawsuits brought by state regulators challenging the agency's authority to issue a national bank charter to a company that doesn't accept deposits. The states argue, persuasively, that Congress alone can decide to change the definition of a bank. If and when a fintech charter is actually issued, it will take at least one trip to the Supreme Court — and two to five more years — before the outcome is clear.

The second problem is that direct access to the Federal Reserve payment system is not guaranteed to fintech banks. The ability to initiate transactions at low cost over the Fed's rails — something that only traditional banks have today — is vitally important to both payments and lending-focused fintechs. The Fed has signaled that the fintech charter presents potentially very difficult policy issues which would need to be resolved on a case-by-case basis.

Then there's politics. Community banks opposed to the OCC's fintech charter argue that it creates an uneven playing field in which heavily-regulated independent banks will be competing with less-regulated fintech banks. Behind this concern lies a reason for opposition shared by all banks: the fear that the fintech charter will allow companies like Amazon, Google and Walmart to enter the banking business. Should the courts approve the fintech charter, look for quick legislation to overturn it.

So, what could change this dynamic and give fintechs a real option for federalizing their operations? The solution lies where part of the problem was created: at the FDIC and the Fed.

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First, the FDIC should start issuing insurance to fintech-style banks chartered by the OCC and the states. The FDIC, working with other regulators, has all the power it needs to supervise and ensure safe and sound operation of fintech banks that take deposits, have full payment system access and are subject to comprehensive, tailored regulation. Deposit taking doesn't have to be a core part of a fintech's business for this to work, but getting deposit insurance does.

Importantly, by allowing fintechs the choice to become insured banks or remain state regulated, legitimate state concerns about regulation of nonbanks and the sanctity of the dual banking system will be fully resolved. Recent encouraging words from FDIC Chairman Jelena McWilliams give me hope that a change in agency attitudes is possible.

Second, the Fed needs to amend its "control" regulations and policies to reverse its practice of splitting hairs and creating ever "more ornate" (in the words of Fed Gov. Randal Quarles) interpretations of what constitutes a controlling influence over bank management and policy.

Except in extraordinary circumstances, the Fed should just follow the statute and allow individual venture capital and private equity investors to hold up to 25% of any class of bank voting securities, and a commensurate number of board seats in banks without triggering the Bank Holding Company Act or the Volcker Rule. Providing a safe path for capital interested in supporting technology-driven banking innovation would be an unalloyed positive. It will be difficult to get the balance right, but it can and should be done.

So, let's give two cheers to the OCC for trying to break the logjam preventing fintech participation in the banking system. For the FDIC and the Fed, it's time to show leadership and get the rest of the job done.