Financial Services Management

National Fintech Charter

Cite

OCC, Exploring Special Purpose National Bank Charters for Fintech Companies

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Impact Assessment

- Added prudential, administrative, and community-service costs proposed by the OCC could dramatically change anticipated returns from a bank charter for fintech ventures, discouraging many and continuing partnership and non-bank efforts.
- Fintech companies would need carefully to structure a federally-chartered bank to circumvent FRB regulation and parent-company restrictions. Limitations would apply to transactions between a fintech charter and its parent even if a BHC charter is not required, limiting actions such as using bank funding-cost advantages throughout the parent or upstreaming dividends should the parent come under stress.
- The OCC's approach is designed for fintechs focused on financial-product delivery, not on infrastructure services such as DLT. It is unclear how, if at all, the OCC would revise its chartering and prudential requirements for infrastructure-focused fintech charters, although the OCC appears willing to consider this.
- Although the OCC now appears intent on ensuring that any federal fintech charters protect consumers, federal preemption could nonetheless create a safe harbor from more stringent state standards, especially under a differently-inclined Comptroller in the Trump Administration.
- Added prudential requirements (e.g., minimum capital standards) could offset the advantages banks fear from special-purpose fintech banks exempt by virtue of size or charter from costly requirements. However, the specific requirements applied to these companies appear to vary based on case-by-case determinations, not by a transparent rule that would bind agency personnel or a future Comptroller. Fintech charters thus might enjoy competitive benefits over more traditional banks

engaged in like-kind activities.

Overview

Based on its vision of the national-bank and federal-thrift charters as industry-innovation leaders, the OCC is considering allowing non-bank financial technology (fintech) firms to avail themselves of a special-purpose federal charter. This would bring them under federal safety-and-soundness and resolution rules, as well as clarify the direct reach of consumer-protection standards for retail-focused fintech operations. However, at least with regard to prudential and resolution standards, the OCC could allow considerable variation from standard national-bank practice. While in some cases they might hike consumer-protection and financial-inclusion requirements, in others they might provide considerable cost benefits through less stringent prudential requirements than applicable to like-kind activities housed in a traditional banking organization. Firms that take advantage of this charter would receive not only greater customer confidence, but also the ability to operate across the U.S. rather than under state-by-state usury, consumer-protection, and other requirements that add significant cost and barriers to efficient operations. States counter, however, that their standards better reflect in-state consumer and economic needs and that a federal charter bypasses state requirements without added prudential benefit.

Impact

This paper follows a previous OCC white paper[1] and broad public debate about how fintech should fit into the broader U.S. financial-regulatory framework. Global and U.S. regulators have longstanding concerns about "shadow" banks,[2] with Gov. Tarullo most frequently voicing these not only about the broad range of non-bank companies active across the spectrum of U.S. financial services, but also about "shadow" retail-payment products. These might be among those most advantaged by a federal charter under the OCC that would give the firm either directly or via its fintech subsidiary the ability to do business on federal terms in all U.S. states as well as access to the Federal Reserve – a liquidity backstop likely of particular value to retail payment-system providers and any fintech entities offering wholesale services such as digital-ledger technology (DLT). However, online marketplace lenders would also gain significant advantages through exemptions from state usury ceilings, an issue raised as a significant business obstacle in the Treasury's analysis of this sector.[3]

1 See **FINTECH**, *Financial Services Management*, April 11, 2016.

2 See *Client Reports* in the **SHADOW** Series.

3 See **FINTECH2**, *Financial Services Management*, May 24, 2016.

The OCC states that any fintech charters would need to engage in at least one traditional banking service. These include "paying checks," an activity that read broadly would allow a wide array of payment, settlement, and clearing services in fintech charters with access to the FRB and other advantages over non-banking companies hoping to offer financial-market infrastructure services such as DLT. The general nature of the OCC's proposal makes it unclear how capital, liquidity, and resolution requirements would apply to such infrastructure services. The FRB has issued a staff paper laying out an array of concerns with DLT that it and other global regulators have also expressed about other fintech activities such as high-frequency trading. The manner in which the current and future Comptrollers impose standards on any infrastructure-focused fintech charters will clearly have significant structural and strategic impact in this rapidly-changing arena.

However, banks fear that these privileges could be won by fintech firms at their expense if special-purpose charters are not accompanied by like-kind prudential regulation. Regulators such as FRB Gov. Lael Brainard have also expressed significant concern about the ability of fintech companies to bypass fair-lending standards through innovative underwriting or market models that have disparate impact on customers based on their race, gender, or other protected characteristics under anti-discrimination law and rule. For example, underwriting models that depend on knowing from which college a borrower has graduated could have significant disparate impact on minority borrowers. Complex technologies that require expensive devices or advanced education could also adversely affect financial inclusion by making access by persons with disabilities or lower incomes to financial services still more difficult.

Reflecting all of these considerations, the OCC's paper lays out restrictions that would govern chartering considerations and, if a fintech company establishes a federally-chartered bank, ongoing operations. Although the paper provides few details, it clearly contemplates special capital requirements to reflect the fact that fintech-chartered firms might have few on-balance sheet assets, inclduing liquidity rules designed to ensure continuing operation in concert with resolution requirements that increase the odds of orderly exit under stress. Fintechs would also need to show how their activities not only do not undermine, but also advance financial inclusion.

Nothing in this paper suggests that the OCC would lay out any of these prudential or chartering requirements in rules or other express standards that would ensure like-kind imposition across the agency and require formal, administrative action before future Comptrollers could change the rules. It is thus possible that, even if Comptroller Curry means to establish a rigorous fintech regime for special-purpose banks, some companies could gain significant advantages or the sector could win back competitive advantages over traditional banks.

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What's Next

The OCC released this policy paper on December 2; comments are due by January 15. OCC is not likely to finalize its policy until well into the spring of 2017, when Comptroller Curry's term expires. It remains to be seen if the Trump Administration is able to nominate a replacement the Senate then confirms by that time or if Mr. Curry is willing to stay on until his successor is in place. The timing of these changes will have major bearing on how the OCC's final fintech policy is shaped and then implemented.

Analysis

A. Activities

Any special-purpose fintech charter would need to include one of the following activities:

- receiving deposits;
- paying checks; and
- making loans.

Further, only bank-permissible activities could be offered in a special-purpose fintech charter. However, the OCC has long construed the "business of banking" in broad terms that takes the three activities described above and defines them in ways some believe permit national banks to go well beyond traditional banking. For example, the OCC has allowed national banks to develop hotels based on the view that rooms might be used by bank employees.[4]

The scope of the business-of-banking authority deployed by the OCC under Mr. Curry and his successor will thus have considerable bearing on the value of fintech charters and their competitive impact. This policy states clearly that new fintech activities will be considered on a case-by-case basis without making clear how decisions will be made or disclosed.

B. Rules and Standards

The agency stipulates that special-purpose fintech charters will come under bank-applicable requirements (e.g., real-estate ownership restrictions, AML, UDAP, and lending limits). Chartering requirements (e.g., regarding capital adequacy and governance) must also apply. Conversely, federal-charter benefits (e.g., exemptions from state supervision, interest-rate preemption) would also apply. The OCC's current policy on when state law is or is not

4 See **REALESTATE11**, *Financial Services Management*, January 9, 2006.

preempted would apply.[5] Resolution of an uninsured special-purpose fintech is under consideration because the procedures applicable to an insured federal depository institution would not govern any such institution in receivership or liquidation.

The CRA also does not cover uninsured institutions but as discussed below would apply to special-purpose charters. The OCC reads enforcement provisions in the FDI Act as generally applicable to fintech firms and other special-purpose charters, with "baseline" supervisory expectations detailed for fintech firms in line with those already applied to full-purpose banks with federal charters. Chartering special-purpose fintech banks (insured or not) would also come under baseline chartering requirements addressing matters such as the bank's business plan and capital and liquidity resources. Governance, compliance, risk-management, and resolution planning is also required; it is general practice for entities seeking a national charter to meet preliminarily with the OCC once these chartering issues have been determined by the applicant to permit the OCC to lay out how it would tailor its standards for the charter if the application were approved. The OCC white paper places particular emphasis on governance and management expertise, likely intending this as early warning to fintech applicants that considerable investment in expertise from the banking sector will be required in any approved applications.

C. Inter-Agency Coordination

Fintech firms seeking a special-purpose charter would likely have relations with other regulators with which the OCC would coordinate in making charter or other determinations. The white paper details which agencies might apply and how.

D. Prudential Standards

1. Capital

In addition to noting the importance of capital forecasting and resources for successful charters, the white paper lays out initial OCC expectations for this critical profit driver. It makes clear that current capital rules for national banks will apply in line with the fintech bank's size and business model, but also that special capital add-ons are likely. For example, the OCC is concerned that the current capital requirements for off-balance sheet

5 See **PREEMPT29**, *Financial Services Management*, August 8, 2011.

exposures[6] may be inadequate for fintech-focused companies which, like other special-purpose entities, may have few on-balance sheet credit risks but considerable off-balance sheet exposures not only to credit risk, but also to operational risk not generally captured for smaller national banks under the U.S. Basel III regulations.[7]

2. Liquidity

As with capital, the OCC's approach to liquidity regulation is to start with the basic requirements and tailor them for special-purpose banks. Fintech banks will likely be far smaller than those now subject to rules such as the liquidity coverage ratio,[8] but the OCC makes it clear that all special-purpose entities will need to ensure they have liquidity for events such as unplanned balance-sheet revisions, market liquidity risk related to factors such as collateral, and contingency funding.

3. Compliance Risk Management

This issue – often not one compatible with fintech corporate culture – is heavily emphasized by the OCC as a baseline chartering and operational requirement. Firms will need to demonstrate a top-down compliance culture and provide the OCC with comfort that the company is particularly attuned to the fair-lending and access issues its strategy may create. Anti-money laundering compliance is another top OCC priority.

4. Recovery and Resolution

The proposed business plan will need to address resolvability under best- and worst-case scenarios, taking into account parent and/or affiliate resolution considerations. The OCC may also require companies to have an advanced, clear exit strategy. This is not detailed in the white paper but likely includes considerations such as circumstances under which a parent company would cease operations and how outstanding obligations would be handled or the conditions under which sale of the charter could realistically be expected to forestall failure and the resulting risk.

E. Financial Inclusion

This issue is implicit in national-bank supervisory standards, especially under the CRA, but not an express chartering or operational consideration. The OCC here proposes to go beyond these requirements for fintech charters and require that even uninsured special-purpose charters comply with the CRA. Any special-purpose fintech company with lending activities would also come under standards to ensure fair access to credit in ways detailed in

6 See **CAPITAL200**, *Federal Financial Analytics*, July 15, 2013.

7 See **CAPITAL199**, *Federal Financial Analytics*, July 10, 2013.

8 See **LIQUIDITY17**, *Financial Services Management*, October 1, 2014.

this white paper. Applications for charters will need to include a special section on financial inclusion. Departures from the financial-inclusion plan in an approved charter could subject company to sanction.

F. Request for Comment

In addition to views on the points noted above, the OCC seeks comment on:

- the public-policy benefits or risks of approving fintech charters;
- appropriate capital and liquidity standards for limited-purpose fintech charters;
- the information a fintech company would need to provide to demonstrate its commitment to financial inclusion (e.g., what products would demonstrate this commitment). Comment is also sought on whether the OCC should seek financial-inclusion commitments from fintech charters not engaged in lending and, if so, how;
- if the OCC should use its chartering authority to ensure that small-business borrowers get the protections now afforded under law only to consumers;
- the challenges for fintech companies meeting bank-like requirements and added inclusion requirements;
- ways the OCC should ensure these charters are safe, sound, and operate in the public interest;
- any competitive advantages enjoyed by special-purpose fintech charters over full-service national banks;
- risks to full-service banks from fintech companies without bank charters;
- fintech services (e.g., digital ledger technology) requiring a different approach;
- ways to enhance inter-agency coordination;
- ways to mitigate risks resulting from concentrations in a small number of activities; and
- ways to support potential fintech applicants.

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