Issue Brief
Charter Wars: What It Takes to Win

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Earlier this month, Acting Comptroller Noreika rattled cages when he argued that his agency – not the FDIC – should be the deciding authority on new national-bank charters. A subsequent statement provided to the *American Banker* clarified that Mr. Noreika wants only to give the OCC the dispositive say-so while allowing the FDIC limited-veto authority. In this brief, we recount a brief tale of a charter we sought to demonstrate that the key to new bank charters isn't who grants it, but whether investors can profit by it.

Bank charters are no different from an investor's perspective than a hot-dog stand. If the business is likely to be profitable, money's in. If the terms of engagement are not viable for long-term return, it's out. As long as there is a "sin tax" on new banks in the form of punitive capital requirements that force realized return well below other comparably prudent investment options, new charters will be few, far between, and viable principally for non-bank parents looking to cross-subsidize their other operations.

This brief looks at a new bank we tried to charter and what went wrong. We then asses current FDIC policy which imposes a capital surcharge on new charters above and beyond the capital requirements demanded of the nation's largest banks. These banks can barely afford these charges on traditional banking activities, but at least they have legacy operations and market dominance to withstand them and, at least arguably, the systemic "footprints" to deserve them. This can hardly be said of small banks looking to serve distinct markets where, absent the sin tax, customers lie and profits are possible from traditional intermediation services. In this brief, we also suggest a better way to protect the FDIC and FRB without tripping up new bank charters before they even have a chance out of the starting gate.

A Tale of a Charter Tried

Confidentiality agreements still preclude much specific disclosure of Federal Financial Analytic (FedFin) work from 2013 through 2015 with private investors to charter a new bank. Suffice it to say that the new bank – which would most likely have had a national charter – was initially envisioned as a de novo focused on a service associated with mortgage lending approved as a traditional bank product but rarely offered by insured depositories.

In the post-crisis market, it looked as if the time was right for bank entry. However, what investors said was a sound business plan wasn't good enough. After much hard work on both de novo and acquisition strategies, the post-crisis regulatory framework proved too costly for a new bank interested in a new product backed by new investors. With all the talk of the need for more innovation, such a venture would seem appropriate, but it was not to be. Despite investor interest in the business plan, we could not make the revenue from the bank match investor profit needs under the capital requirements demanded then as now for start-ups.

The Barrier to Entry: Sin-Tax Surcharge

The post-crisis capital requirement for start-ups regardless of business plan and actual risk profile is essentially a sin tax levied against new charters for the sins of old ones before the crisis and, perhaps, those of the FDIC and other regulators that chartered them. As with so much in post-crisis regulation, regulatory-capital requirements lie at the heart of each new bank's strategic dilemma.

When we looked at a new bank, the FDIC required that it hold an eight percent leverage ratio (LR) – more than double the LR otherwise required of small banks and even well above the six percent enhanced supplementary LR required of the nation's largest and, the FDIC believes, riskiest banks. The FDIC has belatedly recognized the cost of its sin tax on new charters. As a result, it has shortened the time a new bank has to be in the penalty box. In its most recent handbook on new-bank charters, the FDIC has relented somewhat – now, the eight percent LR is required only for three years, not the initial seven-year span that deterred virtually all possible new entrants.

A necessary change, but far from sufficient to spur new charters. Shortening the time investors lose money doesn't mean they still won't lose it in amounts and for longer than likely in other investment opportunities – and there are many of them.

Is the three-year sin tax an insuperable barrier to new charters? Rising interest rates may boost profitability along with improved economic growth, but three years of punitive capital standards and uncertain relief in subsequent years make the twenty percent ROI conservative investors demand difficult, if not impossible. In short, few new charters are to be had since new, traditional charters take investors and the investors we know whom the FDIC might approve have taken a hike.

Importantly, hard-wired ROI demands often do not apply when it comes to innovative charters from outside the banking sector. As we noted in our initial assessment of SoFi's proposed industrial bank, a limited-purpose insured depository – which is seemingly the most capital-burdened of all – is actually an advantageous way for an existing financial company to expand its product offerings, arbitrage the value of access to the Fed, and lower its funding costs. Inter-affiliate transaction restrictions are meant to limit the subsidy value of a bank within a non-bank, but barriers are in fact porous – especially when it comes to intangible benefits derived from cross-marketing and other cross-subsidies within a diversified company that do not require direct transfers of capital or funding from a bank to its non-bank parent.

When the bank charter is the "dog" in a new-bank application, capital costs are crushing for investors. It's not just the FDIC's barriers to private-equity investors that have kept them out of the banking business since 2008 – now, there's little way they can achieve desired investor results given the huge upfront cost of starting or buying a bank.

But, when the bank is the tail on a large financial-services company, then strategic advantages can be gained with little adverse ROI effect on a consolidated basis along with much long-term upside potential. As noted, this is SoFi's hope. It's also the premise of the recent acquisition by TIAA of a large Florida bank (one started by private-equity before the crisis by the way). In this transaction, these initial investors finally did very, very well and the parent insurance company got the ancillary product offerings it wants at little net cost to long-term ROI.

Solution: Start-Up Capital Relief

Whose fault is it that new bank charters are often risky bank charters? The FDIC's sin tax presumes it's the bank that's the problem – why else capital-tax a new $150 million bank more than a $2 trillion GSIB?

From day one, an insured depository has at least two regulators: the primary state or federal supervisor and the FDIC. Throw in a parent holding company, and then there are three. Can none of them review a business plan, determine its riskiness under various economic scenarios, and right-size capital so that taxpayers are protected without profit evisceration?

The FDIC appears to believe that neither it nor its sister agencies can be counted on to catch the wayward ways of newly-empowered bankers. We think they can do it if first they try and then they hold themselves strictly accountable.

Relatively new charters tumbled alongside legacy players during the crisis not so much due to lack of capital but rather because of the absence of prompt corrective action. In 1991, the FDIC was given broad authority along with primary supervisors quickly to intervene and demand a new business model or put an insured depository into receivership. As countless studies and much of our expert-witness work has shown, regulators acted only long after structural flaws in bank business models showed deep, irreparable fissures. Supervision to this day depends far too much on post hoc enforcement than ex ante prevention.

As a result, the regulatory framework for new charters should include:

- right-size capital requirements based on an applicant's business model. The banking agencies have lots of stress tests. Use them or demand that applicants do so to stress test their plans and show how much risk-based and leverage capital is required to withstand them; and
- keep new charters on the aforesaid tight leash. If governance falters, capital erodes, management quiets, or other warning signs blink, then regulators must intervene. Charters premised on clear business plans with milestones for next steps can and should be well supervised to balance profit and growth with safety and soundness.

It's not as if the FDIC and other federal agencies are deluged with dozens of charter applications. Sin-tax capital standards put all the chartering burden on investors. A better-balanced set of application requirements would keep some of the burden on investors, but share it with supervisors to ensure that under-served markets get more competition from the larger number of smaller banks eager to offer products and services targeted to their needs.