THE CHANGING BALANCE OF POWER AND PROFIT:
The Realignment of Bank-Charter Options and Its Strategic Consequence

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Key Points

- Congress will not speedily redesign bank charters and may not act at all, leaving chartering decisions to regulators and the courts.
- Charter opportunities will thus open idiosyncratically and asymmetrically, altering the competitive landscape in key retail, wholesale, and infrastructure markets.
- Even should Congress and the Biden Administration enact new law, novel charters operating before enactment will surely be grandfathered, further enhancing their franchise value.
- Payment-system access is the critical entry point for tech-platform companies and subsequent integration of digital finance with digital commerce. Even if the Fed doesn't formally expand payment-system access, there is ample opportunity for financial-system redesign by one or more powerful entities.
- As a result, policy analytics and advocacy are essential for effective franchise-value optimization.

Although the technologies involved in the fierce U.S. debate about non-traditional charters are innovative, there's nothing novel about the debate itself. As shall be shown, the strategic advantages of integrating banking with other financial and commercial services outside the reach of most bank regulation has been compelling since at least the mid-1950s. Congress then began an after-the-fact battle in which certain novel charters were banned, existing ones were grandfathered, loopholes for additional novel charters were left wide open, and grandfathered companies and charter-adventurers grew to be powerful competitors. After that, crisis struck and the cycle began again with a new class of novel charters, a new group of aggrieved competitors, and still another set of challenges to financial stability and consumer protection.

Many of the most prominent examples of ground-breaking innovation – Sears in the 1980s, GE Capital in the 1980s, and Merrill Lynch and Travelers in the 1990s – saw their basic businesses undermined or even endangered by their banking operations in later years. But no matter – many other innovative charters survived and thrived as each effort to shutter arbitrage-driven charters still grandfathered those wily enough to beat the statutory reaper. Thus, the lure of innovation outside regulation has long been irresistible and seems ever more so today.

Although only barely beginning to formulate policy questions other than those forced by the pandemic, the 117th Congress has already held two hearings on novel bank charters, not only planning more, but also near-term action on at least one immediate concern: the extent to which non-traditional charters leverage the unique powers of insured depositories to gain what some believe to be dangerous advantage. The Office of the Comptroller of the Currency (OCC) is also under immediate pressure to wrestle with the legacy of the Trump Administration's Acting Comptroller, which includes not only a new rule authorizing bank/nonbank "partnerships,"[1] but also several ground-breaking charters focused on crypto-assets.[2,3] Tech-platform companies such as Amazon, Apple, Google, and Facebook are also set for rigorous review that, while focused on antitrust considerations, will inevitably tackle their financial-services ambitions. An array of pending decisions about the U.S. and global payment systems also has immediate strategic implications for the balance of both power and profit.[4,5]

As a result, the questions analyzed in this brief[*] are immediate analytical and advocacy priorities as well as franchise-value strategic make-or-breaks. We conclude that, as before, the race belongs to the swiftest innovators, be they banks or not, with the surest footing in market reality. These firms may well take undue risks and put vulnerable consumers and even the financial system in harm's way, but the pace of technological innovation compared to definitive U.S. policy is such that firms that are able to exploit regulatory loopholes will gain a vital edge that often proves irreversible unless business models, lax internal controls, or changing markets yet again alter the competitive landscape. Banks have proven their resilience in the face of many novel charters and "shadow" competitors, but the business model continues to change and the impact of deep-pocketed competitors will prove a formidable franchise-value challenge, especially if tech-platform companies venture still more deeply into consumer finance and core infrastructure.[6]

Background

First, some history to validate our pessimistic forecast of U.S. policy-making capabilities. Although many other nations long allowed free-wheeling interaction between banking and commercial firms (the "universal" banking model), the U.S. fought a decade-by-decade battle against truly full-service banking in which Congress thought it had settled the question in favor of a strict separation of banking and commerce. This led to changes that maintained the new charter model for about a decade. Then, the

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next round of innovative charters broke through the barricades and the market innovation/legislative rollback struggle begins anew. At each of the steps in this dance, existing novel charters are grandfathered, perpetuating their advantages even as slow-movers are left behind until a new charter option looms on the horizon.

The U.S. first thought it had decided against novel charters in 1956, subsequently toughening the Bank Holding Company Act provisions with a series of amendments in 1970 designed to put a permanent barrier between banking and commerce.[7] This law worked as hoped for about a decade before determined commercial companies found a loophole in the Act and invented what came to be called "nonbank banks." These took advantage of states eager to charter companies within their borders without a thought to parent company activities or the extent to which these firms are to serve as a "source of strength" for an insured depository institution (IDI).

Embodied in Sears Roebucks' plan to sell "socks and stocks," the nonbank-bank boom lasted until 1987, when Congress enacted the Competitive Equality Banking Act.[8] This banned future nonbank-bank charters exercising the full powers of IDIs to accept all forms of FDIC-insured deposits and make loans, but grandfathered those with charters prior to enactment just as a few holding companies with banking and non-traditional activities (e.g., TransAmerica) were grandfathered years before.

There was also at this time another charter with unique advantages known as the "universal thrift." These charters include an IDI through ownership of an insured savings-and-loan (S&L) association or similar entity controlled by a parent company under no limits as to its other financial or commercial powers. The S&L crisis of the 1980s led Congress to institute many regulatory and deposit-insurance changes for insured savings associations, but universal-thrift charters were unaffected. These flourished in the 1990s (think GE Capital), leading Congress to reconsider their powers and ban new universal thrifts in the 1999 Gramm-Leach-Bliley Act.[9] Again, though, existing charters were grandfathered, prospering enormously until their huge positions in mortgage finance led to some of the biggest IDI failures (Washington Mutual) in U.S. history. GE Capital also sought and received $85 billion in funding guarantees to keep its unitary thrift and, perhaps, the company as a whole, alive.[10]

Still, Congress left these charters largely intact. Although the Dodd-Frank Act took a dim view of novel charters, it only allowed the Fed to govern these companies more tightly rather than shutting them down or fully aligning their powers to those authorized for banks and bank holding companies.[11] The FRB has begun the gradual process of aligning very large S&L holding companies with large banks,[12] but line-of-business disparities remain.

The Dodd-Frank Act did, however, respond to a highly-controversial bid a few years before by Walmart to charter a limited-purpose IDI, countering this with a three-year moratorium on such charters. This actually remained in de facto effect until 2020, when the FDIC allowed Square and Nelnet each to own an IDI.

Fast forward to 2021.

Strategic Inflection Points

Two separate, but vital, policy threads determine the future of non-traditional charters and nonbank/IDI alliances. These are:

- express, permissible charter and relationship options; and
- the extent to which forthcoming safety-and-soundness or consumer-protection standards apply asymmetrically to banks and nonbanks governing how data are used, the extent to which AI is authorized, and how IDIS may "partner" with nonbanks, including fintechs and Bigtechs.

The reason to pay attention to emerging rules with no clear link to charter choice is that the extent to which IDIs or their holding companies are allowed to innovate under their existing charter drives their competitive power as innovators on their own and as attractive takeover, de novo charter, or alliance targets. The more constrained an IDI is forced to be, the more innovation will occur around the charter or via selective inter-relationships. Key upcoming decisions in this indirect, but potent, regulatory channel include:

- how the CFPB decides who owns consumer data;[13]
- the extent to which algorithmic underwriting standards are generic across a market segment (e.g., via HUD for mortgages) or bank-specific;
- whether sandbox or pilot programs are authorized, thus permitting IDIs to determine the extent to which innovative product offerings may succeed ahead of major investment in terms of the risk-mitigation and related controls likely always to be more extensive and thus costly for IDIs and regulated parent companies;
- what the Fed does with interchange fees;[14]
- if the banking agencies authorize small-dollar, short-term lending and other new products that ride cost-effectively on the rails of existing product offerings and compete effectively with nonbank options;
- the manner in which the Fed, Department of Justice, and FTC view mergers and acquisitions across the bank/nonbank divide;[15,16]
- overall market concentration policy governing large retailers, telecommunications/media firms, and tech-platform companies; and
- the crypto-asset powers directly authorized for IDIs for deposit-taking, custody, and payment operations, not just for new investment-product offerings.

Imminent decisions with direct impact on charter and alliance options include:

- what the OCC does with the true-lender rule once Congressional action to overturn it is signed into law;[17]
- whether the FDIC proceeds as planned with approvals of more industrial-bank charters for non-traditional companies, demonstrating that implementation of its new parent-company standards is no insuperable barrier to nonbank entry;[18]
- how the Fed revises its merger-approval criteria;

- the extent to which FBO branches and agencies come under consolidated Fed regulation;[19]
- what the "sprint team" of bank regulators now considering crypto rules devises with regard to charter approvals;
- the outcome of court challenges and OCC reconsideration of special-purpose fintech charters;[20]
- whether the new OCC will be open to the payment charters favored under the Trump Administration and, if so, on what terms for whom;
- whether the Fed allows special-purpose charters and/or nonbanks to access the U.S. payment system; and
- whether rules governing nonbanks – be they mortgage servicers, tech platforms, or fintechs – expand the scope of entities deemed nonbank systemic financial institutions by the FSOC.[21]

Conclusion

We'll stop where we started: Congress could change the terms and conditions of each one of these inflection points whether by enacting new law or -- more likely-- by demanding that regulators do their bidding or else. Regulators will of course act as they then deem fit and, in any case, are in the process of making decisions on each of these points and others which also pack a strategic punch.

To the extent the rules of the road change for like-kind activities without regard to charter, then any edge nonbank innovators have achieved by that point will end with the rule's effect. However, to the extent U.S. financial regulation remains asymmetric for key activities and/or charters, significant arbitrage opportunities remain to be exploited and, after they are, grandfathered if Congress ever gets around to caring about them. Further, once a regulator grants a charter, it remains in force even if the regulator later thinks better of these new options, allowing early-innovators to retain their unique franchise advantage for themselves and, perhaps, even an acquirer.

Do not hesitate to contact us if you would like to know more about any of the inflection points noted above, why we think they affect the non-traditional competitive landscape, and how we think regulators and Congress will act on specific decision points. Please send inquiries to info@fedfin.com and we will respond as promptly as possible.

Endnotes

[1] See **PREEMPT35**, *Financial Services Management*, November 2, 2020.
[2] See **CRYPTO15**, *Financial Services Management*, September 28, 2020.
[3] See **CRYPTO17**, *Financial Services Management*, January 12, 2021.
[4] See **PAYMENT22,** *Financial Services Management*, May 10, 2021.
[5] See **PAYMENT23**, *Financial Services Management*, June 7, 2021.
[6] Federal Financial Analytics, *Making "Responsible Innovation" a Reality: BigTech, Small Money, and U.S. Economic Equality*, February 2, 2019.
[7] Bank Holding Company Act (BHC Act), Pub. L. No. 511, 70 Stat. 133 (May 9, 1956), available at https://www.govinfo.gov/content/pkg/STATUTE-70/pdf/STATUTE-70-Pg133.pdf.
[8] Competitive Equality Banking Act, Pub. L. No. 100-86, 101 Stat. 552, August 10, 1987, available at https://www.govinfo.gov/content/pkg/STATUTE-101/pdf/STATUTE-101-Pg552.pdf.
[9] Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1138, November 12, 1999, https://www.govinfo.gov/content/pkg/PLAW-106publ102/pdf/PLAW-106publ102.pdf.
[10] Joe Weisenthal, "GE Capital Will Get to BUY Toxic Assets Through PPIP," *Business Insider*, June 30, 2009, available at https://www.businessinsider.com/ge-capital-will-get-to-buy-toxic-assets-through-ppip-2009-6.
[11] See **FHC19**, *Financial Services Management*, July 29, 2010.
[12] See **SIFI34**, *Financial Services Management*, October 23, 2019.
[13] See **DATA**, *Financial Services Management,* November 4, 2020.
[14] See **INTERCHANGE8**, *Financial Services Management,* May 18, 2021.
[15] See *Client Report* **MERGER5**, September 2, 2020.
[16] See **TAKEOVER8**, *Financial Services Management*, February 14, 2020.
[17] See *Client Report* **PREEMPT36,** April 28, 2021.
[18] See **ILC15**, *Financial Services Management,* December 21, 2020.
[19] See *Client Report* **REFORM200**, December 16, 2020.
[20] See **CHARTER27,** *Financial Services Management,* December 2, 2020.
[21] See **SIFI35**, *Financial Services Management,* December 18, 2019.