ForeSight

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# Fintechs Now Can Apply For National Bank Charters: Update—Has the Train Stalled?

Further definition is available, but potential roadblocks await.

*The U.S. Office of the Comptroller of the Currency has doubled down on its intent to grant special purpose national bank charters to financial technology companies (fintechs). However, it is unknown if and how new OCC leadership will interpret the initiative. Meanwhile, state regulators have introduced a lawsuit to prevent implementation.*

*by Steve Murphy*
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# Bank Charters for Fintech Companies

This report is an update to the ForeSight report titled *Fintechs Can Now Apply for National Bank Charters: The Train Is Leaving the Station*, released by Mercator Advisory Group in January 2017.

In an early December 2016 announcement, the Office of the Comptroller of the Currency (OCC), which is the primary U.S. government regulator for nationally chartered banks, stated that the agency would for the first time start granting banking licenses to financial technology (fintech) firms through special-purpose charters.[i] In a white paper titled *Exploring Special Purpose National Bank Charters for Fintech Companies*, dated December 2016, the OCC lays out case for the initiative.[ii] Based in part on subsequent public commentary, in March 2017 the OCC published a draft supplement to its licensing guide, titled *Evaluating Charter Applications From Financial Technology Companies*.[iii] In the present updated ForeSight report, Mercator Advisory Group reviews the background and implications of this original initiative and new supplemental language, as well as several new developments, including a lawsuit by state regulators that challenges the OCC's authority to grant such charters.

## Background

The U.S. financial services regulatory agencies, including the Federal Reserve and OCC, have been somewhat passive regarding the potential impact of fintech companies and solutions on the banking industry. This is in contrast with the more proactive approach taken by the European Union through the European Commission (EC) and by certain sovereign nation regulators, such as in the United Kingdom. Through the EC's Payments Services Directive (PSD) of 2008 and PSD2 (which will take effect in January 2018 and includes fintech access to bank data), the E.U. has encouraged payments standardization and innovation; general fintech activity has greatly expanded as a consequence. Since 2013, the U.K. has had a restructured regulatory system and policies that support the creation of "Challenger Banks"; the intent is to transform the U.K.'s highly concentrated banking industry into smaller, modern financial services companies.[iii] The way these regulations and initiatives are likely to play out and their level of success remain the subject of debate, but indeed they contrast with the U.S. approach.

Mercator Advisory Group has written about the Fed's Faster Payments Task Force initiative, which launched in 2015 and remains a rather passive, nonregulatory approach to improving the overall performance and security of the U.S. electronic payments systems. (See *Update on Faster Corporate Payments*, released in April 2016.) The Fed is reviewing proposals for faster payments systems under a comprehensive list of guidelines but is not acting as an enforcement agent (to date anyway). The OCC first actively joined the innovation discussion during 2015 and published a subsequent paper, titled *Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective*, in March 2016. In that paper we see a more proactive set of comments, laying the groundwork for the fintech bank scenario now in play, such as the following comment from then Comptroller Curry:

> Innovation is not free from risk, but when managed appropriately, risk should not impede progress. Indeed, effective risk management is essential to responsible innovation. Banks and regulators must innovation along with the strike the right balance between risk and innovation. This paper describes the OCC's vision for responsible innovation in the federal banking system and discusses the principles that will guide the development of our framework for evaluating new and innovative financial products and services. We welcome your feedback.
>
> –Thomas J. Curry, former Comptroller of the Currency

So the OCC is taking a page from the book of its European counterparts and becoming directly involved as a regulatory entity with a specific role. That role is not really different from the agency's current role, but it expands the OCC's purview into uncharted territory. This is discussed further later in this paper.

## The OCC's Motivation

This move is neither outside the scope of the OCC's unilateral regulatory authority nor unprecedented. The OCC has the authority to grant charters for special purpose national banks (SPNBs) and federal savings associations under the National Bank Act and the Home Owners' Loan Act (HOLA), respectively. Indeed, existing regulations define a special purpose national bank as a bank that conducts activities other than fiduciary activities and engages in at least one of three core banking functions: receiving deposits, paying checks, or lending money.[iv] A precedent was the creation of credit card banks. In effect, the OCC is simply reaffirming its own chartering authority.

By reviewing the OCC's recent white paper cited above, one can draw at least a partial conclusion that the OCC recognizes the impact technology is having on the delivery of financial services, including the surge of millennials into the marketplace with their demands for here, now, and easy. Regulators are always concerned about risks and trends that might be destabilizing. Since fintechs have been seeking new and better ways of delivering services, either with bank collaboration and partnerships or without, it can be surmised that the OCC wants to have more visibility into and control over how that is done. Since a fintech

### Related Concerns

If you find this piece of interest and would like to explore this issue further, possible proprietary project work could be done to examine questions like these:

*How might your firm be affected by emerging faster payments systems in the U.S.?*

*Which fintech companies or related technologies present a foreseeable threat to your bank's commercial payments business lines?*

*What lessons can you learn from the European Union's "challenger bank" experience?*

*If you are a fintech firm, what competitive and regulatory hurdles will the new U.S. model present to you?*

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bank would be subject to the same federal regulations as other nationally chartered institutions, the concept allows fintechs to become banks and compete directly if they so choose. However, the former Comptroller of the Currency raised some important questions:

> These industry developments raise fundamental policy questions. Is the nation better served when banking products are provided by institutions subject to ongoing supervision and examination? Should a nonbank company that offers banking-related products have a path to become a bank? And, what conditions should apply if a nonbank company becomes a national bank?
>
> *–Thomas J. Curry, former Comptroller of the Currency*

## Licensing Manual Supplement

After publishing the December 2016 paper, the OCC opened the discussion by accepting public commentary through mid-January 2017. In effect, the document reiterates much of what is required of all national banks as well as special purpose national banks but creates some clarification as to the scope of banking activity expected from fintech companies as SPNBs.

> The OCC recognizes that fintech companies that want to operate in the regulated space will choose different ways of doing so, and the SPNB charter is one option of many. Some may operate under state bank or state trust bank charters in states that offer those options. Some may apply for, or seek to acquire, full-service national bank charters; others may qualify to be another type of special purpose national bank. Still others may wish to continue, or initiate, partnerships with banks by providing technology-related services and expertise. This Supplement is not intended to discourage these other ways of conducting business but rather to clarify the OCC's expectations for a particular segment of financial service providers— that is, fintech companies seeking an SPNB charter
>
> *–excerpt, Comptroller's Licensing Manual, Draft Supplement*

In summary, Mercator Advisory Group sees the following points being made:

- While there does not seem to be language preventing deposit-taking as a core banking activity, it is clear that the OCC is not expecting fintech applications to include this activity.
- There is mention of the OCC not allowing "the inappropriate commingling of banking and commerce". This may or may not put some restraints on interesting or nimble new banking business models that small fintechs might be inclined to pursue.
- It is repeated that fintech banks would be subject to the same supervisory activity as a national bank, which one would expect, but this point certainly has generated discussion.

- There is mention that additional capital requirements might be necessary in certain circumstances, which might again somewhat limit the ability for a start-up fintech to gain approval compared to a more cash-rich mature company that might seek fintech bank status (i.e., Apple).

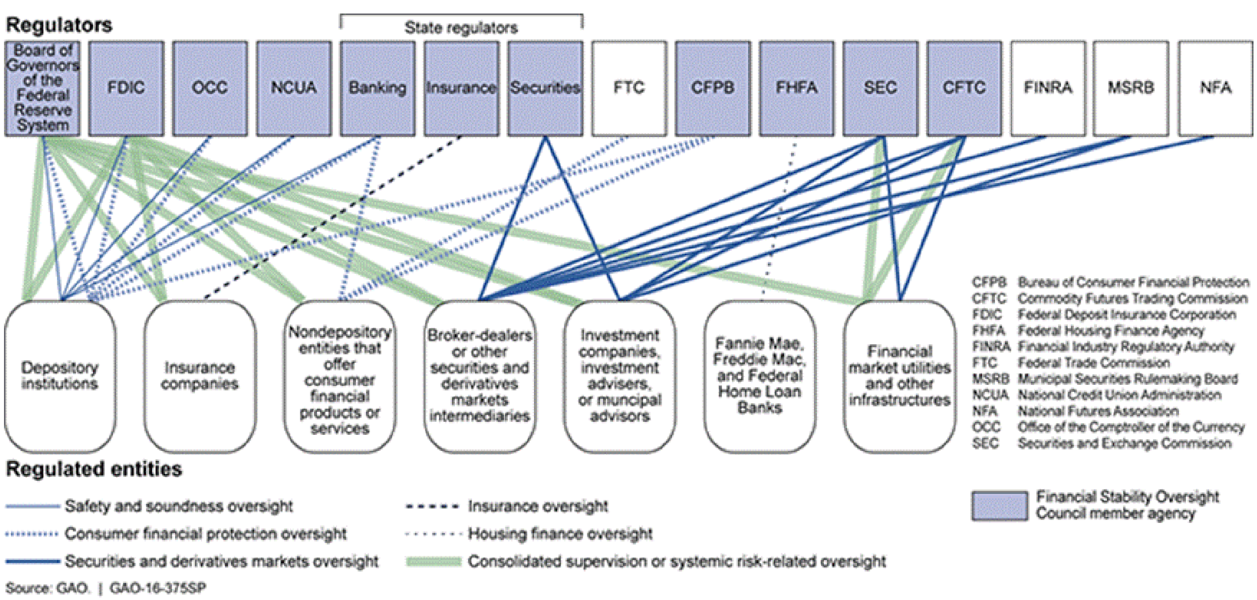
It is important to note that the licensing manual supplement includes the word "draft," which seems to heed the warning by the House Financial Services Committee to the Comptroller against actually starting to accept applications given the new administration changes. The "champion" of this initiative has been former Comptroller of the Currency Thomas J. Curry, who was not reappointed and left office as of May 3, 2017. An interim comptroller is in place, but a permanent OCC head is expected to be named soon. There is speculation around whether or not the new comptroller will pursue this policy with the same zeal.[iv] Indeed this is a major consideration since the new comptroller will have significant influence in shaping the final form. The new OCC head will need to be approved by Congress of course, which puts an even more political spin on progress.

# Regulatory Structure

## The Complicated U.S. System

The United States has the most fractured, decentralized, and complicated regulatory structure in the world, a structure that includes more than a dozen federal agencies and 50 separate state regulatory entities.[v] Figure 1 provides an overview of the U.S. system.

**Figure 1: U.S. Financial Regulatory Structure**




*Source: U.S. Government Accountability Office, 2016 Annual Report, GAO-16-375SP[vi]*

One can compare this structure with that of another nation with a highly segmented financial services industry, namely Japan, which has three regulatory agencies overseeing financial services.[vii]

Depending on how a fintech bank might be structured as a national bank, at the federal level the minimum regulatory impact would come from OCC chartering and oversight, as well as any services governed by applicable federal laws requiring other entities to get involved (e.g., Consumer Financial Protection Bureau, or CFPB). In addition, to function as a bank, a fintech firm would of course need a business license in at least one state, making it subject to that state's regulatory entity. Should the fintech bank decide to take deposits, the Federal Deposit Insurance Corporation would become involved. If for some reason the fintech bank were to become part of a broader financial holding company, the Federal Reserve would join the party.

For the present we can assume that the OCC is the single regulatory entity, in which case a charter application must be filed.[viii] The charter application process for a national bank (unless for some reason the OCC decides to simplify it) is a multistep, lengthy effort involving at least the following:

- **Pre-filing Briefing,** including a discussion with an OCC officer about the proposal, details of the organizing group, CEO, insider implication, and capital structure.
- **OCC Application**
  - **Business Plan,** which must include three years of projections and full details of how the bank will conduct its business, make money, and manage risks
  - **Board of Directors** and senior management, which will undergo a full background evaluation and skills assessment
  - **Capital Plan,** with details on startup funds and ongoing process to maintain required capital funding levels

## Mercator Advisory Group's ForeSight Series

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If final approval is granted, the OCC allows the applicant entity 12 months to raise capital and 18 months to open the bank. The question becomes whether any fintech firm is ready, willing, and able not just to manage this process, but to subject itself to ongoing regulatory scrutiny. Mercator expects the answer to be yes of course, again depending on the nature of the fintech firm, its funding sources, and its business strategy. At the very least, those fintechs that have decided to become a bank will avoid having to file with multiple state agencies to conduct a banking business, since a national bank can operate in any state in the country.

## State Regulators' Objections

In the earlier version of this ForeSight report released in January, Mercator Advisory Group identified state banking regulators as being the primary objectors to the OCC's initiative. Indeed their position has now escalated from contributing objections to one of litigation, which seems to be the new way of resolving policy and territorial disputes. On April 26, 2017, the Conference of State Bank Supervisors (CSBS), a nationwide organization composed of state banking regulators in the United States, brought forth a lawsuit challenging the OCC's fintech bank charter initiative. The underlying arguments include a) state regulators already do a good job of regulating nonbank payments and other financial services providers, b) the OCC doesn't have the authority anyway and c) it will harm markets, innovation, and consumers.

> The OCC's action is an unprecedented, unlawful expansion of the chartering authority given to it by Congress for national banks. If Congress had intended it to be used for another purpose, it would have explicitly authorized the OCC to do so. If the OCC is allowed to proceed with the creation of a special purpose nonbank charter, it will set a dangerous precedent that any federal agency can act beyond the legal limits of its authority. We are confident that we will prevail on the merits.
>
> *–John W. Ryan, CSBS President and CEO*

Mercator Advisory Group will refrain from commentary on the merits of the case and simply keep our members informed as the case progresses. There are arguments and support on both sides. Given the overly complicated system in which the U.S. operates, it seems that any simplification in support of innovation has merit.

## Conclusions

U.S. regulators have been rather passive in the face of the rapidly evolving impact that fintech is having on the financial services industry. The OCC is in the process of expanding its role in this sector by allowing special purpose national bank charters to be filed by fintech companies. The principal reason is ostensibly to gain better control over the potential for instability in the financial services industry driven by lack of direct visibility into this explosive industry sector. Whether or not this continues to move forward depends on both the views of a yet-to-be-appointed replacement for Thomas Curry and the pending litigation introduced by the CSBS.

## Endnotes

i. Wall Street Journal, https://www.wsj.com/articles/regulator-will-start-issuing-bank-charters-for-fintech-firms-1480691712

ii. OCC, Exploring Special Purpose National Bank Charters for Fintech Companies, https://www.occ.gov/topics/.../special-purpose-national-bank-charters-for-fintech.pdf

iii. OCC, https://www.occ.gov/publications/publications-by-type/licensing-manuals/file-pub-lm-fintech-licensing-manual-supplement.pdf

iv. OLPI, https://olpi.info/2017/05/03/breaking-news-curry-replaced-at-occ/

v. GAO, 2016 Annual Report, http://www.gao.gov/assets/680/676473.pdf

vi. GAO, 2016 Annual Report, http://www.gao.gov/assets/680/676473.pdf

vii. GAO, Bank Regulatory Structure: Japan, http://www.gao.gov/assets/160/155689.pdf

viii. OCC, Comptroller's Licensing Manual, Charters, https://www.occ.gov/publications/publications-bytype/licensing-manuals/charters.pdf

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