THE OCC'S NEW FINTECH BANK CHARTER - WHAT YOU NEED TO KNOW

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On July 31, 2018, the Office of the Comptroller of the Currency ("OCC") announced that it will begin accepting applications for national bank charters from nondepository financial technology ("fintech") companies engaged in the business of banking. These "fintech banks," a form of a "special purpose national bank" ("SPNB"), would be required to engage in paying checks or lending money, or both, which are two of the three core banking functions necessary to be eligible for a national bank charter. [1] In the new section of the OCC Licensing Manual relating to fintech banks (the "Fintech Licensing Manual"), the OCC said that "facilitating payments electronically may be considered the modern equivalent of paying checks," thus indicating that at least certain payment processors could obtain the charter under the check-cashing core banking function. These fintech banks also could engage in any other activity that is permissible for national banks.

This article outlines some of the federal regulatory implications of becoming a fintech national bank. In Part 2, we will outline the requirements for and steps to the chartering of a fintech national bank, including the standards that a charter applicant would need to satisfy in order to obtain a charter.

I. CERTAIN BENEFITS OF A FINTECH BANK CHARTER

There are a number of benefits to a fintech national bank charter. The chief advantage for many fintech companies, and perhaps the advantage that most agitates opponents of a fintech bank charter, is the ability to preempt many state laws, including many state licensing laws. The ability to preempt state licensing laws comes with the second advantage of having only one supervisory regulator — the OCC.

Another probable advantage would be the ability to provide payment processing services without partnering with another bank or savings association, though exactly how that will play out in practice is yet to be determined. Finally, at least under current law, the parent company of the bank would not be a "bank holding company" and subject to the obligations and activity limitations of bank holding companies, which could make those companies much more attractive to investors.

A. Federal Preemption.

Both proponents and opponents of a fintech national bank charter point to the federal preemption authority of a national bank. For those in favor of such charters, federal preemption might be considered to be the primary justification for the charter and worth the many regulatory burdens that will come with that charter. For opponents of the charter, federal preemption is seen as limiting control by the states and a granting of benefits to nondepository institutions that creates unfair competition with traditional banks and particularly state-chartered banks that have very little federal preemption authority.

Federally chartered banks, savings associations, and even credit unions do have relatively broad ability to preempt state laws but not every type of law. The following lists the primary types of state laws that a national bank can preempt:

1. Licensing. With some limitations, states generally cannot require a national bank to obtain a license to engage in any activity that the national bank is authorized by federal law to engage in. Examples of activities that may be engaged in by a national bank without obtaining a license under state law include:
   - Making, brokering, or servicing of loans.
   - Cashing checks.
   - Issuing prepaid cards.
   - Accepting funds for transmission or transmitting of funds.
   - Selling or exchanging foreign currencies.
   - Offering debt cancellation and similar contracts with respect to loans made by the bank.
2. Interest Charges and Certain Related Fees. All state or federally chartered banks and savings associations have special interest rate authority. These institutions may charge the interest rate allowed by the state in which the institution is headquartered in all other states in which the institution makes a loan of the same type, except in the relatively few states that opted-out of this particular variety of preemption. In addition, certain loan-related fees also may be exported by banks and savings associations, including late charges, annual fees, over-the-limit fees, and creditor-imposed nonsufficient funds fees charged when a borrower makes payment with a check drawn on insufficient funds. There are conditions to this "exportation" authority, including with respect to determining precisely where the institution is "located," but this clearly is a benefit for these institutions if for no other reason because the institution can charge one rate nationwide and use the same terms generally on loans throughout the country.

National banks also may preempt state law interest rate limits when making first-lien residential mortgage loans, again except in the few states that opted-out of this preemption right. However, this particular preemption authority is available to most institutional lenders, so arguably this is not a significant reason in itself to obtain a national bank charter.

3. Noninterest Charges and Fees. National banks generally are not subject to state law limits on noninterest charges and fees, such as, by way of example, account service charges and check-cashing fees.
4. Loan Term Limitations. National banks also generally can preempt state laws in regard to loan terms and conditions, such as:
   - Loan-to-value ratios.
   - Payment schedules.
   - Amortization of loans.
   - Disclosures and advertising.

5. Branching. Uninsured national banks like fintech banks may establish branches in any state with only the approval of the OCC.

It is important to note, however, that not all state laws can be preempted by a national bank. Types of laws that cannot be preempted include laws relating to contracts, torts, right to collect debts, acquisition and transfer of property, and criminal law. In many instances, local unfair and deceptive acts and practices laws (UDAP laws) also are not preempted.

In addition, since the enactment of the Dodd-Frank Act, agents and nonbank subsidiaries of a national bank no longer enjoy the federal preemption rights of the national bank. If a fintech company that is considering a fintech bank charter is accustomed to conducting certain of its activities through subsidiaries, that company might decide that it is more advantageous to absorb the subsidiary into the company as part of the chartering process or before the process gets underway.

The value of these preemption rights also will depend on the fintech bank's actual lines of business. For example, if the bank is not engaging in lending, preemption of lending laws will be of no value.

In addition, while the fintech bank would be able to preempt state licensing requirements for issuing of prepaid cards, certain prepaid card offerings might raise federal policy issues. When a traditional bank issues a general-use prepaid card, such as a card that is network branded and usable everywhere that brand is accepted, the funds underlying the card are FDIC insured. As prepaid card accounts have become more common and are beginning to replace traditional bank accounts, FDIC insurance is being seen as particularly important. For example, any ability of a fintech bank to issue payroll cards without FDIC insurance might raise regulatory policy concerns. How that might impact a fintech bank's ability to issue such cards is unknown at this time.

B. Payment Processing.

One of the primary hurdles for a nondepository financial institution that provides money transfers or other payment processing services is the inability to conduct such transactions without partnering with a bank or savings association. This arises because electronic payment transactions in the United States, other than wire transfers, are conducted as automated clearinghouse (ACH) transactions, which settle through the Federal Reserve System in most cases, and generally, only banking institutions can obtain the necessary Master Account with a Federal Reserve Bank to settle transactions.

It is uncertain, however, whether the Federal Reserve would grant a Master Account to a non-FDIC-insured bank such as a fintech bank. A fintech bank, like every national bank, would be required to become a "member" of the Federal Reserve System and the Federal Reserve's Operating Circular governing Master Accounts specifically includes Federal Reserve member banks among the institutions that may be holders of Master Accounts. Even so, the Federal Reserve in the past has argued that it could refuse to provide a Master Account to an institution that posed "too great a risk" to the Federal Reserve System. Although that particular case involved a credit union that intended to offer accounts to legal marijuana distributors, the case indicates that the Federal Reserve believes it has at least some discretion in deciding whether to provide Master Accounts.

C. Avoidance of Bank Holding Company Act Obligations and Limitations.

Parent companies of banks, referred to as "bank holding companies," may be engaged only in financial activities and are required to serve as a financial source of strength for their bank subsidiaries. Under current law, subject to exceptions that are not relevant here, a company is a bank holding company if it controls at least one bank, and the term "bank" means a FDIC-insured institution or an institution that both takes demand deposits and makes commercial loans.

Since a nondepository fintech bank would not be subject to the BHCA, it could have an advantage over a traditional bank. For example, a fintech bank could attract investors that otherwise might be reluctant to hold a controlling interest in a bank's parent company in light of the source of strength doctrine and other obligations, such as compliance with the Volcker rule. [2] More importantly, potential controlling investors that are engaged in activities otherwise impermissible for a bank holding company also might find investment in a fintech bank to be attractive.

There is some possibility, however, that the OCC would refuse to grant a fintech bank charter to a company that is engaged in commercial activities such as retail sales of consumer products. When the OCC first announced that it was considering accepting applications for fintech bank charters, it stated in a draft version of the Fintech Licensing Manual that proposals from companies that "inappropriately intermingle banking and commerce could introduce into the banking system risks associated with non-banking related commercial activities" and would be inconsistent with the OCC's chartering standards. The Fintech Licensing Manual released in July does not include this warning, but the OCC still might be inclined to avoid chartering of an SPNB to a commercial company at a time when the concept of a fintech national bank is already so controversial.

In addition, as discussed below, the Fintech Licensing Manual indicates that the OCC might require a fintech bank to enter into a liquidity maintenance agreement with its parent company as a charter condition.

II. FEDERAL REGULATORY BURDENS

While a national bank charter offers many advantages, it comes with regulatory burdens that only relatively sophisticated organizations might want to accept. The following briefly outlines some of those burdens. Some of these regulatory requirements and limitations might be of little consequence to some fintech businesses, but others might be significant.

A. Capital and Liquidity.

Every fintech national bank would be subject to the minimum leverage and risk-based capital requirements that apply to all national banks. However, in its Fintech Licensing Manual, the OCC notes that these requirements only "set a floor" and may not be sufficient for certain fintech banks. Given that the new fintech banks would not hold FDIC-insured deposits, one might think that those banks could have lower capital requirements, but the OCC seems to be indicating otherwise. This may be because capital requirements typically are set in relation to assets and specifically risk-weighted assets. Since a fintech bank likely will have assets that are different than those of a traditional bank, and because the OCC will be unfamiliar with those assets and consequently less able to evaluate the riskiness of the assets, the OCC is likely to require higher capital than otherwise might be required. If the OCC grants charter approval, it will specify the minimum capital level that the bank must maintain or exceed at all times. The Fintech Licensing Manual also emphasizes that the OCC would expect capital levels to increase as the size, complexity, and corresponding risks of the bank evolve.

The liquidity expectations for a fintech bank also might present unique challenges. While insured banks generally can rely on deposits for at least some funding and liquidity, fintech banks will be uninsured and likely would need to find other funding sources. The Fintech Licensing Manual provides that the OCC may impose requirements that are tailored to the bank's funding model and that might include a requirement to into enter a liquidity maintenance agreement with a parent company.

B. Safety and Soundness.

The OCC's Policy Statement on the fintech charter states that a fintech company that receives a national bank charter will be subject to the same "high standards of safety and soundness" applicable to all federally chartered banks. Although the statutory source of bank safety and soundness requirements applies only to insured depository institutions, the OCC notes in the Fintech Licensing Manual that they may achieve the same goals through a charter condition.

The bank regulatory concept of safety and soundness might be unfamiliar to many nonbankers, but, broadly speaking, safety and soundness standards are intended to decrease risks to the particular bank and to the banking system as a whole. A state regulator might not care if a licensed lender or money-services business fails, but bank regulators understand that any bank failure has the potential to undermine public confidence in all banks. The OCC is likely to be particularly sensitive to this concern in light of the opposition to the charter by many banks and bank regulators. Accordingly, at least in the near future, the OCC might place particular focus on the safety and soundness of every fintech bank.

The OCC's safety and soundness regulations specifically address such matters as internal audits and controls, credit underwriting standards, interest rate exposure, executive compensation, and prudent asset growth standards, among other things. However, the OCC can cite safety and soundness concerns to justify a number of requirements and penalties. For example, in the months leading up to the crash of the real estate market, the OCC and other federal bank regulators were citing safety and soundness concerns as a basis for directing banks to decrease concentrations in commercial real estate loans.

Bank regulators generally are not comfortable with any "monoline" bank — a bank that focuses on a single line of business, which might raise issues for fintech banks that, almost by definition, will be offering limited products and services. While the OCC might be comfortable with a fintech bank's business model when granting the charter, later economic trends might cause the OCC to reconsider its position based on safety and soundness.

C. Directors and Management.

Unless the OCC grants a waiver, each director of a national bank must be a citizen of the United States throughout the director's term, and at least a majority of the directors must have resided in the state, territory, or district in which the bank is located, or within 100 miles of the bank's main office, for at least one year immediately preceding election to the board.

One challenge for any group seeking to charter a new bank is identifying management that will satisfy the OCC. The Fintech Licensing Manual states that the OCC would expect some members of the organizing group, the proposed board of directors, and management to have experience in banking or broader financial services. Indeed, in practice, the OCC routinely requires banking expertise of the management of a de novo charter. The OCC also notes, however, that sufficient technical knowledge, skills, and experience might be as necessary as banking and financial experience given the technology focus of fintech companies.

The full Fintech Licensing Manual provides that the organizing group must disclose its proposed chief executive officer when filing the charter application. Because even in the best of circumstances the charter approval process can take months, this often means that the organizers must identify suitable management long before a charter is issued and convince those persons to stay on board throughout the chartering process. The OCC then will conduct background checks on all of these individuals, considering the character, competence, experience, and integrity of all proposed senior managers.

D. Periodic Examinations.

Although one advantage of the fintech bank charter is that the organization usually would have only a single primary regulator and be subject to examination only by that regulator, OCC examiners have very high expectations, and their examinations can be costly. It also is fair to expect that the OCC will be particularly careful and thorough when examining fintech banks given that opponents of the fintech charter worry that those organizations will not be subject to adequate oversight.

E. Affiliate Transaction Limitations.

All national/member banks, which include the new fintech banks, are subject to limitations on their transactions with affiliates, including parent companies and other affiliated companies, although certain controlled subsidiaries of a bank are not considered to be "affiliates." These affiliate transaction rules limit the volume of covered transactions between a bank and its affiliates and prohibit certain transactions. "Covered transactions" for this purpose include, among other things, extensions of credit to an affiliate and the purchase of assets from an affiliate. The affiliate transaction rules also require, among other things, that all contracts for services between a bank and its affiliate be on arm's-length terms.

As an example, if a fintech bank wanted to purchase accounts or loans from an affiliate, the aggregate amount of such purchases, along with all other covered transactions with that affiliate, could not exceed 10 percent of the bank's capital stock and surplus. The total of all covered transactions between a bank and all of its affiliates could not in the aggregate exceed 20 percent of the bank's capital stock and surplus. The bank also generally may not purchase a "low-quality asset" from an affiliate.

F. Heightened Anti-Money Laundering Requirements.

While many fintech companies such as money-services business are already subject to anti-money laundering (AML) program requirements under the Bank Secrecy Act, those companies might find that their AML requirements increase upon becoming a fintech bank. One reason for this is that AML regulations applicable to banks are more detailed and impose greater obligations on banks as opposed to certain other institutions like money-services businesses. Although the Financial Crimes Enforcement Network's AML regulations for banks do not seem to apply to non-FDIC-insured banks at this time, the OCC's regulations require all national banks to comply with those regulations (in addition to the OCC's own AML regulations).

III. CONCLUSION

A fintech bank charter will come with many advantages over conducting a fintech business without the charter. These advantages include the ability to engage in numerous transactions without having to share profits with a bank partner, preemption of state licensing and many other laws, and having fewer regulators to contend with on a daily basis. However, the regulatory burdens and expectations that come with a bank charter might not be worth the corresponding advantages for every fintech company.

It might be reasonable to predict that the largest, most successful, and ambitious fintech companies will lead the way. K&L Gates is prepared to assist in those applications and will closely watch how the fintech charter and related rules take shape. As these matters develop, K&L Gates will publish additional alerts and articles.

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[1] Were the applicant to engage in the third core banking function, receiving deposits, it would be required to apply for Federal Deposit Insurance Corporation ("FDIC") insurance, which may or may not be granted by the FDIC to a fintech national bank and in any event would cause the applicant to be subject to a number of other laws, such as the Bank Holding Company Act ("BHCA"), Volcker, and direct Consumer Financial Protection Bureau supervision, which are not generally viewed as positive.

[2] Despite the fact that, as recently amended by the Economic Growth, Regulatory Relief, and Consumer Protection Act, the Volcker rule applies only to banks/holding companies with more than $10 billion in assets, it is still a significant deterrent to companies investing in banking entities.

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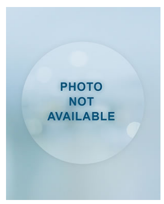

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