

New and Improved? Or Much Ado About Nothing? What To Consider Before Seeking a US National Bank Charter for Your Fintech Company

There's been a lot of talk recently that the US Treasury Department's Office of the Comptroller of the Currency ("OCC") might unveil a new fintech charter that would come with a "regulatory sandbox" in which financial technology ("fintech") companies could be free to innovate and experiment. The OCC's December 2, 2016 announcement (the "OCC Announcement")¹ that it will start accepting special-purpose national bank ("SPNB") charter applications from fintech companies is an overall positive development. Applying for an SPNB charter will be a viable option for some fintech companies, particularly those that are well capitalized and have a strong management team. However, it will not be a panacea for all. Fintech companies should review carefully the OCC Announcement to determine if it is a "fit." We expect trade associations and fintech companies will engage with the OCC at its new "Office Hours" sessions to get a better handle on if and how this announcement will change the competitive landscape.

The OCC also requested comments on the white paper itself and thirteen questions it presented. Comments to the OCC are due by January 15, 2017.

An SPNB charter might be appropriate for some fintech companies, particularly those currently burdened with conflicting 50-state compliance obligations or ineligibility issues (e.g., licensing,

interest rate exportation and payment systems access). But there's not enough detail in the OCC Announcement to say with any kind of certainty that an SPNB charter will be a good fit for a fintech company, particularly in light of capital, liquidity and source of funding issues. Fintech companies will want to engage with the OCC before deciding how the costs and benefits shake out for their business models.

This Legal Update provides an overview of OCC Announcement and some of the key points for consideration by companies evaluating whether to apply for an SPNB charter. This overview is followed by a brief summary of certain national bank application requirements and of the chartering process.

Fintech Bank Charter

Powers, Activities and Preemption. The OCC has authority under the National Bank Act ("NBA") to charter national banks, which are legal entities that engage in one or more of the following activities: (i) receiving deposits; (ii) paying checks; (iii) lending money; or (iv) providing fiduciary services. Full-service national banks may engage in all of these activities, as well as engage in all other activities that are within the business of banking. The OCC and the courts have extensively defined activities that are within the business of banking, such as

lease-financing, futures trading and issuing debit cards.

A fintech company that gets an SPNB charter would be a type of bank that must limit its activities to providing a subset of the three core banking functions and fiduciary services.² A fintech company with an SPNB charter would be permitted to engage in those activities and related activities that are within the business of banking. The OCC has indicated that, for example, an SPNB established to perform the core banking function of paying checks would also be authorized to provide electronic fund transfer services.

The NBA and its implementing regulations generally provide national banks with the authority to conduct their activities without regard to certain state laws.³ Furthermore, the OCC generally has exclusive authority to exercise visitorial powers (e.g., examination, inspection, regulation and supervision) with respect to national banks.⁴ This preemption and visitorial authority would apply to a fintech company operating under an SPNB charter. As a result of this preemption authority, national banks, unlike state banks and other nonbank institutions, are exempt from the effect of many state laws. State laws preempted by the NBA include state licensing laws, which can relieve some fintech consumer lenders from obtaining one or more licenses in all 50 states. The NBA also preempts state usury laws—which again vary on a state-by-state basis—by permitting national banks to follow the restrictions on interest rates and certain loan-related fees under the laws of the state where the bank is located, even when making loans to borrowers located in other states.⁵ That interest rate preemption works well if a fintech company is based in a state with favorable usury laws, like Delaware or South Dakota—but not so well for fintech lenders located in states with lower usury rates like New York and Massachusetts. While being relieved of complying with state licensing and usury laws, there are no corresponding

preemptions under the NBA for state laws on anti-discrimination (including fair lending), rights to collect debts, taxation, zoning, crime, torts, and unfair and deceptive treatment of customers.

Capital and Liquidity. A national bank must maintain levels of capital and liquidity that are commensurate with the risk and complexity of the bank’s activities. The OCC recognizes that the off-balance sheet activities of certain fintech companies may not align well with the generally applicable regulatory capital rules. Furthermore, the varying business activities of fintech companies make it difficult to apply uniform capital standards. Similarly, the contingent nature of the activities of fintech companies may not be consistent with regulatory expectations for liquidity. Accordingly, the OCC expects that fintech applicants for an SPNB charter will propose specific levels of capital that are appropriate for their activities, and that these entities will most likely hold capital in excess of the levels that would be required under the generally applicable regulatory capital rules. Additionally, the OCC has indicated that it expects to establish tailored liquidity requirements for fintech companies operating under SPNB charters.

Other Federal Regulators. The OCC is the primary regulator of national banks, but other federal banking regulators may have a role in regulating the activities and operations of national banks and their affiliates.

First, nearly all national banks are required to be members of the Federal Reserve System.⁶ Therefore, such “member banks” must subscribe to the stock issued by the Federal Reserve Bank that has responsibility for their geographic area and must comply with regulations issued by the Board of Governors of the Federal Reserve System (the “Board”) that are applicable to member banks. This would include Regulation W’s affiliate transaction restrictions, which are primarily intended to protect insured depository institutions, but apply to all member banks.⁷

Second, many national banks are controlled by holding companies that might be regulated by the Board as bank holding companies. A company is a bank holding company if the national bank that it controls (i) is insured by the Federal Deposit Insurance Corporation (“FDIC”) or accepts demand deposits and makes commercial loans and (ii) does not qualify for a statutory exemption.⁸ Bank holding companies are subject to extensive regulation that is independent of the regulation of the national bank, including independent capital and liquidity obligations. Bank holding companies and certain nonbank subsidiaries also are separately examined by Board examiners.

Third, full-service national banks are required to apply to, and receive approval from, the FDIC for deposit insurance. Until recently, limited-purpose trust companies accepting only trust deposits did not need to have deposit insurance. Unless it accepts deposits, a fintech company operating under an SPNB charter would not require deposit insurance.⁹ This would eliminate the FDIC from the chartering process.

Fourth, the Consumer Financial Protection Bureau (“CFPB”) has supervisory authority over large insured depository institutions (i.e., those with assets of more than \$10 billion) and certain nonbank financial services companies, including residential mortgage lenders and servicers, private education lenders and payday lenders, as well as larger nonbank participants in certain other consumer financial services markets, as defined by CFPB rulemaking.¹⁰ Depending upon its activities, a fintech company operating under an SPNB charter could be subject to supervision by both the CFPB and OCC.¹¹

No Regulatory Sandbox. Although there has been a lot of talk of providing fintech companies with a “regulatory sandbox” that would free them from some of the regulatory requirements that might limit their ability to innovate and experiment, any fintech company that receives an SPNB charter will be subject to the same federal laws and regulations, examination and

reporting requirements, and supervision as other national banks. Notable examples of federal laws and regulations that will apply:

- the Bank Secrecy Act (“BSA”),¹² other anti-money laundering (“AML”) laws and economic sanctions administered by the US Department of the Treasury’s Office of Foreign Assets Control;
- prohibitions on engaging in unfair or deceptive acts or practices under Section 5 of the Federal Trade Commission Act,¹³ and unfair, deceptive or abusive acts or practices under Section 1036 of the Dodd-Frank Wall Street Reform and Consumer Protection Act;¹⁴ and
- legal lending limits and limits on real estate holdings.¹⁵

Other federal laws and regulations would continue to apply based upon the activities of the fintech company. These laws would include the panoply of federal consumer protection laws, including the Truth in Lending Act,¹⁶ the Real Estate Settlement Procedures Act,¹⁷ the Home Mortgage Disclosure Act,¹⁸ the Equal Credit Opportunity Act,¹⁹ the Fair Credit Reporting Act,²⁰ the Fair Housing Act,²¹ the Servicemembers Civil Relief Act²² and the Military Lending Act.²³

Although certain provisions of the Federal Deposit Insurance Act (“FDIA”),²⁴ such as the safety and soundness and records retention provisions,²⁵ only apply to insured depository institutions, the OCC can impose similar conditions that are enforceable under the FDIA (notably, “Section 1818”) on an uninsured fintech company operating under an SPNB charter.²⁶

Financial Inclusion. The NBA charges the OCC with ensuring that national banks treat customers fairly and provide fair access to financial services.²⁷ A fintech company operating under an SPNB charter that obtains deposit insurance will be subject to the Community Reinvestment Act (“CRA”).²⁸ Although uninsured depository institutions are not subject

to the CRA, the OCC applies the principles of fair access and treatment that generally apply to national banks.²⁹ Accordingly, the OCC will expect a fintech company engaged in lending to detail in its business plan its commitment to financial inclusion. In developing its business plan, a fintech company engaged in lending should also:

- identify and define its relevant market, customer base or community;
- describe the nature of the products or services that it intends to offer, its marketing and outreach plans and the intended delivery mechanisms for its products and services;
- explain how such products, services, plans and mechanisms promote financial inclusion; and
- provide complete information about how the proposed bank's policies, procedures and practices are designed to ensure that products and services are offered on a fair and non-discriminatory basis (e.g., which consumer protections will be included).

Resolution and Recovery. If an FDIC-insured bank fails, it is resolved by the FDIC under the FDIA.³⁰ Uninsured national banks are resolved by the OCC under the NBA.³¹ The OCC recently proposed rules for the resolution of uninsured national banks.³² The OCC also has indicated that it will require fintech companies applying for SPNB charters to provide a comprehensive framework for how they will remain viable during a period of financial stress. Further, the OCC has indicated that an applicant for an SPNB charter should have a clear exit strategy if maintaining its national bank status is no longer viable.

Points to Consider in Evaluating the Fintech Bank Charter

In considering whether an SPNB charter is a possible option, a fintech company will need to consider a number of issues and perform a cost-benefit analysis. This analysis is an inexact

science and made more difficult given the lack of any specific requirements regarding capital, liquidity or the OCC assessment formula for fintech companies seeking SPNB charters. A few of these points are set forth below.

First, the company will need to determine whether it is eligible and its activities are permissible for a national bank. The OCC invites charter applications from fintech companies, but does not provide any significant guidance regarding the scope of this term or if it specifically excludes any types of businesses. The lack of specificity reflects the broad nature of activities that are within the business of banking and may be designed to provide the OCC with the discretion to consider applications from a wide range of existing banks, mortgage companies, finance companies, retailers or money service businesses. Nevertheless, the OCC could use its discretion to effectively impose parameters for the type of eligible applicants the OCC will find acceptable and their fintech operations. With respect to permissible activities, lending and payment businesses would almost certainly qualify. Other types of fintech companies, however, may require a more detailed analysis to determine how receptive the OCC would be to an application.

Second, the company will need to assess the additional banking laws and regulations that will apply to its business. For example, a fintech company focused on lending will need to consider lending limits, credit classification standards and loan loss reserves. In addition to the laws that are generally applicable to all banks, the OCC could require a fintech company operating under an SPNB charter to comply with those laws generally applicable to insured depository institutions (e.g., the Depository Institution Management Interlocks Act³³ or Anti-Tying Act³⁴) as a chartering condition, even if the company does not intend to seek deposit insurance. The OCC could apply these additional restrictions to ensure competitive equality, safety and soundness, or the needs of the public.

For example, the OCC has indicated that some type of community reinvestment obligation would apply even though the CRA would not technically apply to an uninsured national bank. The OCC could also require the parent of an SPNB to provide financial support through a Capital Assurance and Liquidity Maintenance Agreement or similar agreement.

Third, the company will need to consider the potential impact that the OCC's supervision and examination of the company's policies, procedures and compliance management system could have on the company's business and the ramifications if the OCC finds shortcomings. A fintech company operating under an SPNB charter could face informal, formal, or public enforcement actions as a result of the examination process. In addition to significant monetary penalties, the OCC could require the bank to terminate certain activities, replace management or raise additional capital.

Finally, the company will need to consider the impact of comprehensive safety and soundness regulation on the business. Although the OCC has suggested that it might tailor its supervision of a fintech company with an SPNB charter to some degree, the heightened level of oversight on national banks may effectively restrict or limit the operation of the business. For example, a company operating under an SPNB charter may need prior approval/non-objection from the OCC to deviate from its three-year business plan, create new subsidiaries, pay dividends or invest in other companies. These would be new restrictions for most fintech companies and may impair innovation and limit a company's ability to compete with nonbank institutions.

Application, Business Plan and Chartering Process

Application and Business Plan. Because an SPNB charter isn't a new or different charter, a fintech company seeking one will generally follow the same chartering process that applies

to all national bank applicants. This includes a detailed business plan that thoroughly explains the reason for seeking a charter and engaging in the proposed activities. The business plan should cover a minimum of three years and should reflect in-depth preparation by the organizers, the board of directors and management. In addition, the business plan should demonstrate that the proposed bank has a reasonable chance for success, will operate in a safe and sound manner, and will have adequate capital for its risk profile. Specifically, the business plan should:

- provide a comprehensive explanation of how the bank will use its resources to achieve its goals and objectives, including how it will measure such efforts;
- define the market that the bank plans to serve and the products and services it will provide;
- provide realistic forecasts of market demand, economic conditions, competition and proposed customer base;
- provide a realistic risk assessment that describes management's evaluation of the risks inherent in the proposed products and services (e.g., risks related to BSA/AML requirements, consumer protection, fair lending requirements) and the design of risk management controls and management information systems; and
- describe the experience and expertise of the proposed management and the board of directors.

In addition, the proposed bank should have a governance structure that is appropriate for the risk and complexity of its proposed products, services and activities. The board of directors should have a prominent role in the governance structure through participation on board committees, guiding the bank's risk management framework, as well as actively overseeing management, and generally exercising independent judgment.

Before submitting an application, prospective applicants should engage in discussions with the OCC both to understand its expectations and to assist the OCC in developing appropriately tailored supervisory standards based on the applicant's business activities, size and complexity.

Chartering Process. There is typically an extended chartering process comprising four principal stages:

- **Prefiling:** informal and formal discussions with the OCC take place and the business plan is developed;
- **Filing:** the organizers submit a formal application for a charter;
- **Review and evaluation:** the OCC conducts background and field investigations to determine whether the applicant has a reasonable chance of success, will be operated in a safe and sound manner, will provide fair access to financial services, will ensure compliance with applicable laws and regulations, will promote fair treatment of customers, and will foster "healthy" competition; and
- **Final approval:** the OCC determines that the applicant has met the requirements and conditions to operate under a federal charter. This stage includes the granting of "preliminary conditional approval," at which time a number of standard requirements are imposed (e.g., the establishment of appropriate policies and procedures, adoption of an internal audit system).

Additional conditions are often imposed in connection with the issuance of a new national bank charter. These approval conditions typically include that the newly-chartered bank not deviate from its business plan without prior approval/non-objection from the OCC. The OCC could also impose specific capital and liquidity requirements and require the submission of a resolution plan.

Request for Comment

The OCC has requested comments on 13 questions related to SPNB charters for fintech companies. These questions cover broad topics, such as how the OCC should set safety and soundness expectations for these banks, as well as more specific topics, such as how the OCC should regulate SPNBs that offer new products like bitcoin accounts.

Among other items, the OCC specifically requested comments on (i) how it should establish capital and liquidity requirements for uninsured banks engaged in fintech activities, (ii) the types of challenges fintech companies will face in adapting their business model to the OCC's expectations, (iii) how fintech companies operating under SPNB charters will fit into the competitive landscape of full-service national banks and existing nonbank fintech companies, and (iv) whether the OCC should use its chartering authority as an opportunity to address the gaps in the protections afforded individuals versus small business borrowers.

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Endnotes

¹ See OCC, *Exploring Special Purpose National Bank Charters for Fintech Companies* (Dec. 2, 2016).

² Existing types of SPNBs include trust banks, credit card banks, and cash management banks. See OCC, *Comptroller's Licensing Manual: Charters 50-60* (Sept. 28, 2016).

³ See, e.g., 12 C.F.R. §§ 7.4007-08.

⁴ 12 C.F.R. § 7.4000.

⁵ 12 U.S.C. § 85.

⁶ 12 U.S.C. § 222.

⁷ 12 C.F.R. § 223.3(w).

⁸ 12 U.S.C. § 1841(c).

⁹ Uninsured national banks may accept trust fund deposits. See 12 U.S.C. § 1841(c)(2)(C)(i).

¹⁰ 12 U.S.C. §§ 5514-15.

¹¹ The OCC and CFPB can examine a fintech company that does not have an SPNB charter if it is a service provider to a covered institution, for instance, a national bank. See, e.g., 12 U.S.C. § 1867(c)(1) (stating that service providers are “subject to regulation and examination by [the appropriate federal banking] agency to the same extent as if such services were being performed by the depository institution itself on its own premises.”).

¹² 31 U.S.C. § 5311 *et seq.*

¹³ 15 U.S.C. § 45.

¹⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 1036, 124 Stat. 1376, 2010–11 (codified at 12 U.S.C. § 5536).

¹⁵ 12 U.S.C. § 84 and 12 C.F.R. pt. 32 (lending limits); 12 U.S.C. § 29 and 12 C.F.R. § 7.1000 (limits on holding real estate).

¹⁶ 15 U.S.C. § 1601 *et seq.*

¹⁷ 12 U.S.C. § 2601 *et seq.*

¹⁸ 12 U.S.C. § 2801 *et seq.*

¹⁹ 15 U.S.C. § 1691 *et seq.*

²⁰ 15 U.S.C. § 1681 *et seq.*

²¹ 42 U.S.C. § 3601 *et seq.*

²² 50 U.S.C. §§ 3901–4043.

²³ 10 U.S.C. § 987.

²⁴ 12 U.S.C. § 1811 *et seq.*

²⁵ 12 U.S.C. §§ 1831p-1, 1829b.

²⁶ See 12 U.S.C. § 1818.

²⁷ See 12 U.S.C. § 1(a) (The OCC is “charged with assuring...fair access to financial services, and fair treatment of customers by, the institutions and other persons subject to its jurisdiction.”).

²⁸ 12 U.S.C. § 2902 (defining “regulated financial institution” to mean an “insured depository institution”); see also 12 C.F.R. § 25.12 (defining “bank” as a national bank with federally-insured deposits).

²⁹ See 12 C.F.R. § 5.20(f)(1)(ii) and (iv).

³⁰ 12 U.S.C. § 1821(c)(2)(A)(ii).

³¹ 12 U.S.C. §§ 191–200.

³² 81 Fed. Reg. 62,835 (proposed Sept. 13, 2016).

³³ 12 U.S.C. § 3201 *et seq.*

³⁴ 12 U.S.C. § 1971 *et seq.*

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