Increasing fintech bank charter applications draw ire from banks

By *Patrick Hoff*

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Banks and other traditional financial institutions are wary about the increasing number of applications from fintechs and nonfinancial companies seeking to charter industrial loan companies even as the U.S. Federal Deposit Insurance Corp. mulls a new rule aimed at boosting financial strength requirements for parent companies of the industrial banks.

The FDIC's proposed rule would require parent companies of industrial loan companies to serve as a source of financial strength as a condition of receiving deposit insurance coverage, protecting the Deposit Insurance Fund.

But William Stern, a partner at Goodwin Procter LLP, said the new rule would simply codify requirements that the FDIC has typically already imposed on an individual basis for companies seeking to establish an industrial bank or industrial loan company.

"The proposed rule is nothing new," Stern said. "What's new about it is it would take what the FDIC had done previously and just put it in the Code of Federal Regulations."

Brian Knight, senior research fellow and director of policy and governance at George Mason University's Mercatus Center, said industrial loan companies tend to be controversial, though, because of the potential they have for mixing banking and commerce. Though some industrial banks are owned by financial institutions, others are owned by nonfinancial companies.

Knight said even industrial loan companies run by fintechs narrow the regulatory advantage that banks enjoy.

"They could face a heightened competition, but it goes from being nonbanks versus banks to being new banks versus more traditional banks," he said.

Industrial loan companies first emerged in the early 1900s as state-chartered institutions that provided credit to low- and moderate-income consumers who couldn't get loans from banks. As the financial marketplace evolved, so did industrial loan companies, and eventually, nonfinancial companies, such as automotive and manufacturing firms, saw them as an attractive option.

In 2005, however, Walmart filed applications with the Utah Department of Financial Institutions and the FDIC to form a new industrial loan company, drawing protestations from commercial banks and financial regulators. Walmart subsequently withdrew its application, and the FDIC placed a temporary moratorium on industrial loan company applications. The 2010 Dodd-Frank Act also included a three-year moratorium on industrial loan company applications.

No industrial loan company applications have been approved since 2005.

However, when the FDIC approved deposit insurance applications from Square Inc. and Nelnet Inc. earlier this year, the regulator signaled that it is once more open to allowing new industrial loan companies, according to Tom Curry, a partner at the law firm Nutter McClennen & Fish and a former U.S. comptroller of the currency.

"That's probably the big news, or the big shift is that after a decade or more of the FDIC not approving these deposit insurance applications, they've now indicated a willingness to do it for financial technology-affiliated firms," Curry said.

Stern said chartering an industrial loan company is attractive to fintechs because it exempts them from needing to obtain a license in every state they want to operate in, allows them to accept deposits and frees them from relying so much on banking partners.

"You're able to essentially take control of your own destiny," Stern said.

Knight said fintechs also gain access to the Federal Reserve payment systems and are able to offer more to their existing customer base. For example, he said, Square can now turn to the small businesses that use its services and offer them additional products.

What those products are, said Prat Vallabhaneni, a partner at White & Case, depends on the fintech. Some may be more interested in the lending capabilities of a bank while others are more payment-oriented and want access to the Federal Reserve system.

“The ability to preempt state laws is a big part of it, unquestionably, just because the sheer management of a portfolio of licenses is a big burden,” Vallabhaneni said.

Those benefits, however, come with the cost of supervision, Stern said. Stern tells clients that establishing an industrial loan company is a privilege, not a right, and they will be taking on many of the responsibilities that other financial institutions must carry.

“They need to make sure they have the sort of risk management expertise and capability to comply with all the requirements,” Stern said.

Many fintechs, however, are already subject to stringent regulations at both the state and federal levels, Stern said, and they often work closely with banks and have to comply with the requirements that come with that.

“So I think that the fintechs are sort of in a unique position where they’ve been operating in this model where they’ve been learning from their bank partners and understand how the industry works and are in a good position to comply," Stern said.

It's not just fintechs getting into the banking business, though, and the entry of other players has drawn particular angst from traditional banks. Most recently, Japanese e-commerce company Rakuten resubmitted an application to establish an industrial loan company, called Rakuten Bank America. The company had originally submitted an application in July but withdrew it shortly thereafter.

Curry said bankers are generally opposed to nonfinancial companies chartering industrial loan companies, mainly because they want to maintain a level playing field within the financial industry and they are resistant to mixing banking and commerce.

Knight said banks are also concerned that an industrial loan company could provide bad loans to customers of the parent company in order to boost revenue knowing that the Deposit Insurance Fund is there to back up the bank.

"Now, there are laws against that that are supposed to prevent that from occurring, but there's a debate as to how effective those laws would be," Knight said.

Banks have not been shy about expressing their concerns. Earlier this week, the American Bankers Association, the Bank Policy Institute and the Consumer Bankers Association sent a letter to FDIC Chairwoman Jelena McWilliams opposing Rakuten's resubmitted application, asking the regulator to neither review nor approve the charter.

"We welcome interest in new ILC applications from companies that are primarily financial in nature. … The associations believe, however, that the application for Rakuten Bank raises significant issues," the industry groups said.

The main concerns outlined in the letter include a business plan that is narrow and dependent on the success of nonfinancial affiliates; concerns about the use, privacy and security of consumer information; and vulnerabilities in serving the needs of the proposed bank's community.

"Management at Rakuten, or another information-based technology company with a similar business plan, might well subordinate the interests of the bank and the community it intends to serve in favor of advancing the nonfinancial affiliate's core business," the industry groups said.

These vulnerabilities, they said, are not likely to be addressed by the FDIC's proposed regulatory requirements.

The American Bankers Association declined to comment, saying that its position on industrial loan companies and Rakuten's application was outlined in the letter. The Bank Policy Institute and the Consumer Bankers Association did not immediately respond to requests for comment.

Rakuten also declined to comment, directing Fastinform to a website of frequently asked questions about Rakuten Bank America.

Knight said the American Bankers Association's privacy concerns stem from the fact that Rakuten would have insight into how people use their money, allowing the e-commerce company to market certain products to different people depending on their preferences.

The flip side of that, Knight said, is the question of whether it's a bad thing that people would get more relevant advertising and marketing shown to them.