Consumer Finance Monitor (Season 7, Episode 34): Why do Fintechs Want to Become Banks?

Speakers: Alan Kaplinsky, Scott Coleman, and Michele Alt

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor Podcast, where we explore important new developments in the world of consumer financial services, what they mean for your business, your customers, and the industry. This is a weekly podcast show brought to you by the Consumer Financial Services Group at the Ballard Spahr Law Firm, and I'm your host, Alan Kaplinsky, the former practice group leader for 25 years, and now senior counsel of the Consumer Financial Services Group at Ballard Spahr. And I'm very pleased to be moderating today's program. For those of you who want even more information, either about the topic we're going to be talking about today or for that matter, anything else going on in the consumer finance world, don't forget about our blog, which also like our podcast goes under the name of Consumer Finance Monitor. We've hosted our blog since July 21, 2011, the very same day that the CFPB became operational.

So there's a lot of relevant industry content there. We also regularly host webinars on subjects of interest to those in the industry. So to subscribe to our blog or to get on the list for our webinars, please visit us at ballardspahr.com. And if you like our podcast, please let us know about it. You can leave us a review on Apple Podcasts, YouTube, Spotify, or wherever you access your podcasts. Also, please let us know if you have ideas for other topics that we should consider covering or speakers that we should consider inviting as guests on our program. So today we're going to talk about a very important topic that we haven't previously explored on our program although we talk about the fintech industry all the time, I don't think we've hardly ever talked about the idea of fintechs owning or converting into a banking charter, either a national bank charter, a state bank charter, or special purpose bank charter.

And that is a desire for a lot of fintech companies in the payments area, those that are involved in extending credit, the idea of being able to not partner with another bank in order to export interest rates is something that is very valuable. Also, some of the fintechs like the idea of being able to have access to low cost deposits as the source of funding, because that's often cheaper than other commercial sources of funding. Although we're going to be talking about fintechs in particular, it's almost my entire career, and that's long time, there have always been non-banks that have been interested in getting into the banking industry. At one time, they did it through something called Non-Bank Banks. There was a so-called loophole in the Bank Holding Company Act that companies that were involved in the commercial or industrial space would use to acquire a national bank and still not be a bank holding company.

One time I actually represented a consumer finance company. It was involved in making loans secured by automobiles with second liens on mortgages and believe it or not, was able to convince the comptroller to give a charter to this bank. And we did a purchase and assumption agreement and zap, we had converted a non-bank consumer finance company into a national bank with full national bank powers. Anyway, those are some of the old things, the things that were done before the internet was extant and before there was such a thing as fintech companies. So that's the subject that we're going to explore, and we've got two fantastic guests that are going to be discussing this subject with me. Let me first introduce our very special guest, and that is Michele Alt. Michele is the co-founder and partner of Klaros Group, K-L-A-R-O-S, which is a consulting firm.

Michele helps banks and fintechs navigate the complicated regulatory issues that are critical to their growth and sustainability. She's particularly focused on helping fintechs develop their US banking licensing strategies and draft their US business plans. She joined Klaros after spending time at another consulting group, Promontory Financial Group, where she was also involved very heavily in licensing efforts involving banks or companies that wanted to become banks. Prior to going into the consulting business, Michele spent 22 years in the law department of the Office of the Comptroller of the Currency, and she had several very important positions at the OCC. So Michele, very warm, welcome to you.

Michele Alt:

Hi, Alan. It's a pleasure to be here. Thank you so much for having me. I'm excited for this discussion.

Alan Kaplinsky:

Okay, and let me also introduce a special guest, but since Scott is a colleague of mine, I will say not as special as Michele. We always provide deference to our outside guests, but Scott certainly is a leading expert in this area. For some 30 years Scott has represented banks and bank holding companies in connection with mergers and acquisitions and other expansionary activities. He's also represented organizers seeking to form bank holding companies, apply for deposit insurance and charter new depository institutions. He has significant experience in a wide range of regulatory matters, including Reg O, Reg W, Reg Y, interstate banking and branching lending limits, Basel 3 and regulatory capital guidelines. So Scott, a warm welcome to you as well.

Scott Coleman:

Thank you, Alan. I'm excited to be here and most interested to hear Michele's views.

Alan Kaplinsky:

Yeah. Okay. So Michele, let's get started with you, and I'm going to just lay the foundation for a little deeper discussion as we get into our show, but why is it that so many fintechs want bank charters or put differently what are the problems they have with their existing charter that they're trying to solve for?

Michele Alt:

Well, sure, Alan, you mentioned it already in your introduction a couple of the key benefits of having a bank charter. I often shorthand it by saying it's like the slick Willie quote, slick Willie Sutton, who said he robbed banks because that's where the money was. So there are two very good reasons fintech might want to enter banking, and actually two very good reasons of fintech might not want to. In the pro column is what you already mentioned and where the money is. A bank charter provides access to low cost funding in the form of FDIC insured deposits.

You also mentioned the ability to export interest rates. We can get to that a little while later. Another significant pro is that bank charter eliminates the applicability of myriad state licensing requirements. In the con column of a bank charter are onerous capital requirements and regulators that are reluctant to embrace innovation. And those cons are inarguable, but they are increasingly outweighed with non-bank lending models for which deposit funding is critical, and banking as a service fintechs who are increasingly vulnerable without a bank charter. So for both groups, the overall pro is the ability to stay in business, Alan.

Alan Kaplinsky:

Okay. So Scott, when we talk about bank charters that can encompass a wide range of bank charters. There are federally chartered banks, state chartered banks, and then within each category there are different types of depository institutions. What do you think the best charter is for a fintech? And I'd like to get your thinking about that.

Scott Coleman:

Sure. Although a recent Supreme Court decision, which we might talk about cause into question the breadth of preemption available to a national bank. I think the preferred charter is likely a national bank if the fintech ownership structure permits it to be regulated as a bank holding company or financial holding company. If being a bank holding company or financial holding company is not acceptable either because the fintech or an entity that controls the fintech engages in activities not permitted of a bank or financial holding company, then an industrial loan company structure is preferred. That's not to say there's no regulation because the FDIC adopted 12C FFR 354 and does have some oversight over the parent company of an industrial loan company, but it offers greater flexibility for any parent company than the Bank Holding Company Act. After that, you probably have federal savings banks and state savings banks, but there are QTL limitations and savings and loan holding company limitations that might make those charters less attractive. State charters are also a possibility as well. I'd be curious to hear Michele's thoughts.

Michele Alt:

Sure. Well, here's what I tell my fintech clients. The best charter is the one you can get, and regulators haven't approved a de novo fintech bank application in several years, really not in this administration. And so yeah, an ILC would be great on National Bank. I used to be so pro National Bank Charter Pursuit that my partners at Klaros accused me of being an OCC Homer, to which I pleaded guilty. But we'll talk about the Cantero decision and how that may have lessened the appeal of national banks incredibly. But the more important barrier is that it has been extremely hard to get a new charter in the last few years, and that has left would be bank entrance to pursue charters through acquisition and some of those alternative state bank charters that Alan and Scott, you both mentioned.

Alan Kaplinsky:

Yeah. Well, let me follow up with you, Michele, on that. Why are the regulators being so tough here? Are they being unreasonable or are they perceiving risks with fintechs that maybe we don't see?

Michele Alt:

Well, regulators are reluctant to charter fintechs for a number of reasons. Many fintechs fueled by an FVC funding model that prizes growth over profits means that the fintechs aren't profitable. Many of them when they come knocking on the regulatory doors and profitability is an absolute must for a bank. So that's the first barrier. That growth ethos in some cases have led to lax risk management practices, as we've seen with the synapse debacle recently, and regulators have reason to be concerned about those risks, and they don't really have reason right now to want to own those risks. You charter a bank, you are responsible for it. And so I think that in total explains the reluctance.

Alan Kaplinsky:

Yeah, I mean, so do they require you before they would even entertain the possibility of giving you a charter, would you have to demonstrate profitability for some period of time in order to even get a meeting with them?

Michele Alt:

No, you can certainly get a meeting and you don't have to be profitable at the outset, but your business plan must have financial projections showing that the bank will be profitable within the three-year de novo period to even get a serious audience.

Alan Kaplinsky:

And then of course, their capital requirements as well. Right. I mean, I know at one time, I'm talking about a long time ago when I chartered this consumer finance company, the capital requirements were not that great, but today you need about $10 million of capital to begin.

Michele Alt:

What you need, so of course, to be considered well capitalized, generally you must have a minimum for a bank of 8%, tier one. In practice, and Scott, I'm sure you can share some details from your work, in practice the regulators will require substantial additional capital above that level. So I've seen not uncommonly say about 12%. What have you seen, Scott?

Scott Coleman:

Yeah, I think that's right. And especially in a de novo situation, you've got to fully capitalize for the growth for the entire three-year period. So if you think you're going to get to $200 million in total assets by the end of 36 months, you've got to have all of that capital upfront. And from a risk perspective, if they see aggressive growth, they're also going to scale up to the capital levels. So they might want to see, for an organization that's grown fairly rapidly, somewhere in the neighborhood of 14% even.

Michele Alt:

Yeah, and that's a really good point that Scott made. You have to have that capital upfront and a business plan can't say, "And we will raise the capital by year three." That will not fly. So it's a very expensive proposition.

Alan Kaplinsky:

And very time-consuming too, right?

Michele Alt:

Oh, so time-consuming.

Alan Kaplinsky:

You got to have a lot of patience.

Michele Alt:

You do have to have a lot of patience. The average days pending for review are well over a year, and that's review, and it takes months to prepare the business plan and application months. So it's a lengthy process.

Alan Kaplinsky:

Right, right. Do you do better going to them with an M and A transaction, a fintech wanting to merge or combine with a banking institution, an already existing banking institution?

Michele Alt:

Not necessarily Alan. Again, I'd welcome Scott's views here, but when SoFi and Lending Club acquired banks, the industry, the fintech industry read it as a memo that, okay, this is the way into banking and in practice the regulators do not view M and A as some sort of side door into the regulatory fold. They will review those proposed transactions and the applications and business plans as with the same degree of scrutiny as a de novo. So the main advantage of an acquisition and also the main disadvantage of an acquisition is that it comes with an existing bank. So a de novo, when you're approved for a de novo, you have 18 months to open your doors approved. When your acquisition is approved, you have a bank, it operates currently, so you can get right to business. I say that it's also a disadvantage, however, because typically the banks that are acquired by fintechs are very small and tend to need quite a bit of support to pivot to a fintech type model.

Alan Kaplinsky:

Yeah, I remember, Scott, you handled a transaction, I don't know if it was two or three years ago that I thought involved a fintech acquiring one of your community bank clients if my recollection is correct. How did that work? That seemed to go, at least in my perception, pretty smoothly.

Scott Coleman:

It took a while, and Michele is right about that. Anytime someone not known to banking, whether it be a fintech or an private investor seeks to acquire a bank, the application process is going to be much longer than if the acquirer is an existing bank. And so I usually tell people to expect an application process that is generally between 10 to 18 months, and that's just in the application process. And if you can do it in 10, you're doing great. Normally we see 12 months or more. A lot of analysis and a lot of time is lost in the process as they look through the ownership structure trying to determine whether there are any groups acting in concert for control purposes. So it's not just review the business plan and the financial projections. There are a lot of other things that the board of Governors of the Federal Reserve System in particular will look at that can really slow down that process. That transaction you're referring to, which closed a couple of years ago, took pretty much 24 months to get approved.

Alan Kaplinsky:

Right. Wow. Was that the Comptroller that approved that?

Scott Coleman:

It was. It was a federal savings bank that was acquired in my market that converted in the process to a national bank.

Alan Kaplinsky:

Okay. All right. Well now Michele, we're going to go get into a slightly different area. You mentioned very briefly an important, very important US Supreme Court decision, and you've alluded to it as well, Scott. It came down in the last month or so called Cantero versus Bank of America. And in that case, and I'm being a little bit facetious here, the Supreme Court didn't decide anything. It just kicked the can down the road, punted the case back to the Second Circuit Court of Appeals. What you had there was a New York statute that required the payment of 2% interest on mortgage escrow accounts, and a class action got filed against B of A, which was not paying interest on mortgage escrow accounts, went up to the Second Circuit.

The Second Circuit, basically, although they didn't rely on the Comptroller's regulations that deal with this issue of federal preemption of state law, they basically took a position very similar to the Comptroller's regulations and basically said that this New York law has an impact on a federal power, the power to lend money and the power to require mortgage escrow accounts, and therefore it's preempted. Goes up to the Supreme Court. The Department of the Comptroller that filed amicus curiae in the Second Circuit was frozen out of the Supreme Court because when you're at the Supreme Court level, the Solicitor General represents the US government, and they had a completely different position than the Comptroller.

Comptroller's regs provide in essence for categorical preemption of all types of state laws. But the Supreme Court basically said under Dodd Frank, the standard is the Barnett Bank decision, which was really an easy case for preemption because there you were talking about a bank wanting to engage in the insurance business in a town of less than 5,000. And the federal law expressly authorizes a national bank to do that. Florida had a statute that prohibited banks from getting involved in the insurance business. So it was like two powers conflicting with one another. Seemed like an easy case but the Supreme Court, I think made it more difficult than it had to be by referring to this significant impairment test that if there's not a direct conflict, then there's got to be a significant impairment of a federal right.

And they then cited a whole bunch of old Supreme Court opinions that I think have very little relevance to what the Second Circuit's got to do. And it's a problem not only in the Second Circuit, but there's a case in the Ninth Circuit involving Flagstar Bank that was being held up because of the Bank of America case, that's going back there. The First Circuit has another case that's been stayed. So you've got three circuit courts who are trying to figure out, and they all involve the payment of whether you have pay interest on mortgage escrow accounts.

And all I can say is I'm glad I'm not on that court because the guidance that the Supreme Court gave was pitiful, absolutely pitiful. They obviously just didn't want to spend any time on this case, and they figured it had to germinate for a while. But it's created a real problem for national banks who don't know what to do right now in an area that's fraught with a lot of danger. So Michele, why don't you pick it up from there on how that can have an impact on what fintech's thinking of converting to a national bank?

Michele Alt:

Sure, Alan, this is a subject I feel strongly about because I worked on many of the OCCs preemption opinions and drafted the preemption rules that we're talking about back in the day. Former comptroller, Jerry Hawk, who was really the dean of the banking bar back in his day, used to say that National Bank preemption was the crown jewel of the National Bank Charter. Preemption allows national banks to operate nationwide unconditioned by the need to obtain state or local licenses and to charge favorable home state interest rates regardless of other states' usury caps for example. The decision in Cantero surprised and disappointed me. The National Bank Act dates to the Civil War and its preemptive powers under the Constitution's supremacy clause have been upheld repeatedly by the Supreme Court over the years, including in the Barnett case, which Alan,

as you said, provides that state laws that "prevent or significantly interfere" with the exercise of the National bank's powers are preempted.

And as you said in Cantero, the court reversed a Second Circuit finding that a New York state law requiring the payment of 2% interest on mortgage escrow accounts was preempted because it purported to exert control over a national bank's power under the National Bank Act to establish mortgage escrow accounts. And Alan, as you've noted in your writing on this subject, the really scary part of this decision is the court's conclusion that an evidentiary hearing is necessary to determine whether the law significantly interferes with the national bank's powers. And that's scary because it's just a recipe for confusion and litigation and the beauty of a National Bank charter has been up to this point at least, the clarity of its powers. So I think this decision tarnishes the crown jewel and may make the National Bank Charter less appealing as a choice for some applicants.

Alan Kaplinsky:

Yeah. What's your reaction, Scott?

Scott Coleman:

Yeah, I don't disagree with that analysis of at all. I think it's an extremely problematic decision that's going to lead to litigation in other areas. I think ultimately we may see in this particular case, the right result reached eventually because fundamentally, if you're paying interest on mortgage escrows, you are fundamentally as a bank making less and earning less interest in total. So if you look at it through the interest lens, you might get to the right result. But the question is what other areas are we going to see litigation result? I'd still counsel clients that you're probably better off with a National Bank charter than a state bank charter, but again, we're going to see this shake out and it could take years to resolve.

Alan Kaplinsky:

Well, I mean, the worst case scenario is that you don't have any greater powers than a state bank. I mean, at the end of the day, and I think one of these cases is going to end up back in the Supreme Court again, and they're not going to be able to pun it. And maybe for, although I know it's very rare, maybe they will exercise some really common sense and worry a little bit about the practicality of an opinion that they're rendering to think that federal preemption is going to require an evidentiary hearing, and that could vary from state to state, it could vary with a particular bank over a period of time. What may be significant impairment today may not be significant impairment five years from now for a particular bank. I mean, it is horrible. But I would agree with you, the National Bank Charter I still think is preferable because worst case for you're treated like a state bank. You complied with the state laws that you have to comply with, and there are a lot of them.

I know that. We've done a 50 state survey not that long ago for State Charter Bank where the engagement asked us to identify state laws that as a matter of state law would apply to a state bank and new requirements that they would be subject to that they're not already subject to under some other federal law like Truth and Lending or the Truth in Savings Act, et cetera. So I think at the end of the day, you end up worst case, you're treated like a state bank. But I agree with you, Scott, that I think after these three cases that are in the courts of appeals, after they get decided it's going to go back to the Supreme Court and they're going to hopefully figure out or provide some clarity to an area right now that they have made very, very fuzzy. So let me ask you this, Scott. The OCC has a special purpose charter of some kind. I'm wondering if you could describe for us what that is and might that be an alternative?

Scott Coleman:

Sure. The OCC Special Purpose Charter, it's a full bank charter. You would be regulated by the OCC, but you would not be a deposit taking entity and you would not be regulated by the FDIC. I think it's probably not, in my opinion, an alternative for a fintech. When the special purpose charter was announced and when applications were being filed, litigation was started by state banking regulators and by the College of State Bank Supervisors. And the potential for delay of future litigation over whether or not the OCC has authority to issue these special purpose charters make it a far less viable alternative than it might otherwise be.

I also don't sense that there's a lot of support for it under the current administration, even though the OCC has stated in some cases a willingness to consider fintech acquisitions of banks as Michele mentioned. I just don't see them really pushing the special purpose charter in the near term. That could change with a different administration and maybe Michele's heard something I haven't on this subject.

Alan Kaplinsky:

Do you have any comment on that, Michele?

Michele Alt:

Yeah, I'm sorry to jump in here. Yeah, I consider that to be a dead charter. It never got off the ground, and I don't think it'll be resurrected. There were questions from the get-go. As Scott said, nobody wants to enter banking subject to litigation and confusion about the authority of the agency to grant the charter. And there were questions about whether that special purpose bank would have access to a Fed Master account. We've seen that play out, that question play out in connection with state alternative charters. So there's not been a clear demonstration of the utility of this charter. I don't anticipate it being revived.

Alan Kaplinsky:

Do you feel the same way, Michele, about, I think Georgia enacted some kind of special purpose charter, am I right, where the idea was to facilitate fintechs who wanted to get access to the Fed payment system?

Michele Alt:

Yeah. State alternative charters are definitely an interesting space to watch. The big obstacle, Alan, as I mentioned, to the usefulness of those charters like the Georgia Merchant Acquiring Limited Purpose Bank, the mouthful, Georgia MALPB and the Wyoming Speedy, the Special Purpose Depository Institution and Connecticut's Uninsured Bank. Those are examples. There are others. The big obstacle to the usefulness of these charters has been the fed's refusal to grant holders of these charters master accounts and the reluctance of the card networks to grant the membership. Recently, however, the Fed approved a master account for Numisma, and Fiserv has a pending application for Georgia MALPB, which is an indication that Fiserv has confidence about card network membership. So alternatives charters are looking more promising than they were a while back. So depending on the business model, Fed master accounts are a possibility, and I think we'll see some significant movement on the Georgia Charter, which that one, Scott, you can remind me probably, but that's been on the books for years and no one has pursued it because of this question about network membership and Fiserv pursuing it as big news in our circles.

Alan Kaplinsky:

So let's turn now to the IOC charter, industrial loan corporations or sometimes called industrial banks. My familiarity is with the Utah Charter principally because that's where a lot of our clients have owned industrial banks, and it used to be a few years ago, maybe more than a few, pretty easy way to get into the banking industry. The Utah Bank Commissioner was very receptive to commercial enterprises, non-engaged in banking coming into Utah to typically acquire an existing industrial loan company or industrial bank. And it's got FDIC insurance, and it was a nifty little thing that seemed to work for a while until it didn't work. So tell us a little bit about that, Michele.

Michele Alt:

You bet. An industrial loan company or industrial bank, as they are called in Utah, is an FDIC insured and supervised state financial institution that can be owned by commercial firms that are not regulated by a federal banking agency. That means a tech company or a manufacturing concern, for example, could own an ILC without being deemed to be a bank holding company subject to the fed's supervision. And that makes the ILC really the Holy Grail fintechs and other commercial companies that would like a bank charter because as Scott mentioned, a few minutes back holding companies, bank holding companies are restricted in their activities to those that are permissible for banks or financial in nature. This allows a parent

company of an ILC to continue its business outside of those narrow confines and without the supervision of the Fed, albeit now with some limited supervision by the FDIC. But it is nearly impossible in the current environment for a company like that, a manufacturing concern or a fintech to get an ILC charter. Scott, what are your thoughts there?

Scott Coleman:

Yeah, I think that's correct. Remember that there are really only seven states that technically you could have this charter and there are only two where there are active industrial banks or industrial loan companies, and those are Nevada and Utah. It's not without limitations themselves. You can't accept demand deposits, and the total assets of the institution have to be less than a certain dollar amount. But we saw Square get approved and Nelnet get approved a few years ago, and then things stopped until recently. And I've had clients that had applied and had to withdraw their application because it just wasn't going anywhere.

Alan Kaplinsky:

And I take it the roadblock is the FDIC, right? It's not the Utah or Nevada regulators?

Scott Coleman:

That's right.

Alan Kaplinsky:

Yeah. And so what's the issue there? Is it a political issue, the fact that part of the banking industry doesn't want the competition from major commercial enterprises? Is that the issue? Or is there really a safety and soundness issue?

Scott Coleman:

There's potentially a safety and soundness issue. There's also competitive issues in the fear of the unknowns, right? We had a long dormancy for this charter until Square and Nelnet were approved, in part because Walmart had applied for an industrial loan company charter, and there was concerns about the size of the institution, the breadth of the institution. I think today the concern is probably about Alphabet and Apple and others applying to be an industrial loan company because of the dominant market position they could have. And I think fear of the unknown is also most definitely an issue.

Alan Kaplinsky:

And I take it hasn't mattered whether it's been a Republican or a Democratic administration, that through both Democratic and Republican administrations, the FDIC hasn't been approving anything until we're going to get to one that they just approved. And I'd like to get your reaction to that.

Scott Coleman:

Joanna McWilliams was a little more interested in the charter, and when she was chair, that's when the Square and Nelnet applications were approved. And since then it was quiet until extremely recently.

Alan Kaplinsky:

Right, right. So let's talk about the approval that just happened, very conveniently for our podcast show, and that is Thrivent. First of all, why don't you tell us, Scott, what Thrivent is?

Scott Coleman:

Thrivent is, it's a mutual organization. It used to be AID association for Lutherans, and Thrivent holds currently a credit union. And so had applied for an industrial loan company charter into which it proposes to merge the credit union. And what we saw is that the FDIC has approved now their charter, which gives them 18 months, as Michele mentioned earlier, to

consummate. They do not yet, I do not believe, have NCUA approval of the merger of the credit union into the industrial loan company. But that is certainly the direction they're proposing to head.

Alan Kaplinsky:

And so why do you think they approve this after they've not shown any receptivity toward approving many other applications from much bigger organizations?

Scott Coleman:

Well, I'll defer to Michele on some of this because I know she wrote about some of this recently and what she thinks is going on. But I will note that from competitive standpoint, if there was already a credit union and a mature credit union with about $830 million in total assets, approving an industrial loan company isn't really expansionary and isn't really adding competition, number one. Number two, from a risk to the deposit insurance fund perspective, the fact that they've already got capital behind this credit union, that they've got an operating history and that they probably are not forecasting significant growth from here, means that from the FDA's perspective, prudentially, there's less risk to the deposit insurance fund than there might be from a fintech coming in.

Alan Kaplinsky:

Michele, so tell us what you think this signifies.

Michele Alt:

Yeah, I think you have to look at Thrivent's application outcome in conjunction with GMs ILC application outcome. And that tells you everything you need to know about the FDIC's views on ILCs right now. So on June 14th, the Utah Department of Financial Institutions approved the ILC applications of both GM and Thrivent Financial for Lutherans. And Alan, as you mentioned, Utah is very receptive to new bank formation and ILC formation, but it is still unusual to publicly make a different decision than the FDIC. On June 19th, GM withdrew its insurance application and two days later the FDIC approved Thrivent's application. So the question of course that I've been asked several times is why did GM withdraw its application after being approved by Utah? Why would GM have done that when it was so close to success? Apparently just two days away? And the answer is because GM wasn't close to success at all.

Now, I should make clear I do not represent General Motors, so this is my speculation, but it is informed speculation. And the only reason an applicant would withdraw their application in this situation is that the FDIC gave the applicant the choice to voluntarily withdraw the application or have the agency publicly deny it. And that way the applicant avoids public embarrassment while perhaps waiting for a more favorable regulatory climate. And the FDIC avoids the appearance of blocking new bank formation, and this is a very routine play on the part of the agencies.

By approving Thrivent the FDIC can also rebut the criticism that the agency is particularly antagonistic to industrial bank formation. But the key here to figuring out what happened to GM versus what happened to Thrivent comes in the statement of acting comptroller Michael Sue on Thrivent's approval. He said, and I quote, "The proposed bank would look a lot like a community bank." And so what you're looking at is a statutory charter created specifically for commercial entities to own ILCs being used for 501(c)(8) fraternal order to effectively run a community bank. And that is not a traditional model for an ILC, but it does tell you a lot about what the FDIC is comfortable with.

Alan Kaplinsky:

Right, right. Let's turn to another subject, and that is the rise of embedded finance. How does that impact the outlook for ILCs? Maybe first tell our listeners what you mean by embedded finance.

Michele Alt:

Oh, gosh. There are lots of different definitions of embedded finance, but it's basically where the banking aspect of a transaction is embedded into the way you are interacting with the other party in the transaction. So a frequently cited example

is your Starbucks app or your Uber app. What's embedded in that app is your payment information. So it makes these transactions extremely easy and embedded finance is a huge and growing market. Some predictions are that it'll reach $384 billion annually by 2029, and with major providers in very well-resourced segments like healthcare, for example, offering embedded finance, I think the power dynamics may change the political environment for ILCs in the coming years. So we'll have very, very wealthy corporations with a lot of political power providing services to a great number of US consumers who, by the way, love their apps and looking at ILCs as a perfect solution to their banking aspirations, one that will serve community convenience and needs and bring these companies under the regulatory purview, the banking agencies. So I think that has the potential to change the dynamic for ILC.

Alan Kaplinsky:

Right. So Scott, what should a potential applicant consider in weighing the option of trying to acquire a bank and to try to get regulatory approval to acquire a bank charter?

Scott Coleman:

First of all, they've got to have patience. As we talked about, it's a long process. If you're talking about an application process that could be over a year, you're talking about whether it's acquiring existing charter or filing a de novo application preparation time in front of that, that's going to add substantially to the project. You also need to identify a team of trusted advisors. The crucial part of the application is always going to be the business plan, and that will be weighed in connection with the experience and expertise of the management team and the availability of the capital. The business plan and the financial projections that are wrapped up within the business plan are a significant lift to prepare, and you need somebody expert to do that. Somebody like Michele and Klaros, for example. It is just almost impossible for an organization on their own to be able to put it together.

So you have to, as I said, have the patience and the resources and the advisors to put it together. And you have to be willing to color within the lines. Your business plan has to make sense to regulators that do not like rapid growth, who want to see slow, steady development, who don't like novel financial products. And so you have to consider all of those things and weigh all of those factors to determine whether filing for a charter is right for you. I've had many conversations with some of our clients, Alan, where at the end of the day we say the charter doesn't, the application doesn't make sense, or acquiring a bank doesn't make sense because growth expectations or capital expectations just can't be satisfied.

Alan Kaplinsky:

Right. So Michele, what are your thoughts on what Scott had to say?

Michele Alt:

Well, I absolutely agree with Scott's criteria that fintech should be considering. I would add only one additional, which is does the fintech have an alternative? And this is an increasingly existential question in the banking as a service context. So we are seeing lots of enforcement orders in this space directed towards the banks, limiting the bank's ability to support new fintechs or expand existing programs, offer new products and services. And we are seeing increasingly the partner banks offboarding fintechs or not allowing them to grow as a result. And this creates, as I said, an existential problem for the fintechs.

Some of the saddest calls I get in my work are from fintechs in a panic over being offboarded, and increasingly now just being able to find a redundant relationship if not being onboarded, but another one to manage their partner bank risks. And so they are at existential risk to regulatory outcomes that they have no control over. And this becomes a question of, can you stay in business? If not, are you able to meet all the criteria Scott just laid out? And if the answer is no, can't stay in business otherwise, and yes, I can meet all those criteria, then that's a good time to start thinking about applying for a bank charter.

Alan Kaplinsky:

Wow. The history tends to repeat itself, Michele. I recall, again, I'm rolling back the clock, when I think Jerry Hawk may have been the comptroller of the currency, Julie Williams, I think it was the general counsel and maybe you were the OCC when the

OCC decided that they didn't like the idea of banks partnering with payday lending companies. And over a relatively short period of time, they told the national banks, and then eventually this thing leaked, came down, the FDIC developed the same hostility, and they said, "You've got to get rid of your relationships with payday lenders." At the time, I was very hostile to that because they were all doing quite well. They just politically, it just didn't look good. Nobody liked the payday lending industry, and it tarnished the National Bank Charter and any bank's charter. Am I right? Isn't this history repeating itself?

Michele Alt:

Well, yes, and it's interesting you should bring that up. It is important that as part of your application, you convinced the regulators not just that you will not be a risk to the deposit insurance fund, but that you will not create reputation risk for the agencies, and the agencies do not want to see their banks engaged in unsavory activities. And in the matter you mentioned, that was an example of Jerry Hawk saying, "If you want all the benefits of the National Bank Charter, including preemption, the old crown jewel, you're not going to be lending it out to payday lenders."

Alan Kaplinsky:

Right, right. Yeah. That's when the colloquial expression Redibank started. So Scott, also, what other lessons can be drawn from OCC enforcement actions that have been taken?

Scott Coleman:

Yeah, and it's OCC and FDIC enforcement actions. Basically, the bank partnership model has been under attack. We've seen a number and a flurry of these consent orders. And what they emphasize is that if you're a fintech, you need to understand the importance of third party risk management. And that's true if you're partnering with a bank or if you're going to be acquiring a bank yourself. It's particularly important that you've got to have strong BSAML policies and practices. We have seen financial institutions that, for example, were focused on foreign correspondent banking, get hit with enforcement actions over the last couple of years for BSA concerns. You have to recognize that, as I mentioned before, the regulators are going to be concerned by rapid growth. And as Michele mentioned, there are political components to this. If you're going to be pushing the edge from a consumer compliance standpoint or running high interest rate loan programs, you're going to find some challenges to either get approval or be seen as a viable acquirer.

Alan Kaplinsky:

Right, right. So what happens if we have a new president? Come January 20th, I think of next year, Trump comes into office, Michele? Does everything change overnight?

Michele Alt:

Maybe not overnight, but very quickly. You can expect new leadership at the OCC, certainly the CFPB, the chair of the FDIC will change hands to a Republican, will see a markedly different approach to banking, bank regulation and fintech in all likelihood.

Alan Kaplinsky:

Yeah. Well, any final thoughts? We've come to the end of our podcast show today, but before we bid everyone farewell, just wondering, first of all, Scott, do you have anything that you'd like to add?

Scott Coleman:

It's important to talk to experts early as you're considering opportunities and early pre-filing meetings with regulators can also be very productive if you're thinking that this is a realistic alternative for you.

Alan Kaplinsky:

How about you, Michele?

Michele Alt:

Well, I agree absolutely with Scott's comments and echo his earlier statement that this is a project that is extremely difficult to handle on your own. So I would urge those who are thinking of meeting to the regulators to not do so without guidance.

Alan Kaplinsky:

That's for sure.

Michele Alt:

Only have one chance to make a good first impression, and that is the most critical meeting you will have.

Alan Kaplinsky:

Yeah. Okay. Well, let me, first of all, thank you, Michele, for joining us today. I really appreciate your taking the time and being willing to share with our audience what's involved in this subject of fintech's acquiring or converting to banks. I think we covered it pretty thoroughly. And while I think you painted a, both you and Scott, painted a negative picture about the ease of doing this type of acquisition or conversion things, as you pointed out, could change very quickly. Whether they say the old expression elections have consequences, and we certainly saw that last time during the first Trump administration, things changed very rapidly at the CFPB, and then when Biden got elected, they changed very rapidly the other way.

So thank you Michele and Scott, my thanks to you as well. And I want to thank our audience for downloading our podcast show today. And to make sure you don't miss any of our future episodes, subscribe to our show on your favorite podcast platform, apple, Spotify, YouTube. Don't forget to check out our blog, consumerfinancemonitor.com for daily insights on the consumer finance industry. And if you have any questions or suggestions for the show, please email us at podcast, that's singular, @ballardspahr.com. Stay tuned each Thursday for a new episode of our show. Thank you for listening, and have a good day.