



So, you want to be a bank?

Disruptors and innovators in the financial services field, so-called “fintech companies,” are facing important strategic decisions and perhaps opportunities regarding the next phase of their development. As we approach 2019, fintech companies are internally asking:

- Does my business plan have long-term viability?
- Can I survive the next credit cycle?
- Will what got me here today so successfully get me where I want to be in the next 5 to 10 years?
- Is my current bank partner delivering as expected?
- Is my desired scale being limited due to regulatory barriers?

Introduction

Specific advantages that fintech companies have had relative to banks are a start-up culture, a lack of legacy and outmoded technology infrastructure, and a regulatory environment that has allowed them more time to focus on product development and customer experience.

Successes to date have been accomplished through bank partnerships, nonbank funding models, and a group of licenses at the state level.

Notable figures include:

A growth in extensions of credit from

\$11b to **\$284b**
(2013) (2016)

36% of unsecured personal loans in 2017 were the responsibility of fintech companies in the US alone.¹

While fintech organizations have forged important partnerships and relationships with traditional banks to deliver innovative solutions, many are still ultimately reliant on banks for many of the aspects of money movement.

While operating outside of the banking industry has had its advantages, there are numerous advantages to having a bank charter, including:



Access to stable, lower-cost Federal Deposit Insurance Corporation (FDIC)-insured deposits



Direct payment system access for dollar clearing



Ability to operate across state boundaries under a single regulatory framework through national pre-emption, which enhances regulatory certainty



Imprimatur of approval from licensing authorities



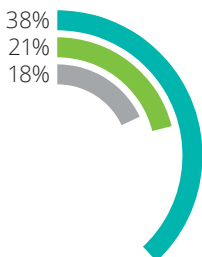
Emergency borrowing from the Federal Reserve Bank (FRB) discount window

Based on a recent survey of fintech companies, these advantages can assist with many concerns:

Figure 1. Top three concerns for 2018

■ First concern ■ Second concern ■ Third concern

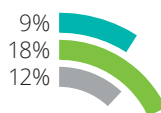
1. Cost of funding



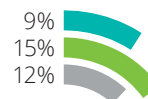
2. Liquidity



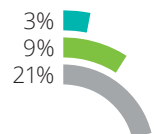
3. Inability to diversify



4. Lack of demand



5. Regulatory



Source: "Online Lending Cost of Capital Survey," Deloitte Center for Financial Services and Lendit Fintech, April 2018.

Why become a bank?

Depending on the fintech company's product mix and future strategy, these banking industry advantages may be critical to obtaining sustainable profitability and generating scale in the next phase of their evolution.

Some of the strategic choices that fintech companies face today include:



Operate and fund independently of the banking system



Utilize bank partnership model for access to the payments system and credit product funding and/or offering of joint banking or financial products



Formally enter the banking system with a charter



Prepare for sale to traditional banks or other fintech companies

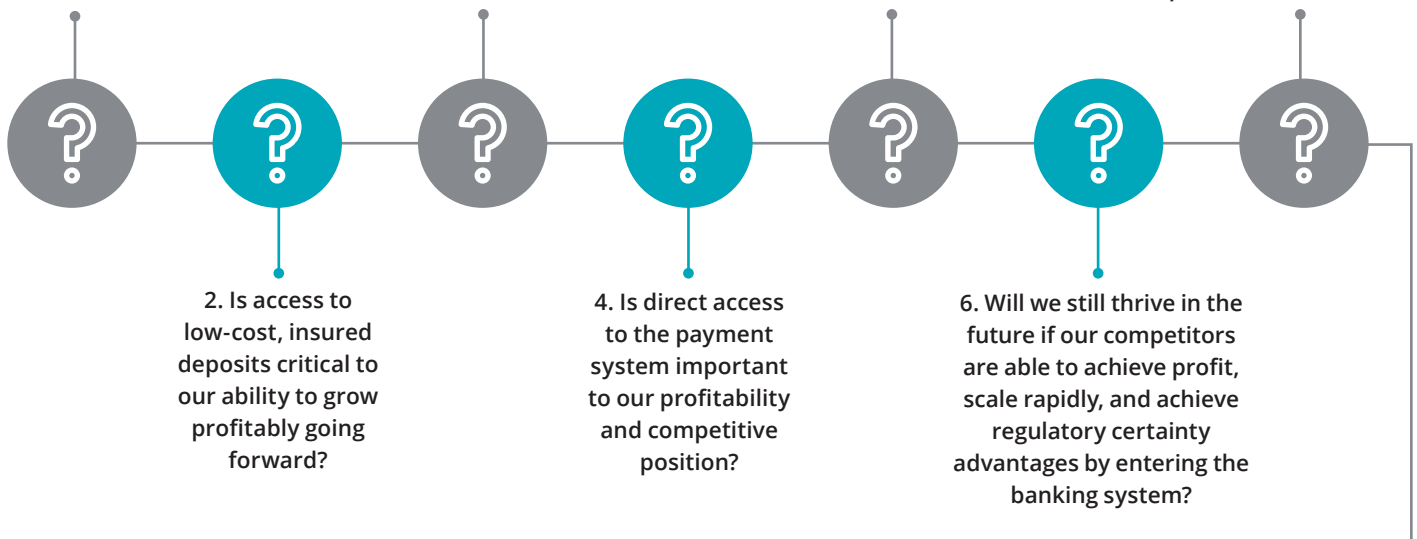
As many fintech companies ponder whether entering the banking system is the applicable strategy for them, they should consider the following questions:

1. Does our current business model involve a strategic dependency on a bank or other partner?

3. Would a stable funding base of insured deposits and access to the discount window materially improve our ability to weather times of stress?

5. Is the ability to operate across state lines in a consistent manner critical to our ability to scale profitably in the future?

7. Would more traditional banking deposit and lending products complement our set of existing products and services?



If the answer to one or more of those questions is yes, then fintech companies should consider dedicating effort to evaluating the benefits, costs, and opportunities of further entering the banking system through a banking charter.

Methods of entry

Entry into the banking system can be accomplished by organizing as a new, so-called *de novo* bank or through the acquisition of an existing bank. For simplicity, our analysis will consider a fintech company's acquisition of an existing bank as a *de novo* charter formation since the bank regulatory agencies will effectively evaluate the acquisition through that regulatory lens. At present, there are several charter types for entering the banking system that a fintech company should consider, each having its own distinct advantages and potential drawbacks.

Bank charter types include:



National bank charter

(full service and special purpose "FinTech Charter")



State Charter

(Federal Reserve member/State and Federal Reserve nonmember and FDIC/State state nonmember)



Industrial Loan Corporation

(ILC charter by FDIC)



Thrift or savings and loan charter

(Federal and State)



Trust Charter

National Bank Charter

The Office of the Comptroller of the Currency (OCC) charters, regulates, supervises, and examines national banks. A key attribute of the national bank charter is the ability to operate across state lines under uniform federal laws and regulations. The national charter affords preemption of certain state usury laws and any other state laws that may significantly interfere with a national bank exercising its powers. These preemption powers provide the ability to offer uniform products across state lines more efficiently and effectively with greater regulatory certainty. In parallel to the charter application, an institution must also apply for and receive deposit insurance from the FDIC.

Special Purpose National Bank Charter— FinTech Charter

The recent announcement by the OCC of a special purpose national bank charter targeted toward fintech companies ("FinTech Charter") has received widespread attention (see also our blog <https://www2.deloitte.com/us/en/pages/regulatory/articles/treasury-and-occ-push-for-new-fintech-tone-direction-and-opportunities.html>). While it has many of the features and advantages of a full service charter including preemption of usury laws, the FinTech Charter does not permit access to FDIC-insured deposits. By the same token, the FRB has noted that should a FinTech Charter be approved by the OCC, the FRB would need to scrutinize carefully whether to provide the company with direct access to the payment system and the emergency discount window borrowing privileges. These capabilities are routinely approved or granted by the FRB for traditional bank charters.

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Advantages of the FinTech Charter include the lack of a formal requirement to adhere to the Community Reinvestment Act (CRA); but there would be expectations that a fintech company demonstrate a commitment to “financial inclusion” tailored to its activities and scope of operations. Another advantage is that the traditional parallel application seeking approval for insurance from the FDIC is not necessary.

While the OCC has asserted that granting the FinTech Charter is fully within their authority to grant, the New York State Department of Financial Services (NYDFS) and Conference of State Banking Supervisors (CSBS) have sued to prevent granting of the charter. Regardless of a focus on the external threats to traditional banks and public interest in the chartering decision, the first FinTech Charter applicant will likely undergo a rigorous review by the OCC as it appropriately vets the proposal against its regulatory and policy standards.² As such, many of the companies considering a FinTech Charter have been hesitant to be the first to go down this path.

State Bank Charters

Each state licenses commercial banks and other charters. Unlike national banks, state banks have both a state and federal regulator. So-called “state member banks” are chartered by a state and establish membership in the Federal Reserve System, thus making them subject to joint regulation, supervision, and examination by both the FRB and the state financial regulator. So-called “state nonmember banks” are state chartered banks whose federal regulator is the FDIC rather than the FRB as part of their joint regulation, supervision, and examination.

As a practical matter, applications for state charters require approval by both state and a federal regulator. While state commercial bank charters have the many advantages noted earlier, such as payment system and discount window access, their ability to operate in other states without being subject to local restrictions is not as certain from a legal perspective compared to national banks, which benefit from federal preemption of certain state banking laws. Moreover, with both a state and federal regulator, there are certain built-in redundancies in the supervisory process such that there are more regulatory relationships to manage.

Another advantage of the FinTech Charter is that the traditional parallel application seeking approval for insurance from the FDIC is not necessary.

Industrial Bank or Industrial Loan Corporations

The Industrial Bank or Industrial Loan Corporation charter (collectively “ILC”) is granted by several states, notably Utah and Nevada, which brings the advantage of being exempt from the Bank Holding Company (BHC) Act. In effect then, the FRB does not regulate, supervise, or inspect the holding company for ILCs. While ILCs are permitted to offer FDIC-insured deposits, they generally cannot offer traditional demand deposits. A distinct advantage of the ILC charter is the ability to, in many cases, operate across state lines while preempting individual state usury laws.

Due to US laws designed to separate banking and commerce, controlling owners of banks held directly or through a holding company are limited in their permissible activities³ to those directly related to or incidental to banking. In contrast, owners of ILCs are not limited in their ability to conduct nonfinancial commercial activities. As many fintech companies are partly owned or controlled by funds that may also invest in commercial enterprises, the ILC charter avoids the burden of a required holding company formation by the funds and potential required divestiture of commercial (nonbanking) activities required by the BHC Act.

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One current drawback to the ILC charter stems from the fact that no new charters have been granted since prior to the financial crisis. The charter remains controversial, as some commercial firms have tried to use this as a vehicle to enter the banking system, only to face public and competitive opposition. At least one fintech company has applied, but stated that it temporarily withdrew its charter application to bolster its business plan.

Thriffs, Savings and Loans, Credit Unions

Thriffs, savings and loans, and credit unions are also offered with a national and state charter. Similar to banks, the deposits of credit unions must be insured by the National Credit Union Association (NCUA). All of the above references relative to full national and state charters apply for each, with the exception that thrift charters have certain mandates and requirements with regard to the amount of lending and investing that is directed to home loans, and credit unions must adhere to certain requirements to maintain their tax-exempt status.

Trust Charter

Trust companies are starkly different from traditional banks in that their scope of services is generally limited to fiduciary services such as trust and estate administration, corporate trust, retirement plans, investment management and advisory, and other general custodial activities that do not involve the taking of FDIC-insured deposits or extensions of credit. Given the limited business model, which is dependent on service fees as opposed to interest or “spread income,” and therefore poses little-to-no risks to deposits, trust companies’ liquidity and capital requirements are less stringent.

Depending on the selected banking structure (National Bank, State Bank, etc.), also consider the bank holding company structure depending on activities and services provided.

Bank Holding Company

Whether a fintech company needs a parent bank holding company that owns the bank will depend on the charter type, ownership structure, and whether the fintech company itself engages in activities that are not incidental to or permissible for commercial banks (with the exception of the ILC charter). If a class of fintech company or other corporation is deemed by the FRB to have explicit or implicit control over the bank, the BHC Act may require that company to become a BHC in order to hold those shares. The FRB generally will begin evaluating quantitative and qualitative factors of whether control exists if the voting share ownership is above 9.9 percent and/or a shareholder or fund has one or more board seats. A 25 percent or more voting share ownership or a majority of board seats is considered control according to statute. If the fintech company is engaged in nonbanking financial activities, such as trading activities through a broker dealer, then the company would need to establish the holding company to hold both a bank and broker dealer subsidiary as affiliates. A bank holding company requires an application with the FRB and will come under FRB supervision. The depth and intensity of that consolidated supervision would be dependent on the size, complexity, and scale of the fintech company’s proposed subsidiary and parent operations as a bank holding company. In summary, while the holding company structure provides additional flexibility in terms of a fintech organization’s scope of operations, it also entails a myriad of additional requirements including reporting, as well as a supplemental layer of application, approval, and ongoing supervision.

The application process

Each chartering authority whether federal or state has its own application requirements and process. The federal banking agencies and the CSBS have established a uniform application template for consistency and ability to meet multiple application needs with a single filing. The content of a charter application and its corollary business plan can be summarized as follows:

- ✓ Describes organizers who are familiar with applicable banking laws and regulations
- ✓ Describes overall governance structure including competent management, a board of directors, with the ability and experience relevant to the type of products and services to be provided
- ✓ Provides for sufficient capital in relation to the proposed business plan
- ✓ Demonstrates how the entity can reasonably be expected to achieve and maintain profitability
- ✓ Describes how the entity will be operated in a safe and sound manner
- ✓ Demonstrates how its business poses acceptable risk to the FDIC's Deposit Insurance Fund, if applicable
- ✓ Demonstrates that its corporate powers are consistent with applicable federal and state banking laws and regulations

As practitioners in the field can confirm, regulators expect applicants to consider meeting with the relevant federal and state authorities prior to a formal application to provide an overview of their interest and plan in owning and operating a banking organization. This can assist potential applicants in understanding any potential impediments and garner feedback as to any special or additional information that they may seek in order to fully evaluate whether to approve the application. In some instances, especially where the proposed business plan is novel or the company is seeking a FinTech Charter, providing a draft application prior to formal submission can assist with a more efficient and effective path to preliminary and then final approval. As a nod to advances within the industry and innovative solutions, many regulatory agencies have established or announced the establishment of Offices of Innovation, including the OCC, Bureau of Consumer Financial Protection, and FDIC.

Important considerations for the business plan components as part of the application review include, but are not necessarily limited to:

- > Risk assessments
- > Records, systems, and controls, including risk oversight, compliance risk management program, and anti-money laundering program
- > Financial management, including financial and capital projections
- > Monitoring adherence to the business plan and revising the plan if needed
- > Alternative business strategy, including contingency plans and recovery/exit strategies
- > Community Reinvestment Act strategy or Financial Inclusion plan for FinTech Charters

Financial, governance, risk management, and compliance expectations

The regulatory requirements and expectations for access to FDIC-insured deposits and the banking system include robust financial, governance, risk management, and compliance capabilities that mitigate risks to the federal safety net and potential harm to consumers. As part of the bank entry evaluation and preparation, firms should consider conducting a gap analysis against current and future capabilities, evaluating how their current financial resources, risk, and governance approach may fall short of the more formal requirements embedded in bank regulations and guidance.

Focus, in particular, should be on the level of capital and liquidity required to weather cyclical and adverse conditions given the fintech company's proposed business strategy and risk profile. A specific capability

expectation is for roles and responsibilities across what are commonly referred to as the "three lines of defense" (business line, independent risk management, and internal audit) to be adequately defined and supported by qualified staff and infrastructure. Further, a well-designed governance framework—including the board of directors and committees of senior management, risk, and assurance functions. Further, a well-designed governance framework—including the board of directors and committees of senior management, risk, and assurance functions—is required in order to provide reasonable checks and balances over the firm's risk taking and operations. For firms contemplating a FinTech Charter, there is an additional requirement for recovery and resolution planning as well.

All of these capabilities will be tested by examiners potentially prior to approval and through post-approval exams, to verify that the company's operations are fully aligned with supervisory expectations.

How can we help?

Bridging the space that exists between banking application regulatory requirements and a company's existing business model is how we help clients translate the implicit and explicit capabilities of becoming a bank while aligning to the overall strategy of the company.

We can facilitate the process to reach alignment on the preferred bank chartering option to move forward. Once the preferred chartering option is identified, we can help project-manage the application process across your company. In doing so, we can further enable workstreams through *pro forma* development, supporting regulatory capability assessments, writing sections of the business plan, or providing thought leadership on industry practices to help you build the internal capacity regulators will seek. Starting up a bank while operating a successful enterprise is no small task.

Conclusion

So where to now?

First and foremost should be an evaluation across the core elements of your business plan and growth strategy. While entry into the banking system may appear daunting at first, its many long-term strategic advantages may, for some entrants,

outweigh the initial costs. As the fintech and banking ecosystems further evolve and intertwine, time will tell how much competitive advantage fintech banking entrants are able to gain relative to their nonbank peers.

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Endnotes

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2. Office of the Comptroller of the Currency. July 31, 2018. Policy Statement on Financial Technology Companies' Eligibility to Apply for National Bank Charters. Available at <https://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/pub-other-occ-policy-statement-fintech.pdf>.

3 Engaging in Activities That Are Financial in Nature, 12 U.S.C. § 1843, available at <https://www.gpo.gov/fdsys/pkg/USCODE-2017-title12/pdf/USCODE-2017-title12-chap17-sec1843.pdf>.



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