

LendIt Fintech



Welcome to the Fintech One-on-One Podcast, Episode No. 321. This is your host, Peter Renton, Chairman and Co-Founder of LendIt Fintech.

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Peter Renton: Today on the show, I'm delighted to welcome Michele Alt, she is a Co-Founder and Partner at Klaros Group. I wanted to get Michele on the show because we're going to be digging deep into bank regulation here, bank charters, fintech charters, the whole nine yards. I learned a great deal in this episode and I'm sure you will too so make sure you stick around all the way to the end.

We cover the nuances of different types of bank charters, why fintechs go for one charter over another, we talk about some of the unique things that are happening like what Figure is doing, talk about the Wyoming State Special Charter they have there. We talk about Varo's charter and we also cover some of the things that Brian Brooks talked about last year when he was head of the OCC and Michele also talks about what she would do if she was head of the OCC. It really was a fascinating episode, hope you enjoy the show.

Welcome to the podcast, Michele!

Michele Alt: Well, thank you, Peter, it's delightful to be back talking to you.

Peter: Yes, indeed. So, let's get started by giving the listeners a little bit of background about yourself. I know you spent many years as a bank regulator, but why don't you give us some of the highlights of your career to date.

Michele: Be happy to. I am a Co-Founder of the Klaros Group and a Managing Director of Klaros Advisors. I am a lawyer by training and inclination, I must admit. I spent more than 20 years in various policy and legal roles at the OCC focusing on national bank powers, preemption, inter-agency regulation, licensing and Dodd-Frank. After leaving the OCC, I cut my teeth in the consulting world helping a range of banks with various risk and strategy matters, ultimately, focusing on bank chartering and fintech before leaving to co-found Klaros.

Peter: Right. So, tell us a little bit about that. What was the impetus behind the founding of Klaros Group?

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Michele: Well, my partners and I believed that there was a need for a consulting firm focused on the future of financial services. We observed that legacy consulting firms were too tethered to the legacy financial services industry and not really attuned to the business models and technologies that increasingly define financial services in the US and around the globe. So, we set out to build a firm that combined deep experience in the management of financial services businesses, deep regulatory expertise and deep understanding of the capital markets and investment landscape.

Peter: Okay, interesting, interesting. So, I want to dive right in and just talk about bank charters. We're going to spend a bit of time on this, not the entire interview, but it's really interesting watching the space over the last several years where, you know, there was initially a real push for a fintech charter and we're going to talk about that in a little bit, but then in recent times, fintechs are really going after a full bank charter. So, why do you think fintechs, you know, want this bank charter?

Michele: Well, you know, when my fintech clients come to me... they're typically late stage, they're worried they're outgrowing the bank partnership they grew up with. Their options, at that point, are to figure out how to optimize that bank partnership, become a bank, acquire a bank or sell themselves. I work with my clients to figure out which of those options work for them and then help them execute on their decision.

For the fintech clients who decide they want a bank charter, the reason they do is very simple. A bank charter provides direct access to the payment system, low cost stable funding in the form of insured deposits and in certain instances preemption of state laws so it's a pretty good deal. Fintechs also...they want to reduce the complexity of their businesses, increase their efficiency and reach more consumers and for some fintechs the bank charter is the way to do that.

Peter: Right. So, let's maybe talk about the different types of bank charters, I know there are several. Maybe you could kind of just give us a little bit of an overview of the different types of charters that are available.

Michele: Since you don't want this podcast to be 45 minutes of bank charters, I will try to be brief because it could really be a long discussion, Peter. So, let me rate the charter types into two very broad categories. First Category are those that subject the bank's parent company to the Bank Holding Company Act, that's Category One. Category Two is those that don't.

Peter: (laughs) Okay. So, all charters fit into one of those categories, I'd say.

Michele: Almost all, almost all, yeah.

Peter: Okay.

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Michele: So, on the non-exempt bank charters, so we have two basic types, FDIC-insured national banks, those are OCC-regulated, they're members of the Federal Reserve and they can engage in a full range of banking services and then there are State Fed member and non-member banks. They are state-regulated and they can also engage in a full range of bank services. So, really on the non-exempt bank charters there are two basic types, national and state and they are full service banks. When we get into the exempt bank charters it gets more complicated and fintechs are typically interested in exempt charters. They are interested in those exempt charters so that the fintechs will not be subject to federal oversight and they can continue to engage within the broader corporate group and activities that may not be permissible for the bank holding company.

Broadly speaking, there are five types of exempt charters. Let's start with the one that is always the most popular is number one, ILCs, industrial loan companies or industrial banks, depending on the state statute, they're the same thing, ILCs and industrial banks are the same thing. They're offered in about six states, they are state-regulated, they can pretty much do what a full service bank can do with certain limited exceptions that you can work around. They are FDIC-insured, they are very controversial and we'll get more into that in a minute.

Number two on the hit parade is the national trust bank, those are OCC-regulated, they can only engage in activities permitted by state laws for state trust banks so they derive their powers from state law. Generally, that means no lending. So, a national trust charter is a very old type of charter, but the OCC recently conditionally approved national charters for several crypto companies which is, of course, a controversial use of that charter and we'll get more into that in a minute too.

Number three in the exempt charters are state trust companies, those are state-regulated, basically the same as national trust banks. Now, some states like New York are for trust charters for crypto companies, specifically.

Number four would be the uninsured national bank, we're going to talk about that in a minute when we talk about the Figure Bank application.

And then, finally, Number Five is the Wyoming Special Purpose Depository Institution which is a SPDI, that is primarily a bank that accepts deposits and provides digital asset custody services and is prohibited from lending. A SPDI that is not FDIC-insured does not qualify as a bank under the Bank Holding Company Act so we'll talk about those in a minute too. And then I would just say that there are some other states that are getting into the Wyoming SPDI game like Nebraska and Illinois and I think that's a space to watch.

Peter: Interesting.

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Michele: (laughs) So, those are the exempt and non exempt

Peter: Well, you've given us a lot to dig into there. Maybe you can talk about the different....like you said, the ILC charter is one that many fintechs are going after and Square has been approved for theirs, but there are then others that are doing the, I don't know what officially the charter is called, but Varo got this, they were the first.

Michele: That's a national bank charter.

Peter: That's just a national bank charter and so they are non-exempt, right.

Michele: That's correct.

Peter: Yes. So, they have to adhere to all of the Bank Holding Company Act rules. Is the main reason that a fintech would go for an ILC rather than what Varo did, a national bank charter, is it because of some of those rules really aren't very suitable for fintech companies. Maybe you can talk about that.

Michele: So, ILCs, pretty much every fintech client who comes across the transit for me ask me first about ILCs, they always want an ILC, right, and an ILC is a good gig if you can get it. (both laugh) You get pretty much all of the benefits of a full service bank without the Bank Holding Company oversight, but as I mentioned, they are controversial. Banking industry advocates argue that ILCs are a loophole to the Bank Holding Company Act sort of. Personally, I like this oversight and they argued that loophole should be closed. I would say that that has a receptive body ends of the FDIC, I think that the shift at the FDIC Board recently makes the prospect for new ILCs perhaps a bit dimmer and there haven't been very many ILCs in the first place.

There was a moratorium post-financial crisis and then you mentioned Square and now that has two ILCs that got approved for something. I don't know how many more we're going to see make it, make it across the finish line, but the other thing to come caution about ILCs is that the FDIC also has proposed a rule that would effectively impose Bank Holding Company Act-like requirements on the parent of an ILC. So, that might lessen the interest in these charters a little bit.

Peter: I mean, if a new fintech were not a new fintech but a new client of yours, potential client, comes to you and says, we're interested in ILCs, do you advise them because there's going to be risk involved because as you said, the FDIC Board has changed its make up, they're not going to approve any more ILCs. So, you could go down that path and not have any luck, do you advise your clients now to sort of go to the national bank charter-type like what Varo did or what do you say?

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Michele: Well, not in the first instance. What I do when a client comes and says, I want an ILC, usually, my first question is why, even though I know the why is because they don't want a Bank Holding Company Act application to their business. But then, I dig a little bit deeper, right, so what is it that you're concerned about, what is it that you think having an ILC will help you avoid, what are you trying to do. I'm not saying that Bank Holding Company Act application is not a big deal, it is a big deal, but being a bank of any kind is a big deal.

So, what we do is we just work through the options with these clients and one of the main criterion that I apply is likelihood of approval and that depends not just on charter type, but what is the business at issue, etc. If you read the Nelnet and Square approvals there's some insights on what the FDIC might be receptive to so it's really not something I can say, you know, thumbs up, thumbs down about, it depends on the business itself. That said, fintechs should certainly consider national bank charters a la Varo, right.

There are some really important benefits to a national bank charter for fintechs. Absent a national bank charter to operate nationwide, a fintech company must rely on a complex patchwork of licenses, attempt to comply with conflicting state rules, sometimes conflicting state rules and submit to perhaps a dozen different examinations by state agencies each year, it's a hassle, right. A national bank charter, by contrast, is a single charter administered by a single regulator pursuant to a comprehensive set of rules.

So, obtaining a national bank charter will allow a fintech to offer a cohesive set of products and services nationwide, focus its compliance efforts on the requirements of a single regulator, reduce its legal and regulatory costs, complexity and risk and offer its customers the security and safety of dealing with a federally-regulated and supervised national bank. That's great, but it's a big lift.

Peter: So, what is it about the Bank Holding Company Act that really is a stumbling block, is that something like a number of investors? I think I've read, what is the main stumbling block?

Michele: You know, there are often issues about ownership with fintechs. Quite often, they have, you know, very concentrated ownership and that doesn't always align with the Bank Holding Company Act requirements. Ownership is an issue and often comes down to just are the FTVs, right, that are going to be conducted within the broader corporate group. For many fintechs, it's no big deal, you know, they are primarily conducting activities that are bank permissible or financial in nature, but sometimes, I've had clients that, and I'm not going to name any, it's no unusual for a fintech to have a brilliant visionary founder/CEO, right.

Sometimes, they want to get into some pretty interesting (Peter laughs) areas that are just going to be non-starters before the banking regulators. And so, what I often see when we're talking about when I said, you know, the potential applicant comes to me and says, I want an ILC, I don't want a bank holding company and I say, okay, how come. In fact, a lot of times, what

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they're doing is completely permissible within a bank holding company structure, but they don't want to be constrained in case something really interesting comes up that they'd like to do.

Peter: Right, that makes sense. So, speaking of visionary founders, I want to talk about Figure and obviously Mike Cagney's company. We had a session on this a few months back with the general counsel and yourself discussing this in detail and I'll link to that in the show notes, but when I sort of heard about what Figure was doing I didn't even know this path existed so maybe you can explain it and why someone would want to go down this sort of path that is not well trodden.

Michele: That's true, it's not well trodden. It's very simple though in concept and here it is. Figure Bank would not take retail deposits, therefore, it would not be FDIC-insured, therefore, it would not be a bank for purposes of the Bank Holding Company Act and, therefore, the holding company will not be a bank holding company subject to that supervision. Very simple in concept, right.

Deposits, the rest of that stuff does not flow. The thing that's important to remember when we're talking about this because a lot of people would say, what do you mean a bank that doesn't take deposits, right, it doesn't take insured deposits, I want to stress, insured retail deposits. There is ample historical precedent for this charter, keep this in mind, because the National Bank Act dates to post-civil war, time of Lincoln.....

Peter: Right.

Michele:which preceded the Federal Deposit Insurance Act by many decades, right. All of the national banks, originally, were not FDIC-insured. So, lawyers can do what they do and, you know, split hairs and get in the arguments, but that is the crux of it. The National Bank Act is not conditioned or premised on the idea that the banks would be FDIC-insured because when it was written federal deposit insurance didn't exist. That said, there isn't a lot of examples of banks currently that are uninsured in the way that Figure is attempting. That decision is pending with the OCC so we will see.

Peter: Right, right, interesting. So then, does this still mean that the fintech charter is dead. I mean, you were at the OCC I think with the genesis of this with Tom Curry, it all sort of came out then. What is the status and your opinion of the fintech charter?

Michele: Yeah. Everything that we've been talking about does not lead to the conclusion that the fintech charter is dead, but indeed, the fintech charter is dead, in my opinion. The OCC and I really commend Tom Curry on this, in 2016 recognized that the traditional national banks subject to the Bank Holding Company Act just doesn't work for many fintechs seeking to innovate within the financial services space. Unfortunately, though, I think that the OCC got out

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of over it's skis with the fintech charter in 2016 and didn't have the buy-in of the other banking agencies or the trade groups and without that, I just don't think that charter could succeed.

Peter: I mean, we've certainly seen a lot of traditional banks, trade organizations, you know, particularly the state, competent state board...supervisors, for example, have come out and they tried to sue to the OCC that there was no charter that had been issued so it was trying out, but I'd love you to weigh-in on this sort of conflict between the state bank supervisors and the fintech companies that want a federal charter-type thing. What do you say to them and what...fintech companies, by definition, are online-based, it knows no state boundaries typically so how do you kind of approach that argument.

Michele: This is a toughie. The debate and the dual banking system, state versus Fed, I am not going to say it's as old as Adam and Eve, but it's old (Peter laughs) and I'm not going to be able to solve that problem on this podcast. But, I think what we see, with respect to the idea of the fintech charter, are really good intentions on both sides, right. We see, as I said, the OCC seeking to foster innovation, right, in the national banking system and do so in a way that accommodates fintech business models, that's great, right.

On the state side, we see similarly good intentions, right, but what the CSBS typically points out is state regulators often are the incubators for innovation, we'll get to that, the SPDI is a good example of that and that they are primarily focused on consumers in their states and know their needs very well, right, and are concerned about what might appear to be a work around some of the regulatory burdens that their state banks are faced with. Their state banks are not getting a pass on the BHCA.

Peter: Right, right, got it. So, before we move on, I want to just go back to revisit the Special Purpose Charter which is what the fintech charter was because we had Brian Brooks who had a short but quite active time as acting head of the OCC late last year and early this year, I mean, he was really vocal about how we should have special purpose charters. He talked about the fintech charter, he talked about the payments charter, what are your thoughts on those sort of narrowly-defined charters.

Michele: Well, I also commend Brian Brooks on his desire to foster innovation in the national banking system, but I think the current regulatory environment just isn't conducive to new types of charters. With the caveat and in a minute we'll talk about the possible StableCoin issuer charter that's very intriguing, but leaving that aside, I think it's also important to remember, there's a lot you can do within the existing national bank charter, for example, or some of the state charters.

So, within the existing national charter as we see, you're not demonstrated by the Figure application, you can accommodate some very innovative business models and, as I said, there

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are a number of the SPDIs and the trust charters that we recently conditionally approved for some crypto companies show that within very, very old legal frameworks, innovation is possible.

Peter: Well, can we touch on that then now like the Wyoming Charter which...you know, they've granted the charter to at least two crypto companies, Avanti Bank and Kraken, can you describe what is unique about what Wyoming has done.

Michele: First let me say, I think that the Wyoming SPDI and other similar efforts afoot show that the states are going to eat the Fed's lunch, right. (both laugh) As the winds are blowing cold on crypto in DC right now, there is more and more interest in developing these state charters. I'm getting more questions about it and I don't see the state regulators, you know, comparing crypto to credit default swaps, right, they are very much signaling that they are open for business and receptive to new applications.

So, I promise this will be my last commendation at the podcast, but Albert Portner in Wyoming has really provided a very interesting option allowing SPDIs to accept all types of deposits, including demand deposits from consumers which may be an on-ramp to crypto and other digital assets like in the Kraken Bank model. So, I think there's much to be explored there and with, as I said, similar state efforts.

Peter: You keep saying SPDIs, I haven't heard that term before, would you explain that.

Michele: Oh, I'm sorry. It's Special Purpose Deposit Institution.

Peter: I've heard that, I just didn't think that was how it was said.

Michele: (laughs) Are we talking about Speedy Gonzalez here?

Peter: Right, right, okay, great. So, let's go back to Varo because...I believe you worked on that as well, but that was a long process and they got it over the line. It's always hard to be first, but do you think that the fact what Varo has done has paved the way for an easier time for fintechs to go down that route now?

Michele: I don't think it's ever going to be easy (Peter laughs). You know, I just, a moment ago, promised that was going to be my last commendation and I know I'm doing a lot of commending on this, but my hat is off to Colin Walsh and his team including his general counsel, Marina Gracias. A De Novo National Bank application is not for the faint of heart. Varo applied for and received approval for a national bank charter then it had to apply for FDIC insurance which got approved, then they had to apply for status as a bank holding company, right, that is a lot of work.

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So, in response to your question, do they make it easier for other fintechs? No, they provide a model which is very important, they provide an example that the lift is large, but it's not impossible. But, any applicant for a bank charter should prepare for a very lengthy chartering or perhaps change of bank control application if they go the acquisition route and if they succeed, a very high degree of regulatory complexity and scrutiny, right.

Peter: So, should it take three years, is that what people should expect which I think is roughly what it was for Varo.

Michele: I don't think it should take (Peter laughs) three years, I don't think the process is going to be fast. One important difference I think in the current environment, and we're seeing and Michael Soo has made an important point of this which is we're seeing a greater emphasis on inter-agency coordination in reviewing these applications. I think that one thing that's kind of unfortunate is, speaking of the OCC, the OCC and the FDIC have slightly different application processes, but they use the same application. So, I think in Varo's case and there were good reasons why it did a serial set of applications that I described, first National Bank and FDIC and the Fed, you can apply for the bank charter and the FDIC insurance at the same time which may reduce the overall processing time.

Peter: So, I've seen a lot of fintech companies over the years, let's say some, they apply and then they withdraw the application. Why do they do that, is that just inexperience or is there some reason behind this apply/withdraw kind of process?

Michele: Nobody should ever apply thinking they may withdraw. Withdrawals happen for a variety of reasons. One reason though is that the agency has determined that the application will not succeed, either it's not complete as presented or raises fundamental concerns on the part of the regulator. Common concerns with fintech applications are lack of profitability at the parent level or uncomfortable with banking and commerce. Those are two things that give regulators quite a bit of heartburn. The profitability issue, it's a real rub.

Fintechs often focus on growth over profitability, at least in their initial phases, and that is not an approach that the regulators are particularly comfortable with, right. Pursuant to Dodd-Frank, the parent company of a bank is required to serve as a source of financial and managerial strength to the subsidiary bank so if the parent is not profitable, that raises concerns about its ability to serve as a source of strength. These are issues that can tank an application or at least cause it to be withdrawn and resubmitted. I always tell my clients, we're not going to go forward if there is any risk of withdrawal.

Peter: Obviously, profitability isn't a deal breaker because Varo has not been profitable and they were approved so what's the rub there?

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Michele: I do believe Varo is intending to be profitable within the de novo period and that is, in fact, a hard requirement of the regulators.

Peter: Okay.

Michele: They don't expect profitability out of the gate, but they do expect a bank to achieve it within three years.

Peter: Got you. So, final question, I want to sort of do a little fantasy game here like let's say the current OCC pick is rejected and President Biden puts your name forward, you are confirmed by the Senate and you're running the OCC, what changes are you going to make? I'm particularly interested in things that would make it better for fintech companies.

Michele: If in this fantasy I were leading the agency, I would make changes that would help consumers and help banks and fintechs by leveling the field on which they compete. I'm deeply concerned that a significant portion of Americans receive their financial services outside the regulated banking system.

The fundamental purpose of bank regulation is to protect consumers and without visibility into what's called the "shadow banking system," the banking regulators really can't protect these consumers. Unfortunately, I think that recent statements from Washington are reflective of a profound reluctance to allow fintechs into the regulatory fold and keeping fintechs out of that fold means that the banking regulators will not have to address the risk of certain innovative business models.

Peter: Right.

Michele: And it will mollify banking industry advocates worried about competition from fintechs and, therefore, opposed to chartering them, but it won't keep consumers from seeking alternatives to banks and, therefore, really won't keep the fintechs from eating the banks' lunches. (laughs) There's a lot of lunch-eating going on in this podcast right now, maybe I'm hungry. In other words, there's a consumer demand for services provided by fintechs, that's clear, right.

Fintechs are going to meet that demand and unless chartered, fintechs will be able to do so free of the costly regulatory burden imposed on their bank competitors and that's a fact. In my opinion, the best way to ensure consumer protection and healthy competition among financial services providers is to require fintechs offering banking services to consumers to apply for bank charters and submit to the rigorous oversight to which banks are subject.

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Peter: Okay, interesting, simple and probably not what every fintech wants to hear, but it's a great point to end on. It's been really insightful, Michele, I've learned a lot today, I hope the listeners have as well. Thank you so much for coming on the show.

Michele: It's my pleasure, thank you, Peter.

Peter: Okay, see you.

Michele: Bye.

Peter: You know, Michele and I were chatting after we stopped recording just now and we figured, it's almost amusing in some ways how some of the banks and the bank trade associations how they have approached fintechs, in general. On the one hand, they say, well, it's not fair because fintechs have a lighter lift when it comes to regulation, on the other hand, it says, we don't want them to become regulated. So you can't sort of have it both ways.

The reality is it's inevitable that the major players in fintech are all going to become fully regulated banks, there may be one or two exceptions, but the vast majority, if you want to be a really national scale fintech company and you really do want to have some kind of bank charter and that's what we're starting to see. I think, long term, it's inevitable that we are going to see most of the major fintech companies with charters.

Anyway on that note, I will sign off. I very much appreciate your listening and I'll catch you next time. Bye.

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