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NEW YORK · LONDON

January 13, 2017

Office of the Comptroller of the Currency
Washington, DC
Via email: specialpurposecharter@occ.treas.gov

Exploring Special Purpose National Bank Charters for Fintech Companies

Response to Request for Comment

General Statement:

Auriemma Consulting Group (ACG) (www.acg.net) is a boutique management consultancy in business for over thirty years. ACG serves the consumer lending and payments space generally and has worked for virtually all of the major credit card banks and non-bank lenders. Our practice is based in NYC and London and we serve clients in the US, Canada, UK and Europe. As a result of our reputation and long standing presence in the credit card business, we have been involved in many assignments related to Fintech and have engaged in numerous strategic discussions around their existence in the financial marketplace. As such, we have a keen interest in the Office of the Comptroller of the Currency's (OCC) proposal.

As a general rule, we believe that consumers are well served by financial innovation. Innovation, or research and development more broadly, requires capital. At present, equity investors in the fintech arena invest in a non-regulated entity which is dependent upon a third party -- a regulated bank. In the event of a bank problem, the fintech business may cease. Moreover, since there are a small number of banks currently providing this type of arrangement to fintech companies, arranging a replacement bank partner is, at the least, a business continuity risk and, perhaps, an insolvency risk.

In addition to the indirect exposure to bank regulatory risk, this business arrangement also exposes the equity investor to the business risks of the other fintech companies of the bank partner. While each fintech entity is independent, and obviously not liable for the other bank partners per se, there is a potential "contagion risk" that is unavoidable; a problem with one fintech company could precipitate a regulatory action against the bank that could impact the bank's other fintech arrangements.

The proposed OCC fintech charter would enable a fintech company to eliminate this reliance upon a third party in exchange for a direct regulatory relationship. We believe the greater stability afforded by this direct relationship with the OCC would facilitate incremental capital investment.

1. **What are the public policy benefits of approving fintech companies to operate under a national bank charter? What are the risks?**

First, we should recognize that the term "fintech" is very broad and covers, but is not limited to, firms that are primarily technology companies related to payments as well as the category of lenders typically referred to as "marketplace lenders." The OCC's decision to make available a national bank charter for fintech firms has clear applicability to the second category (and to extenders of credit generally) and perhaps less relevance to the first category. Our response will focus on fintech companies that all extend credit or provide payment services to consumers.

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The marketplace lenders as a class have utilized the existence of third party banks to act as loan originators and loan sellers. Although there are variations on the approach, the traditional structure has a non-bank party (the fintech company) that is skilled at (1) user interface or user experience (UI / UX) and (2) sourcing and underwriting borrowers. The fintech company collaborates with a chartered national bank with the understanding that: (1) the national bank is willing to independently underwrite credit applicants in a way which is consistent with the fintech company's underwriting algorithms; (2) the national bank will sell the originated loan to the fintech company (or its designee) within a short time of loan origination – typically one to three days. By virtue of this arrangement, the fintech company is able to achieve certain benefits afforded to a national bank, primarily the national bank exemption from state usury laws and regulations. While this practice has been in existence for many years, it has lately been challenged under the "true lender" theory. Several recent court cases (notably, Madden v. Midland Funding and the CFPB v. CashCall, Inc.) have cast doubt upon the long term viability of these types of arrangements.

The main public policy benefit of approving the fintech companies to operate under a national bank charter is that it would eliminate the risk of a fintech company losing its bank partner in a way which precluded the fintech company from operating. Given that many of the banks active in this type of structure offer services to multiple non-bank entities, it is entirely possible that a well-run, sound fintech company could find itself out of business as a result of regulatory action against its bank partner for activities of the bank (or of another fintech client of that bank). Allowing the fintech company to obtain its own national bank charter would provide the OCC with direct supervision and free the fintech company of the "contamination risk" inherent in the current bank partner arrangements.

It is difficult to imagine how the proposed fintech charter could create any new or incremental risks. If we assume that all viable fintech companies currently working with a partner bank are potential candidates for the fintech charter it would seem there would be no increase in the traditional lending risks. Would the OCC's direct supervision be less stringent than the regulatory guidance now in place through the bank partners? We believe the direct relationship between the OCC and the fintech company will enhance the soundness of the business and lower the overall level of risk presented by the fintech company. This comment further assumes that the new fintech bank has elected not to become an FDIC insured depository institution; doing so would naturally increase the risk to the insured deposit base since the fintech companies have largely existed with non-deposit funding.

It would be incumbent upon any fintech bank to clearly represent to the public what services it can and cannot provide. For example, the consumer should never be confused about whether a bank is FDIC insured and can accept deposits.

2. What elements should the OCC consider in establishing the capital and liquidity requirements for an uninsured special purpose national bank that limits the type of assets it holds?

An uninsured special purpose national bank presents no risk to the FDIC deposit network but instead presents systemic risk, which is a function of its size. (As long as we are considering non-FDIC insured institutions, there would be no need for a bailout.) A very large, national fintech bank that failed, however, could disrupt consumer credit and, more importantly, create a cascade of failure for other fintech banks if the capital markets perceive a systemic weakness. While the application of existing regulatory capital guidelines as promulgated under Basel III would seem to be excessive, it remains the best current assessment of safe levels of capital and liquidity. But this regulatory regime would be unduly burdensome for a small fintech bank so a simpler rule (perhaps a basic leverage ratio?) would suffice for fintech banks below a certain asset size.

Ultimately, a non-deposit taking bank will be judged by the capital markets and institutional investors for credit worthiness. The debt and equity investors in the fintech bank bear the insolvency risk – not depositors.

3. **What information should a special purpose national bank provide to the OCC to demonstrate its commitment to financial inclusion to individuals, businesses and communities? For instance, what new or alternative means (e.g., products, services) might a special purpose national bank establish in furtherance of its support for financial inclusion? How could an uninsured special purpose bank that uses innovative methods to develop or deliver financial products or services in a virtual or physical community demonstrate its commitment to financial inclusion?**

Many fintech companies are focused on financial inclusion, financial literacy and generally finding a way to reach the underserved banking community. Some of these fintech companies are utilizing non-traditional underwriting methods to find and solicit customers. Given that a large segment of the subprime consumer space is made of "thin file" customers (i.e., customers without a sufficient credit history to allow for a credit bureau score), fintech lenders utilizing other credit metrics offer the prospect of providing credit to a needy market segment.

Apart from fintech companies that are targeting their products to underserved individuals and small businesses, any fintech national bank should have a defined policy regarding financial inclusion and relevant procedures to see that the policy is implemented. While it would be inadvisable to establish quotas or specific benchmarks for loans to underserved constituencies, it would certainly be within the regulatory sphere of influence to require formal financial literacy programs.

4. **Should the OCC seek a financial inclusion commitment from an uninsured special purpose national bank that would not engage in lending, and if so, how could such a bank demonstrate a commitment to financial inclusion?**

While traditional CRA obligations have been a requirement of FDIC insured banks, it would not be irrational for the OCC to require some type of financial inclusion requirement for a noninsured Fintech bank. A noninsured, fintech national bank that did not engage in lending could still be required to make a financial inclusion commitment. In one sense, this should be less burdensome for the non-lender than for a lender. Presumably, the non-lending fintech bank is offering other services, likely payment or cash movement services, that would have value to underserved communities. Unless there was a compelling difference in the business risk to the fintech company between the subprime and prime customers, it would seem a financial inclusion requirement would be both acceptable and non-controversial.

5. **How could a special purpose national bank that is not engaged in providing banking services to the public support financial inclusion?**

The need or benefit to becoming a national bank is much less significant to a fintech company that does not provide banking services. But a fintech company that does not engage in banking services but still finds it advantageous to become a national bank undoubtedly is providing some type of service or product that may have appeal to the underbanked population. It would not be unreasonable for such a business to be required to stipulate its plan of outreach to support financial inclusion and for the plan to be part of the OCC application review process.

6. **Should the OCC use its chartering authority as an opportunity to address the gaps in protections afforded individuals versus small business borrowers, and if so, how?**

ACG is very familiar with this "gap" as it exists in the small business credit card arena. Since small business credit cards are exempt from the CARD Act, a sole-proprietor using a small business credit card would not have the protections of the CARD Act even though these products are largely underwritten on personal credit. This distinction in the law, however, would not appear to be something which the OCC could remedy in the chartering process. Even if the chartering authority could address this, it would leave existing card issuers unencumbered by the new approach. Moreover, it is not at all clear how much of an issue this is in reality. CARD Act is now several years old and the small business card issue does not appear to be a significant market problem.

7. What are potential challenges in executing or adapting a fintech business model to meet regulatory expectations, and what specific conditions governing the activities of special purpose national banks should the OCC consider?

Fintech lenders (i.e., marketplace lenders primarily) have come into existence because they offer a better customer experience in the lending process. In general, this means a process that is faster, easier, less cumbersome, and possibly less expensive, for the consumer. Inherent in the fintech business model is the imperative that testing and experimentation drive product and service enhancements. While fintech lenders understand the CFPB's concerns regarding fair lending, will the business models allow for testing to confirm that underwriting is not resulting in disparate treatment of applicants? Internet based businesses tend to innovate rapidly, something that will present regulatory challenges. Must the fintech companies slow down or must the regulators accelerate review of changes to the business plan?

In the U.K., the FCA has created a "regulatory sandbox" in which interested financial institutions may plan, develop and test new products or services under proscribed regulatory safeguards. If the consequences of a regulatory error are business termination, innovation becomes stifled. In the U.S., if a government authorized regulatory sandbox would seem too close to "regulatory capture" then at the least, something analogous to an SEC "no action letter" would be very helpful. Regulating by enforcement action freezes potential investments and retards innovation.

8. What actions should the OCC take to ensure special purpose national banks operate in a safe and sound manner and in the public interest?

Presumably, Fintech national banks seeking FDIC approval and deposit taking ability will comply with the necessary FDIC regulations. We assume this question is directed at the non-depository fintech national banks. Apart from regulatory capital and liquidity requirements discussed in question number 2, the OCC could bolster the safety and soundness of such banks by requiring a funded capacity to absorb six months of loan origination (or some other level of loan origination continuity). This could assure lending continuity during a liquidity crisis. The OCC should also require these national banks to present loan portfolio results on a managed basis to capture the full credit loss experience of the originated loans. Since non-depository lenders must rely upon the asset backed securities market, or other capital markets as purchasers of loans, these banks will already be accustomed to providing a high level of disclosure regarding asset quality.

Regarding the "public interest," the marketplace is a ruthless arbiter of utility; a fintech national bank not providing a compelling product or service will not be around very long. The existing laws regarding unfair and deceptive practices as well as other laws governing consumer treatment should be adequate to protect the public interest. Moreover, the OCC's level of supervision can be targeted to national banks that are underwriting more aggressively or growing very quickly.

9. Would a fintech special purpose national bank have any competitive advantages over full-service banks the OCC should address? Are there risks to full-service banks from fintech companies that do not have bank charters?

At the risk of generalization, fintech lenders should have a competitive advantage in loan origination. If the fintech lender is not improving the process for a customer (ease of application, speed of decision, flexibility of product terms, finer credit risk underwriting, etc.) the customer would have no reason to prefer the fintech over a traditional bank. The traditional, deposit-taking banks, on the other hand, will typically have a lower cost of funds and should be able to compete economically. If the fintech lender's cost of new loan/account acquisition is significantly lower than a traditional bank's cost of loan acquisition, this can partially offset the traditional bank's cost of funds advantage. The UI/UX improved process is not a function of the national bank charter but rather of the fintech application of new technology, so full-service banks are threatened as much by non-bank fintech companies as they would be by fintech national banks.

10. Are there particular products or services offered by fintech companies, such as digital currencies, that may require different approaches to supervision to mitigate risk for both the institution and the broader financial system?

The emergence of digital currencies, such as Bitcoin, indeed will require different approaches to supervision by bank regulators. But this is not limited to fintech companies – traditional banks are rapidly exploring blockchain technology and looking for new and more efficient ways to solve financial problems digitally. While fintech companies may have greater interest in digital services than some traditional banks, the regulatory challenge is already underway and must be addressed.

11. How can the OCC enhance its coordination and communication with other regulators that have jurisdiction over a proposed special purpose national bank, its parent company, or its activities?

Coordination among the regulators is crucial to creating a successful environment for fintech companies. The OCC can enhance the prospect of coordination by facilitating an inter-agency body (perhaps similar to the FFIEC). Establishing the OCC as the "primary regulator" would greatly assist the new fintech banks with compliance.

Of particular importance is the extent to which a fintech bank will fall under the Bank Holding Company Act. While Fed supervision of a fintech bank holding company under the BHCA would itself not be problematic, it would be helpful to clarify that private equity investors in a fintech bank holding company would not become subject to the BHCA restrictions regarding investing in non-bank businesses. As mobile payments become more mainstream, for example, a technology company (e.g., Apple or Alphabet) could choose to form a fintech bank subsidiary to provide consumer credit. Obviously, this could not happen if the parent technology company became subject to the BHCA. Foregoing the tangible economic advantage of FDIC insured deposits seems a fair trade to be free of the BHCA restrictions and of the "Source of Strength" issue.

12. Certain risks may be increased in a special purpose national bank because of its concentration in a limited number of business activities. How can the OCC ensure that a special purpose national bank sufficiently mitigates these risks?

The risk posed by a lack of diversification may be partly offset by an improved level of expertise resulting from a narrower focus. Diversification is only a risk mitigant if one assumes that all activities are handled with an equal level of expertise. While this is certainly feasible, it is more likely that a specialty consumer lender, for example, might be a much less effective lender to commercial real estate. Further, if we accept the premise that many of the entities attracted to the OCC Fintech charter will be earlier stage businesses, a regulatory mandate to be in diversified business activities could well prove harmful.

Perhaps it is better to stress the quality of the activity rather than the diversification of activities. For example, perhaps a monoline fintech lender would be required to have its critical risk models validated annually by an external third party? Perhaps all new fintech banks would operate under a disclosed memorandum of understanding (MOU) for the first five years of their existence until sufficient history can be produced?

13. What additional information, materials, and technical assistance from the OCC would a prospective fintech applicant find useful in the application process?

Recognizing that this is a new charter, but that the application process is likely to be similar to the OCC's handling of other charter applications, perhaps one or more case studies of successful (and perhaps of unsuccessful) applicants could be provided? In particular, a case study which described the initial pre-filing meeting, including post-meeting review, the initial business plan proposed, the process by which the plan was updated and revised, and the subsequent meetings leading to application resolution would be extremely valuable.

While we believe the fintech charter is a bold and progressive step for the OCC, we also believe that many potential applicants will have considerable trepidation about becoming a regulated bank. To the extent that the OCC is more accessible for pre-filing meetings with potential applicants and advisors, that will go a long way toward improving the quality of the applicants and minimizing the number of rejected applicants.

Thank you for the opportunity to offer these comments.

Cordially,

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