State-chartered fintech banking and financial services: What solutions will states pursue?

When the Office of the Comptroller of the Currency (the "OCC") proposed a plan in late 2016 to authorize a limited purpose, non-depository financial technology ("fintech") national bank charter, state bank regulators immediately responded with legal and policy arguments against the concept.

In April of 2017, the Conference of State Bank Supervisors ("CSBS"), the nationwide association of state bank regulators, filed suit against the OCC to try to stop it from moving ahead with the fintech national bank charter initiative.[1]

The OCC's initiative is intended to foster fintech innovation by allowing nonbank fintech companies, such as licensed Internet lenders and money transmitters, to become national banks and thereby gain the benefit of nationwide federal preemption authority over state financial services regulatory law, like other national banks.[2] This preemption authority would address the current costly and burdensome 50-state financial regulatory compliance regime imposed upon such nonbank fintech companies. [3]

However, fintech activities, such as Internet-based lending and deposit taking, are also conducted directly by banks, and, as explained below, this 50-state compliance burden also impacts state-chartered banks conducting interstate Internet fintech banking operations and puts them at a disadvantage to national banks conducting the same type of operations.

Despite the state protests over the OCC's fintech charter plan,[4] the states did not initially appear to offer regulatory alternatives to address the underlying issue of the 50-state compliance burden or a solution to level the playing regulatory field so that state-chartered banks can engage in multi-state fintech operations in a manner competitive with national banks. However, certain states are now publicly recognizing these issues and becoming proactive in pursuing solutions to address them.

States seeking fintech regulatory solutions

In March of 2017, the Secretary of the Illinois Department of Financial and Professional Regulation issued a public statement recognizing the need for the states to develop a framework for fintech regulation

[1] *See* https://www.csbs.org/NEWS/PRESS-RELEASES/PR2017/Pages/042617.aspx.

[2] Comptroller's Licensing Manual Draft Supplement, Evaluating Charter Applications From Financial Technology Companies (March 2017); *see* https://www.occ.gov/publications/publications-by-type/licensing-manuals/file-pub-lm-fintech-licensing-manual-supplement.pdf.

[3] Under current law, most nonbank fintech companies are state-licensed entities that are subject to a 50-state compliance regime, involving varying requirements and standards in jurisdictions across the nation. In other words, there is no general federal preemption of state law applicable to these types of state-licensed nonbank financial services entities. They are subject to the law in each state in which they serve customers, which is commonly all 50-states for fintech companies reaching customers via the Internet without regard to geographic boundaries.

[4] The states have asserted that the OCC lacks the authority to charter a nondepository fintech national bank unless the bank fits into certain limited exceptions, such as a "national trust bank." States have also claimed that the OCC fintech charter proposal would involve harmful economic policy because the high cost of establishing a fintech national bank would preclude many interested smaller and start-up fintech companies, thus creating a two-class system of fintech industry competitors: one class with federal preemption over state laws and one without. *See* comment letter from Conference of State Bank Supervisors to the OCC, https://www.occ.gov/topics/responsible-innovation/comments/comment-csbs-comment-letter-special-purpose-national-bank-charters-fintech.pdf, January 13, 2017.

that not only fosters innovation in a responsible manner, but also addresses problematic issues concerning the state-by-state regulatory system, including the "lack of uniformity in state requirements result[ing] in regulatory inconsistency, which is a pain point for the industry."[5]

Similarly, the California commissioner of the Department of Business Oversight recently publicly recognized "legitimate criticisms" of the current state regulatory regime applicable to most fintech companies and invited a select group of fintech companies to meet with her on the issue.[6] The concerns acknowledged by the California commissioner also center on the cost-intensive and time-intensive burden of the state-by-state licensing regulatory system and the related risks.[7] Her department announced publicly that it is interested in all ideas and solutions related to the concerns about the state-by-state system for fintech licensing and regulation.[8]

Although the Illinois and California regulators' comments were aimed at nonbank fintech companies, the current state-by-state regulatory system impacts state-chartered banks and state-licensed nonbanks alike in a manner that puts them at a competitive disadvantage to national banks when conducting interstate fintech activities. Accordingly, both state-chartered banks and state-licensed nonbanks could benefit from state initiatives to reduce regulatory burdens that are inherent in their interstate financial services activities under current law.

Initiatives to make state-chartered banks and state-licensed nonbanks more competitive in fintech

Leveling interstate regulatory playing field for banks. Under current federal law, according to OCC regulations, national banks – including the proposed new nondepository fintech national banks – are not subject to state banking laws on a panoply of financial services regulatory issues, such as licensing, disclosures, fees and interest rates, limitations and requirements for the terms of loans or deposits, escrow accounts and advertising.[9] However, a state-chartered bank is subject to all of these types of state laws[10] in every state in which it has customers, except for the following: [11]

- **Usury exception**. A state-chartered bank can follow its chartering state's usury laws, rather than the laws of other states in which the bank's customers may reside, if the state-chartered bank adheres to certain procedural requirements.[12] This authority is nearly identical to the authority of national banks to offer loans at rates using the home state of the national bank, rather than the home state of the borrower.[13]

[5] "State regulator to fintechs: We hear you," American Banker, March 31, 2017, pgs. 8 – 9.
[6] "California regulator acknowledges 'legitimate criticisms' of state licensing," American Banker, February 16, 2017, pgs. 5 – 6.
[7] *Id*.
[8] *Id.*
[9] *See*, e.g., 12 CFR Part 7, Subpart D -- Preemption. According to the OCC, certain other types of state laws generally apply to national banks, such as anti-discrimination, zoning, taxation, criminal and tort laws.
[10] Although certain state statutes may include exemptions for out-of-state banks, such exemptions usually cover only certain aspects of a state's overall regulatory framework, leaving other state laws applicable to out-of-state, state-chartered banks.
[11] Both exceptions apply only to FDIC-insured banks.
[12] *See* 12 USC 1831d; FDIC General Counsel Opinion No. 10, 63 Fed. Reg. 19258, April 17, 1998; FDIC General Counsel Opinion No. 11, 63 Fed. Reg. 27282, May 18, 1998.
[13] *Id.*

- **Interstate branch exception**. In the case of a state-chartered bank with a branch in a "host state" (i.e., a state other than the bank's chartering state), the bank is subject to the law of that host state only to the extent that such laws would be applicable to a national bank, in connection with activities of the bank's branch operations in that host state.[14] In such a situation, under federal law, the law of the state bank's home state would apply to those branch activities, instead of the host state law.[15] However, unlike the "usury exception" described above, this exception only applies if the state bank is conducting activities from the physical branch situated in the host state, so it would rarely apply to a bank offering fintech Internet banking services, which would normally be done from the bank's home state, rather than from a host state branch.

In each of the above limited exceptions, a state-chartered bank can follow its chartering state's law, rather than adhere to a potential multi-state regulatory regime. The problem is that these exceptions apply only to usury issues and branch-based activity, so they are much more restrictive than the rules applicable to national banks.

Updating the federal law (specifically 12 USC 1831a(j)) so that the laws of states in which bank customers reside would apply to state-chartered banks only to the extent that they apply to national banks would effectively level the playing field between all state and national banks conducting fintech operations, i.e., not just between state banks and the proposed national fintech banks. In other words, under this legislative reform, state banks could engage in fintech activities and only be subject to their own home state laws and applicable federal law, which would be similar to the national bank regime of national banks following OCC regulations and other applicable federal banking law.

Coordinating uniform state laws and reciprocity for state-licensed fintech nonbanks. With regard to the 50-state compliance dilemma of state-licensed fintech nonbanks, states are considering:

- adopting uniform laws and procedures so that compliance requirements are the same in each state, and

- coordinating reciprocity and exemption provisions in state statutes to allow a fintech company licensed in one state to do business without the need to comply with all of the licensing and compliance requirements of each other state in which customers reside, but instead to be primarily obligated only to follow the licensing and compliance obligations of that company's home licensing state.[16]

A recent example of state efforts to initiate uniformity for multi-state regulatory obligations is the announcement on April 18 of 2017 by CSBS of the development of a uniform financial report to be used by money services businesses, such as money transmitters and prepaid card companies, in connection with meeting regulatory reporting requirements under the laws of various states.[17] CSBS also announced a program in May of 2017 aimed at coordinating a multi-state initiative to modernize state regulation of

[14] 12 USC 1831a(j).
[15] *Id.* The concept of interstate branch preemption for state banks was implemented into federal law via the Riegle-Neal Amendments Act of 1997. The intent of this federal law was to even the playing field between national and state-chartered banks doing interstate banking business. However, in 1997, Internet banking was in its infancy and the concept of "fintech" did not practically exist. So, the law addressed only interstate business conducted from actual interstate bricks-and-mortar branch offices.
[16] "State regulator to fintechs: We hear you," American Banker, March 31, 2017, pgs. 8 – 9.
[17] *See* https://www.csbs.org/news/press-releases/pr2017/Pages/041817.aspx

nonbanks, including fintech firms, with a goal of harmonizing multi-state supervision of those companies.[18]

Facilitating state banks' use of limited purpose FDIC-insured state bank charters. Federal law and the banking law in many states allow an FDIC-insured state bank to be established for a limited purpose.[19] Examples of these types of limited purpose banks include trust companies, credit card banks, bankers' banks and other types of "monoline" banks that specialize in only certain designated banking services.[20] Many states have chartered and currently regulate such limited purpose FDIC-insured banks.

Because these limited purpose state-chartered banks are actual FDIC-insured banks, they are:

- subject to the same federal banking law framework that more traditional banks are subject to, such as the Community Reinvestment Act, the Federal Deposit Insurance Act and, except in certain limited cases, the Bank Holding Company Act (the "BHCA");[21] and

- are very different from the OCC's proposed concept of a non-depository fintech national bank that would not be FDIC-insured and not be subject to many of these federal banking laws.[22]

State bank regulatory authorities could implement – and may already be implementing – this limited purpose state bank authority to facilitate state banks pursuing monoline business plans in the fintech sector.[23]

Because such limited purpose state banks would generally be subject to the same federal banking law framework as other state banks, they would not have an unfair competitive advantage over those banks, as the state regulators fear would be the case with non-depository fintech national banks proposed by the OCC that would be exempt from many federal banking laws. However, some bank industry groups may object to a state chartering a type of limited purpose bank to conduct fintech activities if that bank's parent entity would be exempt from the BHCA.

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[18] https://www.csbs.org/news/press-releases/pr2017/Pages/051017.aspx

[19] *See* 66 Fed. Reg. 20102 (April 19, 2001); 66 Fed. Reg. 54645 (October 30, 2001); *see also* 12 CFR 303.14.

[20] State law commonly affords flexibility to tailor state bank charter powers to fit bank business plans and otherwise prescribes various bank regulatory standards specific to the state, subject to federal law. All state banks – including limited purpose FDIC-insured state banks – are subject to capital requirements under federal and state law and to regulatory assessment cost requirements under state law.

[21] For example, under the Competitive Equality in Banking Act of 1987, if a bank engages only in credit card operations and otherwise limits its activities in certain ways, its parent may be exempt from the BHCA.

[22] The OCC's concept of a fintech "special purpose national bank," as explained in its recent Draft Supplement for the Comptroller's Licensing Manual expressly excludes FDIC-insured institutions and requires only that the fintech national bank conduct one of the following core banking functions: lending money or "paying checks" (interpreted by the OCC to include electronic facilitation of payments). Comptroller's Licensing Manual Draft Supplement, Evaluating Charter Applications From Financial Technology Companies (March 2017); *see* https://www.occ.gov/publications/publications-by-type/licensing-manuals/file-pub-lm-fintech-licensing-manual-supplement.pdf. Under this concept a fintech company could become a national bank, for example, if it only conducted Internet lending or only facilitated electronic payments via the Internet.

[23] For example, under FDIC regulations, a limited purpose state bank would not have to engage in any type of public deposit-taking functions to obtain FDIC-insured status. Under its current regulations, the FDIC considers any bank to be "in the business of receiving deposits other than trust funds" as long as it has at least one deposit account and minimum aggregate deposit amounts totaling $500,000. That deposit account could be from an affiliate of the bank. *See* 12 CFR 303.14 and 66 Fed. Reg. 54645 (October 30, 2001).

As FDIC-insured banks, limited purpose state banks benefit from the same federal preemption described above that is applicable to other, more traditional types of state-chartered FDIC-insured banks.[24] Accordingly, the potential equalization of preemption authority for state and national banks described above would also benefit these FDIC-insured, state-chartered limited purpose banks.

Challenges for states pursuing fintech state banking initiatives

Challenges for leveling interstate regulatory playing field for banks. The equalization of federal preemption for state and national banks would likely involve the following challenges:

- **Passing federal legislation**. The most obvious obstacle is the need to pass federal legislation to expand the existing federal preemption authority available for state banks so that it would apply to their Internet banking operations like preemption under the National Bank Act applies to national bank Internet banking. This type of legislative initiative may involve significant challenges to achieve passage, including resistance from parties that do not want any additional federal preemption authority added to the existing banking law.
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- **Potential objections**. While the update in preemption authority explained above would simply be evening the playing field for all state banks with the current national bank preemption authority, some states may balk at such a change due to a concern that the change would cause them to lose power to protect customers in their states. Certain banks and bank trade groups may oppose the change due to the additional competition it would facilitate. However, such concerns of the states may be mitigated by the fact that current federal law already restricts the states' ability to engage in this type of protection with regard to financial services provided by any national bank or by any state-chartered bank operating from an interstate branch, as well as with regard to usury limits on any interstate bank loans by either a state or national bank. This preemption law change would simply expand the existing state bank preemptive authority so that, rather than only applying to old-fashioned bricks-and-mortar office activities, it would also apply to modern, Internet-based activities. The industry concerns over additional competition may also be mitigated due to the fact that Internet-based lending competition from various sources is already commonplace.

Challenges to coordinate uniform law and reciprocity for state-licensed fintech nonbanks. With 50 state legislatures involved, it is likely to be very difficult and time-consuming to implement the concept throughout the United States of:

- uniform state statutes for the licensing and regulation of nonbank fintech companies, and/or

- statutory provisions recognizing reciprocity throughout the U.S. so that each state would defer to the authority of the home state of a fintech nonbank to license and regulate that entity.

Challenges to facilitate state banks' use of limited purpose FDIC-insured state bank charters. The idea of state-chartered limited purpose banks is not new, but promoting the ability of state banks to utilize such limited purpose charters for monoline fintech business plans would likely involve the following challenges:

[24] *See* e.g., 12 USC 1831d and 12 USC 1831a(j).

- **State-federal cooperation on limited purpose charter**. The facilitation of such limited purpose state bank charters would take cooperation between state banking authorities and the FDIC. However, similar cooperation has existed between the states and the FDIC on prior limited purpose bank charter concepts. The FDIC acknowledged in a 2001 rulemaking its "long-standing practice of approving applications from … non-traditional depository institutions."[25] The FDIC cited trust banks, credit card banks and other types of "specialized institutions" as being among the types of banking institutions that the FDIC has agreed to insure.[26]

- **Potential bank industry objections**. Although the concept of state-chartered limited purpose banks has been around for many years, certain banks and bank industry trade groups may object to states issuing such charters to banks wishing to institute only fintech operations, out of concern over the additional competition such entities would bring. These objections would likely be stronger if a state were to consider chartering a limited purpose bank whose parent entity would be exempt from the BHCA. However, for other types of limited purpose banks, these objections may be mitigated due to the fact that such limited purpose banks would be FDIC-insured (unlike the OCC's version of fintech national banks), and, therefore, subject to the same types of compliance requirements that more traditional FDIC-insured banks face.

Summary

For the past 150 years the U.S. has utilized a "dual banking" system to regulate financial services. Under this system, the states are the primary regulators of most nonbank financial services companies and both the states and the federal government charter and regulate banks that compete with each other to offer banking services to the American public.

Prior to the advent of Internet-based financial services and the explosion of fintech, the flexibility of the U.S. dual banking system allowed states – within their geographic boundaries – to be laboratories for innovation and change for U.S. financial services.[27] States are now poised to utilize this unique role in U.S. financial regulation to create the same type of laboratories for innovation and change in the fintech arena.

As noted above, certain state-based regulatory initiatives that could facilitate innovation and change in delivery of fintech services will certainly involve challenges, such as the passage of federal legislation to equalize the playing field for state and national banks to offer Internet-based fintech banking services. However, if successful, these types of state-based regulatory alternatives could facilitate banks and nonbanks in meeting the needs of the rapidly expanding fintech customer base.

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[25] *See* 66 Fed. Reg. 54645 (October 30, 2001).

[26] *Id.* The FDIC noted that "… for over thirty years, the FDIC has approved applications from many institutions that did not intend to accept [bank] deposits from the general public. Also, the FDIC has approved applications from institutions that only intended to hold one type of deposit account (*e.g.*, certificates of deposit) or that did not intend to hold more than one or a few [bank] deposit accounts."

[27] The OCC itself has acknowledged, the dual banking system "allows the states to serve as laboratories for innovation and change, not only in bank powers and structures, but also in the area of consumer protection." *National Banks and the Dual Banking System*, Office of the Comptroller of Currency (September 2003), quoting Joseph A. Smith, Jr., North Carolina Commissioner of Banks, on behalf of the Conference of State Bank Supervisors, before the House Committee on Financial Services, June 4, 2003, and acknowledging the statement was "rightly asserted."