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FinTech Industrial Banks and Beyond: How Banking Innovations Affect the Federal Safety Net

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Abstract

The FinTech industry has been utilizing technological innovations to provide services traditionally offered by the banking and financial industry. Until now, many FinTech firms engaging in these activities had non-bank state licenses. The uncertainties surrounding their current business models and the desire to expand the operations led some of these firms to apply for industrial bank charters. An industrial bank charter is one of the few ways for a commercial firm to control a depository institution and allows FinTech firms to retain their technological investments that are not directly related to banking. However, access of these industrial banks to the federal insurance, payment services, and the discount window raise some concerns. It is claimed that the parent companies of these banks might gain an unfair advantage over their competitors, misguide their creditors, or limit their liabilities by benefitting from the federal subsidies given to the banking industry. This Note analyzes these claims and proposes two alternatives—credit card banks and state bank subsidiaries—for the FinTech firms seeking to engage in the business of banking. Particularly, engaging in non-bank activities through bank subsidiaries could eliminate some of the persistent moral hazard problems that the industrial bank model might entail. Although the industrial bank activities would not pose a significant risk to the federal safety net, these alternatives to the industrial banks could be preferable for sustaining the development of the FinTech industry as well as maintaining a safe and sound banking system.

KEYWORDS: FinTech, Technology, Federal Subsidies, Banking, Finance

FINTECH INDUSTRIAL BANKS AND BEYOND: HOW BANKING INNOVATIONS AFFECT THE FEDERAL SAFETY NET

Cinar Oney[*]

ABSTRACT

The FinTech industry has been utilizing technological innovations to provide services traditionally offered by the banking and financial industry. Until now, many FinTech firms engaging in these activities had non-bank state licenses. The uncertainties surrounding their current business models and the desire to expand the operations led some of these firms to apply for industrial bank charters. An industrial bank charter is one of the few ways for a commercial firm to control a depository institution and allows FinTech firms to retain their technological investments that are not directly related to banking. However, access of these industrial banks to the federal insurance, payment services, and the discount window raise some concerns. It is claimed that the parent companies of these banks might gain an unfair advantage over their competitors, misguide their creditors, or limit their liabilities by benefitting from the federal subsidies given to the banking industry. This Note analyzes these claims and proposes two alternatives—credit card banks and state bank subsidiaries—for the FinTech firms seeking to engage in the business of banking. Particularly, engaging in non-bank activities through bank subsidiaries could eliminate some of the persistent moral hazard problems that the industrial bank model might entail. Although the industrial bank activities would not pose a significant risk to the federal safety net, these alternatives to the industrial banks could be preferable for sustaining the development of the FinTech industry as well as maintaining a safe and sound banking system.

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INTRODUCTION

Recent applications of two financial technology (FinTech) firms, Square and SoFi,[1] for industrial bank (also known as industrial loan company or ILC) charters rekindled the decennial debate on these types of institutions. The ILC charter is the only active state bank charter that allows an enterprise to control a deposit-taking institution while also not

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1. While SoFi has withdrawn its application due to change in management shortly after the initial application with the FDIC, the company has announced that it has not given up its plans for an ILC charter. Mike Breslin, *SoFi Withdraws U.S. Banking Application*, LEXOLOGY (Oct. 16, 2017), https://www.lexology.com/library/detail.aspx?g=774d36ce-bb23-44e7-8a5b-a733d5d0074e [https://perma.cc/2CNT-EB27].

being subject to the Bank Holding Company Act's (BHCA)[2] limitations on the parent companies' commercial activities. Opponents of ILCs have long claimed that these institutions undermine the established policy of separation of commerce and banking. According to these critiques, industrial banks exacerbate systemic risk by extension of federal subsidies to commercial firms without the consolidated supervision of the Board of Directors of the Federal Reserve System (Board or Federal Reserve) and create conflicts of interest.

FinTech companies utilize the developments in information technologies to create efficiencies in underutilized segments of the financial industry (for example, student loan refinancing) or they deploy novel systems, such as distributed ledger or blockchain, to implement elaborate solutions to minimize counterparty risk in transactions.[3] Nearly all FinTech firms are operating under state supervision using money transmitter, money lender, or similar licenses. Until recently, the resurgence and profitability of FinTech firms were attributed to the regulatory arbitrage these firms employ by state licenses instead of seeking to operate as a fully-regulated chartered bank. However, recent developments indicate that some players in the FinTech industry, including supervisory authorities, believe these licenses are not adequate for the flourishing of the industry. Thus, some firms are seeking national[4] or state bank charters.

This Note focuses on the controversy surrounding the extension of the federal safety net to FinTech firms through ILC charters. The three components of the federal safety net—federal deposit insurance, payment systems, and discount window—are viewed as federal subsidies that are granted to the depository institutions in order to maintain the safety and soundness of their banking activities. Some commentators claim that if ILC charters are granted to FinTech firms that participate in non-banking

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2. Pub. L. No. 84-511, 70 Stat. 133 (1956) (codified at 12 U.S.C. § 1841 (2012)).

3. *Examining the Fintech Landscape: Hearing Before the S. Comm. on the Banking, Hous., & Urban Affairs*, 115th Cong. 66 (2017) [hearinafter *115th Cong. Hearing*] (prepared statement of Frank Pasquale, Professor of Law, University of Maryland Francis King Carey School of Law).

4. Lalita Clozel, *Mobile-Only Fintech Makes Play for (Regular) Bank Charter*, AM. BANKER (July 25, 2017, 8:00 AM), https://www.americanbanker.com/news/mobile-only-fintech-makes-play-for-regular-bank-charter [https://perma.cc/649J-56LD] ("A mobile-only financial institution called Varo Money . . . has filed formal applications . . . to become a national bank.").

activities, then the commercial parent companies may benefit from the subsidies designated solely for the banking system. Extending the safety net to these institutions might give the commercial parent company access to cheap loans, thereby giving an unfair advantage over their non-bank-owning competitors. Further, it may induce risk-taking behavior on the part of these firms, increase bank failures, and could result in a catastrophic contagion that affects the entire financial system.

This Note argues that the the federal safety net does not actually extend to the commercial ventures of industrial banks in most instances due to the firewall provisions in Sections 23A and 23B of the Federal Reserve Act (FRA).[5] Furthermore, in the current economic context, some aspects of the federal safety net might not function as a real subsidy. Nevertheless, the industrial bank charter is not the only option for the FinTech firms that seek to engage in the business of banking. This Note proposes two alternatives, namely credit card banks and state bank subsidiaries, for the firms that would like to continue their non-bank activities. Particularly, engaging in these novel financial activities through bank subsidiaries could eliminate some of the persistent moral hazard problems that the commercial ownership of banks might entail. In some circumstances, these alternatives could be preferable for sustaining the development of the FinTech industry as well as maintaining a safe and sound banking system.

Part I of this Note discusses the current regulatory framework for FinTech operations, the ILC charter, developments in industrial bank applications, and the reasoning behind FinTech applications for federal insurance and bank charters. Part II of this Note considers how the separation of banking and commerce relates to the federal safety net, and the legal framework to contain the risk stemming from extending the federal subsidies to commercial firms. Part III of this Note proposes two alternatives—credit card banks and state bank financial subsidiaries—for the FinTech firms that might want to engage in the business of banking beyond the industrial bank model. Potential federal safety net leakage issues pertaining to these alternatives are analyzed and differentiated from the moral hazard problems surrounding industrial loan companies.

5. 12 U.S.C. §§ 371c, 371c-1 (2012).

I. REGULATORY FRAMEWORK FOR FINTECH AND INDUSTRIAL BANKS

A. OVERVIEW OF THE CURRENT FINTECH REGULATORY FRAMEWORK

FinTech does not have a strict definition.[6] While originally used to define firms that provided back-office services for banks,[7] today the definition of FinTech encompasses nearly all enterprises that implement developments in information technologies to provide financial services. The FinTech firms that applied for industrial bank charters, SoFi and Square, belong to the two most significant FinTech subsectors: marketplace lenders and payment systems providers. Marketplace lenders rely on unique data collection, analytics, and algorithms to underwrite consumer or small business loans.[8] Payment systems providers enable customers to make payments to vendors or other customers using mobile applications.[9] Marketplace lenders and payment systems may also utilize distributed ledger systems[10] or other novel technologies to conduct their operations. There are many more emerging fields and new financial products—such as robo-bankers, Insurtech, and RegTech—that are expected to disrupt established industries in the near future.[11] In fact, industry and regulator usage of the terminology is broad enough to

6. U.S. GOV'T ACCOUNTABILITY OFF., GAO-17-361, FINANCIAL TECHNOLOGY: INFORMATION ON SUBSECTORS AND REGULATORY OVERSIGHT 1 (2017), https://www.gao.gov/assets/690/684187.pdf [https://perma.cc/4QCS-NCSY].

7. PAYPAL, FINTECH FROM THE FRONTLINES: THE OPPORTUNITY FOR TECHNOLOGY TO IMPROVE FINANCIAL SERVICES FOR ALL 10–11, https://publicpolicy.paypal-corp.com/sites/default/files/paypal-policy-paper_fintech-from-the-frontline.pdf [https://perma.cc/5YQD-ARAT].

8. *115th Cong. Hearing*, *supra* note 3, at 50–54 (prepared statement of Eric W. Turner, Financial Technology Research Analyst, S&P Global Market Intelligence).

9. *Id.* at 55–56.

10. *See generally* Elizabeth Sara Ross, *Nobody Puts Blockchain in a Corner: The Disruptive Role of Blockchain Technology in the Financial Services Industry and Current Regulatory Issues*, 25 CATH. U. J.L. & TECH. 353 (2017) (examining the impact of the distributed ledger technology in the financial services industry).

11. *See generally* PWC, GLOBAL FINTECH REPORT (2017), https://www.pwc.com/jg/en/publications/pwc-global-fintech-report-17.3.17-final.pdf [https://perma.cc/B7LW-ARVH].

include many established technology firms[12] and partnerships with traditional banks[13] in this field.

While the technologies might be new, the underlying transactions are not. Many FinTech firms operate under state licenses to transmit money or to grant loans in the states where they conduct business.[14] While a small minority of these firms are seeking bank charters, currently no FinTech companies have obtained state or national banking licenses that would enable them to take deposits.[15] If FinTech firms decide to own banks, under the dual banking regime,[16] they have a range of options from state banks supervised by the Federal Deposit Insurance Corporation (FDIC) and the state regulators to national banks regulated by the Office of the Comptroller of the Currency (OCC). Still, most of these firms target specific segments of consumers or provide specific financial products and may not have the desire to become fully-fledged depository institutions. Furthermore, any bank charter requires compliance with regulations that range from restrictions on products, services, number and location of offices, and interest paid on deposits, as well as, requirements regarding minimum capital and reporting of the financial condition and nondiscriminatory activities.[17] These costs associated with owning a bank might have dissuaded many FinTech firms in the past.

Engaging in lending or money transmitting activities with state licenses has its own disadvantages for the FinTech industry. Some marketplace lenders have ongoing deals with banks to provide loans to small businesses or consumers. These firms, rather than relying on deposit-taking for capital accumulation, fund loans by securitizing or

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12. *See, e.g.*, PAYPAL, *supra* note 7, at 10–11.

13. *115th Cong. Hearing*, *supra* note 3, at 39–40 (prepared statement of Lawrance L. Evans, Director, Financial Markets and Community Investment, Government Accountability Office).

14. *See id.* at 19 (statement of Frank Pasquale, Professor of Law, University of Maryland Frances King Carey School of Law).

15. As of this Note's publication, the author could not find any FinTech companies that have obtained state or national banking licenses.

16. *See generally* Emmette S. Redford, *Dual Banking: A Case Study in Federalism*, 31 L. & CONTEMP. PROBS. 749 (1966) (analyzing the components of the federal and state banking law).

17. Christian Johnson & George G. Kaufman, *When a Bank Is Not a Bank: The Case of Industrial Loan Companies*, *in* FINANCIAL INSTITUTIONS AND MARKETS 1, 4 (Robert R. Bliss & George G. Kaufmann eds., 2008).

selling loans to institutions or individuals.[18] Square Capital, LLC, Square's subsidiary,[19] through its deal with a Utah ILC, brokers loans to small businesses.[20] In this business model, "a bank makes loans and then sells and assigns such loans to a non-bank entity that is engaged in assisting with the origination and servicing of the loan."[21] While this practice has been successful for a while, there is uncertainty regarding the future of these arrangements. For example, the Second Circuit has found that state usury laws are not preempted when a bank assigns a credit agreement to non-bank third-parties for collection.[22] This threatens the marketplace lender model, because the marketplace lender may have to charge an interest rate lower than what was previously agreed upon when the loan was assigned to the lender by the originator bank. [23]

Varying licensing practices across states and the requirement of obtaining a separate license in each jurisdiction is also a hurdle these firms must overcome.[24] The lack of a unified regulatory framework might increase the compliance costs and creates uncertainty.[25] For example, obtaining state lender licenses from all jurisdictions might take up to one year and can easily cost half a million dollars.[26] Some markets are located in jurisdictions, such as New York, with extensive cybersecurity laws affecting many firms that do business in that jurisdiction.[27] Compliance

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18. Brian Knight, *Federalism and Fintech*, *in* PROSPERITY UNLEASED 335, 336 (2017) https://www.heritage.org/sites/default/files/2017-02/22_ProsperityUnleashed_Chapter22.pdf [https://perma.cc/P9PT-YM2W].

19. Square, Inc., Registration Statement (Form S-1) 3–7 (Oct. 14, 2015).

20. Square, Inc., Quarterly Report (Form 10-Q) (Nov. 8, 2017).

21. *Id.*

22. Madden v. Midland Funding, LLC, 786 F.3d 246, 247 (2d Cir. 2015).

23. Square, Inc., Quarterly Report (Form 10-Q) (Nov. 8, 2017).

24. *E.g.*, *PayPal State Licenses*, PAYPAL, https://www.paypal.com/us/webapps/mpp/licenses [https://perma.cc/8RCM-GXF2] (last visited Mar. 1, 2018) (listing PayPal's money transmitter licenses in each jurisdiction).

25. Brian R. Knight, *Federalism and Federalization on the Fintech Frontier*, 20 VAND. J. ENT. & TECH. L. 129, 144 (2017).

26. MIKE WHALEN, BANK PARTNERSHIP OR GO IT ALONE? 2 (2016), https://www.goodwinlaw.com/-/media/files/viewpoints/alerts/2016/082316-bank-partnership-article.pdf?la=en [https://perma.cc/F6ZC-D227].

27. For an overview of the developments in the New York cybersecurity laws, see Jeff Kosseff, *New York's Financial Cybersecurity Regulation: Tough, Fair, and a National Model*, 1 GEO. L. TECH. REV. 436 (2017).

with these laws might increase the costs of services provided by the FinTech firms nationwide.[28]

Recognizing the inherent limitations of state lender and money transmitter licenses for FinTech industry, some regulators have attempted to address some of these issues. In December 2016, the OCC proposed a special purpose national bank charter for non-depository FinTech companies (OCC FinTech Charter).[29] The OCC Fintech Charter would allow the special purpose banks to engage in all activities that are permissible for national banks and these banks would have the preemption rights that enable national banks to avoid state laws that might limit their exercise of bank powers.[30] However, if they accept deposits, parent companies of the FinTech banks could still be subject to the BHCA and its limitations on activities.[31]

Facing a preemption threat, state financial authorities challenged the OCC's authority to grant such special purpose charters.[32] The uncertain future of the charter, fueled by these developments, and the possibility of parent companies being regulated as bank holding companies (BHC) under the OCC FinTech Charter, persuaded FinTech companies seeking a bank charter to look elsewhere.

B. THE INDUSTRIAL BANK EXEMPTION

The BHCA governs the activities of parent companies of banks and the activities of nonbank subsidiaries of these parent companies.[33] All institutions that are FDIC-insured or that accept demand deposits and

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28. Knight, *supra* note 25.

29. OFFICE OF THE COMPTROLLER OF THE CURRENCY, EXPLORING SPECIAL PURPOSE NATIONAL BANK CHARTERS FOR FINTECH COMPANIES (2016), https://www.occ.gov/topics/responsible-innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf [https://perma.cc/HES6-KNGR].

30. *Id.* at 4–6.

31. *Id.* at 6–7.

32. Complaint for Declaratory and Injunctive Relief, Conference of State Bank Supervisors v. Office of the Comptroller of the Currency, No. 17-cv-00763 (D.C. Cir. Apr. 26, 2017); Complaint for Declaratory and Injunctive Relief, Vullo v. Office of the Comptroller of the Currency, No. 17-cv-03574 (S.D.N.Y. May 12, 2017), 2017 WL 2115444. However, the OCC asserted that it has the authority to grant special purpose national bank charters to non-depository FinTech companies pursuant to 12 C.F.R. § 5.20(e) (2017). OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 29, at 3–4.

33. 12 U.S.C. § 1841 (2012).

make commercial loans are "banks" under the BHCA.[34] Any company exerting control over these "banks" are BHCs and can only be involved in the business of banking and other closely-related activities.[35] Subsidiaries of BHCs including the banks are also subject to the same restriction.[36] The Competitive Equality Banking Act of 1987 (CEBA)[37] exempted some depository institutions from this definition of "bank," effectively making the parent companies of these institutions exempt from a federal limitation on their activities. One of the exempted institutions was the industrial bank, a relatively obscure state bank model licensed and supervised by state regulators in California, Colorado, Nevada, Hawaii, Indiana, Minnesota, and Utah.[38] Industrial banks are exempt under the BHCA if they do not accept demand deposits, have total assets of less than $100 million or were acquired before August 10, 1987.[39] To avoid the limitation on assets, institutions applying for an industrial bank charter can offer negotiable order of withdrawal (NOW) deposits, which are similar to demand deposits, except that customers write drafts against the deposit in order to transfer funds to third-parties.[40] Other than this limitation, ILCs would virtually have the same powers as the other state banks.[41] Thus, under the current banking framework, an industrial bank charter is one of the few ways for a commercial firm to control an institution with lending and deposit-taking powers, making it

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34. *Id.* § 1841(c)(1).

35. *Id.* § 1843(a)(2).

36. *Id.*

37. Pub. L. No. 100-86, 101 Stat. 552 (codified as amended in scattered sections of 12 U.S.C.).

38. Industrial Bank Holding Company Act of 2007, H.R. Rep. No. 110-155, at 9 (2007).

39. 12 U.S.C. § 1841(c)(2)(H)(i).

40. The main difference between NOW accounts and demand deposits is that NOW accounts give the ILC the right, but not obligation, to require a written notice from the depositor at least seven days before withdrawal. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-621, INDUSTRIAL LOAN CORPORATIONS: RECENT ASSET GROWTH AND COMMERCIAL INTEREST HIGHLIGHT DIFFERENCES IN REGULATORY AUTHORITY 23 (2005).

41. BD. OF GOVERNORS OF THE FED. RESERVE SYS. ET AL., REPORT TO THE CONGRESS AND THE FINANCIAL STABILITY OVERSIGHT COUNCIL PURSUANT TO SECTION 620 OF THE DODD-FRANK ACT 33 (2016), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160908a1.pdf [https://perma.cc/3UDT-MKRV].

an attractive venue for FinTech firms seeking an alternative to national or state banking regimes.

Subsequent to the 1987 exemption for industrial banks and until 2006, total aggregate assets of industrial banks increased from $4.2 billion to more than $177 billion.[42] The exceptional growth of industrial banks between 1987 and 2006 and the increase in applications to incorporate ILCs under Utah law drew attention to this state bank model.[43] In particular, an ILC application from Walmart raised opposition from many individuals and industry representatives[44]—with criticisms centered on the conflict of interest issues. For example, opponents argued that an ILC operated by Walmart would either decline to extend credit to competitors of its stores[45] or favorably underwrite loans to its stores' customers.[46] The FDIC received approximately 13,800 letters protesting Walmart's attempt to operate an industrial bank.[47] As a response to the widespread opposition, the FDIC declared a six-month moratorium on all applications that involve a newly established industrial bank or an industrial bank going through a change in control in July 2006.[48] The FDIC extended the moratorium for non-financial parent companies until January 31, 2008.[49]

In response to the adverse public reaction, Walmart withdrew its application with the FDIC in March 2007.[50] During the 2008 Financial

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42. Industrial Bank Subsidiaries of Financial Companies, 72 Fed. Reg. 5217, 5218 (proposed Feb. 5, 2007).

43. *See generally* Lalita Clozel, *Square's ILC Bid May Open Floodgates for Fintechs*, AM. BANKER (Sept. 11, 2017, 2:14 PM), https://www.americanbanker.com/news/squares-industrial-loan-company-application-may-open-floodgates-for-other-fintech-firms [https://perma.cc/FK78-X6SF].

44. *See* Michael Barbaro, *Bankers Oppose Wal-Mart as Rival*, N.Y. TIMES (Oct. 15, 2005), http://www.nytimes.com/2005/10/15/business/bankers-oppose-walmart-as-rival.html [https://perma.cc/UYP4-K8RD].

45. Igor Fasman, *Wal-Mart Banking Bid*, 26 ANN. REV. BANKING & FIN. L. 116, 122 (2007).

46. Kenneth Spong & Eric Robbins, *Industrial Loan Companies: A Growing Industry Sparks a Public Policy Debate*, FED. RES. BANK KAN. CITY: ECON. REV., Fourth Quarter 2007, at 41, 41–42.

47. Moratorium on Certain Industrial Bank Applications and Notices, 72 Fed. Reg. 5290, 5291 (Feb. 5, 2007).

48. Johnson & Kaufman, *supra* note 17, at 2–3.

49. *Id.*

50. *Wal-Mart Withdraws ILC Charter Application*, WALMART (Mar. 16, 2007), https://corporate.walmart.com/_news_/news-archive/2007/03/16/wal-mart-withdraws-ilc-charter-application [https://perma.cc/AQ99-K7EX].

Crisis, Goldman Sachs and Morgan Stanley converted their industrial banks into state banks when the respective parent companies were christened as BHCs by the Federal Reserve.[51] Finally, in 2010, the Dodd-Frank Act brought a three-year moratorium on industrial bank charters.[52] These developments, as well as the FDIC's reluctance to accept new applications from industrial banks, put the debates on hold.

Expiration of the moratorium and the FDIC's decision to shorten[53] the enhanced supervisory monitoring period for new depository institutions to a three-year period[54] has reignited interest in this model. Recent applications of two financial services firms, Square and SoFi,[55] for Utah industrial bank charters and federal insurance rekindled the debate. Some opponents called upon the FDIC to impose another moratorium on the industrial bank applications.[56] Others—driven by the concern that if the initial applications are accepted, then it would open the floodgates for other FinTech companies—urged Congress to abolish the exemption for industrial banks under the BHCA.[57]

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51. The Goldman Sachs Group, Inc., Goldman Sachs Bank USA Holdings LLC, 94 Fed. Res. Bull. C101 (2008), 2008 WL 7861871; Morgan Stanley, Morgan Stanley Capital Management LLC, Morgan Stanley Domestic Holdings, Inc., 94 Fed. Res. Bull. C103 (2008), 2008 WL 7861872.

52. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 603, 124 Stat. 1376, 1597–98 (2010).

53. Press Release, Fed. Deposit Ins. Corp., FDIC Rescinds De Novo Time Period Extension; Releases Supplemental Guidance on Business Planning (Apr. 6, 2016), https://www.fdic.gov/news/news/press/2016/pr16027.html [https://perma.cc/ZZT3-AR3N].

54. FED. DEPOSIT INS. CORP., DEPOSIT INSURANCE APPLICATIONS: PROCEDURES MANUAL 36 (2017), https://www.fdic.gov/regulations/applications/depositinsurance/procmanual.pdf [https://perma.cc/4YBG-6R77].

55. *See supra* note 1.

56. *See* Letter from Christopher Cole, Exec. Vice President & Senior Regulatory Counsel, Indep. Cmty. Bankers of Am., to Kathy Moe, Reg'l Dir., Fed. Deposit Ins. Corp. S.F. Reg'l Office 2–3 (Oct. 10, 2017), http://www.icba.org/docs/default-source/icba/advocacy-documents/letters-to-regulators/2017/17-10-10_fdic_ltr.pdf [https://perma.cc/9H4T-LZFC].

57. Letter from Maxine Waters, CA, Ranking Member, U.S. House of Representatives Comm. on Fin. Servs., to Martin Gruenberg, Chairman, Fed. Deposit Ins. Corp. 2–5 (Aug. 25, 2017), https://democrats-financialservices.house.gov/uploadedfiles/2017.08.25_cmw_to_fdic_re_sofi_ilc_hearing.pdf [https://perma.cc/4JGY-KLHQ].

As of this Note's publication, there are only sixteen industrial banks,[58] and only Utah actively charters these institutions.[59] Most industrial banks are relatively small banks concentrating on specific customer segments or financial products.[60] A small minority, including BMW Bank of North America, Inc., is owned by industrial or financial services firms to extend commercial and consumer credit to customers of their parent companies.[61]

Industrial bank charters are likely to be preferable for FinTech firms that want to engage in the business of banking and need to retain their other commercial activities. The BHCA limits the activities of BHCs and their subsidiaries to banking, managing and controlling banks and other subsidiaries, and performing services for its subsidiaries.[62] Besides, some activities that were determined by the Board before 1999 to be "so closely related to banking as to be a proper incident thereto" are permissible for BHCs.[63] This list of permissible activities can be found in Regulation Y.[64] Many operations of FinTech firms might fall into one of the permissible activities even though these activities might not be directly related to the financial services they provide. One prominent example is data processing, where a marketplace lender might collect data to predict the default risk of their customers. Providing data processing, data storage, and data transmission services is permissible for BHCs and their subsidiaries.[65] Many marketplace lenders are able to offer consumer loans using software tools that utilize non-traditional data for underwriting.[66] If the company decides to process data collected from a customer's social

58. *Financial Institutions*, UTAH DEP'T FIN. INSTITUTIONS, https://www.utah.gov/dfi/FinancialInstitutions.html [https://perma.cc/V7A9-9PRL] (to replicate the search results, select "Filter by Type;" then "State Industrial Banks") (last visited Mar. 1, 2018).

59. *Why the ICBA Doesn't Want Square to be a Bank*, PYMNTS (Oct. 17, 2017), https://www.pymnts.com/news/alternative-financial-services/2017/icba-fights-industrial-loan-charters-for-fintechs/ [https://perma.cc/F982-28H3].

60. Michelle Clark Neely, *Industrial Loan Companies Come Out of the Shadows*, FED. RES. BANK ST. LOUIS: REGIONAL ECONOMIST, July 2007, at 5.

61. Johnson & Kaufman, *supra* note 17, at 12 tbl.1.4.

62. 12 U.S.C. § 1843(a)(2) (2012).

63. *Id.* § 1843(c)(8).

64. 12 C.F.R. § 225.28 (2017).

65. *Id.* § 225.28(b)(14).

66. *115th Cong. Hearing*, *supra* note 3, at 66 (prepared statement of Frank Pasquale, Professor of Law, University of Maryland Francis King Carey School of Law).

media accounts or their lifestyle choices, then there might be an issue.[67] Regulation explicitly allows collection of data that is "financial, banking, or economic" in nature and forbids processing or storing nonfinancial data if the total annual revenue derived from those activities exceeds forty-nine percent of the revenues derived from data processing.[68] Or perhaps the firm develops a completely novel way of providing banking services using blockchain technology, and the categories may not encompass this new technology. In these cases a BHC may be required to file a notice containing the description of the activities for the Federal Reserve's approval and prove that the activity is "so closely related to banking or managing or controlling banks as to be a proper incident thereto,"[69] and that it "can reasonably be expected to produce benefits to the public (such as greater convenience, increased competition, or gains in efficiency) that outweigh possible adverse effects such as undue concentration of resources, decreased or unfair competition, conflicts of interest or unsound banking practices."[70] The Board will send the notice for publication in the Federal Register and invite public comment on the proposal before making a determination.[71] The Board may request additional information anytime, and the approval process may take up to 120 days.[72] These requirements might be dissuading for start-ups that find them costly and time-consuming for an industry that is continuously innovating and changing. Furthermore, when requesting approval from the Federal Reserve, few firms would be eager to make their algorithms or trade secrets publicly available to the entire industry (and their competitors).

The FinTech firm might be already engaged in activities that are not permissible under the BHCA. For example, Square owns several subsidiaries that are engaged in operations such as online scheduling

67. *Id.*
68. 12 C.F.R. § 225.28(b)(14) (2017).
69. *Id.* § 225.21(a)(2).
70. *Id.* § 225.26(a).
71. *Id.* § 225.24(c).
72. *Id.* § 225.24(d)(3)–(4).

services for merchants,[73] food delivery,[74] and data analytics for customer engagement prediction.[75] None of these services are listed under the permissible activities list of the Regulation Y, and it is not unreasonable to assume that the Federal Reserve would not find the food delivery service to be incidental to the business of banking. A scheduling or data analytics service might be permitted under the services exemption of Regulation Y.[76] This exemption allows the BHCs to perform services such as data processing, courier services, advertising for the internal operations of the BHC or its subsidiaries.[77] At the same time, the services exemption is limited to services provided to the BHC and its subsidiaries and does not authorize these services to be provided to the third-parties.[78] If Square decides to enter the business of banking through non-ILC licenses, it most likely would have to cease the non-banking activities of some of its subsidiaries or would be required to limit these activities to its internal operations

II. SUPERVISION AND REGULATION OF TRANSACTIONS BETWEEN THE INDUSTRIAL BANK AND THE PARENT COMPANY

A. THE SEPARATION OF BANKING AND COMMERCE

The separation of banking and commerce is a distinctive trait of Anglo-Saxon banking regimes.[79] Contrary to the oft-repeated statements,

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73. Leena Rao, *Square Acquires BookFresh to Add Booking Services for Merchants*, TECHCRUNCH (Feb. 26, 2014), https://techcrunch.com/2014/02/26/square-acquires-bookfresh-to-add-booking-services-for-merchants/ [https://perma.cc/9USF-8BRQ].

74. Press Release, Square, Inc., Caviar Introduces Pickup, Creating Even More Ways for Diners to Order (Mar. 1, 2017), https://squareup.com/news/caviar-introduces-pickup-creating-even-more-ways-for-diners-to-order [https://perma.cc/8XA7-U6WQ].

75. Square Engineering, *Framed Data Team Joins Square*, MEDIUM (Mar. 14, 2016), https://medium.com/square-corner-blog/framed-data-team-joins-square-6f12d1fcef27 [https://perma.cc/437N-UHMJ].

76. 12 C.F.R. § 225.22(b)(2).

77. *Id.* § 225.22(b).

78. *Id.*; *see* John L. Douglas & Reuben Grinberg, *Old Wine in New Bottles: Bank Investments in Fintech Companies*, 36 REV. BANKING & FIN. L. 667, 688 (2016).

79. For the history of the concept, see Bernard Shull, *The Separation of Banking and Commerce in the United States: An Examination of Principal Issues*, 8 FIN. MKTS., INSTITUTIONS & INSTRUMENTS, May 1999, at 1.

the law does not explicitly prohibit affiliations between banks and commercial business.[80] Haubrich and Santos have found many examples of close ties between commercial enterprises and the banking industry in the United States.[81] Furthermore, by enacting the Gramm-Leach-Bliley Act (GLBA)[82] in 1999, Congress effectively allowed BHCs to own financial firms. This made some new activities that are not related to the business of banking exempt beyond the industrial bank exemption. When approved as a financial holding company,[83] an institution has five years to comply with the BHCA limitations of activities.[84] After being classified as financial holding companies in 2008, for a while Morgan Stanley and Goldman Sachs were able to own businesses categorically unrelated to banking, such as coal mining[85] and oil merchanting,[86] under the merchant banking exemption for the financial holding companies.[87]

Since then, banking and financial activities merged into each other, and the remaining separation is now only between finance and commercial activities.[88] While some regulators view this merger as a

80. *But see, e.g.*, Igor Fasman, *Wal-Mart Banking Bid*, 26 ANN. REV. BANKING & FIN. L. 116, 119 (2007).

81. Joseph G. Haubrich & João A. C. Santos, *Alternative Forms of Mixing Banking with Commerce: Evidence from American History*, 12 FIN. MKTS., INSTITUTIONS & INSTRUMENTS 121 (2003).

82. Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 12 U.S.C.).

83. The financial holding company is a type of bank holding company that can engage in financial activities and activities incidental or complementary to those financial activities. 12 U.S.C. § 1843(k)(1) (2012).

84. *See* Saule T. Omarova, *The Merchants of Wall Street: Banking, Commerce, and Commodities*, 98 MINN. L. REV. 265, 310–11 (2013).

85. Ianthe Jeanne Dugan, *Goldman Sachs in Talks to Sell Its Coal Mines*, WALL STREET J. (May 3, 2015, 6:53 PM), https://www.wsj.com/articles/goldman-sachs-in-talks-to-sell-its-coal-mines-1430693591 [https://perma.cc/MR4X-A7T5].

86. Press Release, Morgan Stanley, Morgan Stanley Completes Sale of Global Oil Merchanting Business to Castleton Commodities International LLC (Nov. 2, 2015), https://www.morganstanley.com/press-releases/21e458d2-0231-493b-a95a-5084c3b4c701 [https://perma.cc/X8FQ-SFKV].

87. For the scope of the merchant bank activities, see Omarova, *supra* note 84.

88. Christine E. Blair, *Banking and Commerce: What Difference Did Wal-Mart Make?*, *in* FINANCIAL INSTITUTIONS AND MARKETS 25, 39 (Robert R. Bliss & George G. Kaufman eds., 2008).

reaffirmation of the separation of the commerce and banking,[89] others have interpreted the GLBA's authorization of the Federal Reserve to create a list of permissible activities as part of the gradual blurring of the difference between commercial activities and the business of banking.[90]

Nevertheless, under the current banking system, exceptions to the separation of banking and commerce might entail some unique risks. The risk of mixing banking and commerce in industrial banks was summarized by the Government Accountability Office (GAO) as "(1) expansion of the federal safety net provided for banks to their commercial entities, (2) increased conflicts of interest within a mixed banking and commercial conglomerate, and (3) increased economic power exercised by large conglomerate enterprises."[91]

One reason for the opposition to the potential FinTech banks is the potential conflict of interest issues that may arise from their affiliation with non-financial industries. For example, the Independent Community Bankers of America (ICBA), claimed that "SoFi could encourage SoFi Bank to deny credit to customers of SoFi's competitors or alternatively, could encourage SoFi Bank to offer loans to SoFi's customers based on [terms] not offered to its competitor's customers."[92] An industry representative claimed that "[t]he commercial company can easily be incentivized to make the bank favor the commercial company when it regards [its] competitors."[93]

These concerns are fundamentally the same conflict of interest arguments against granting Walmart an ILC charter.[94] While some of these issues, especially denial of credit to competitors or their customers,

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89. *See, e.g.*, *Financial Services Regulatory Relief: Hearing on H.R. 1375 Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 108th Cong. 10–12 (2003) (statement of Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, Office of the Comptroller of the Currency).

90. Laurence H. Meyer, Governor, Fed. Reserve Bd. of Dirs., Remarks Before the American Law Institute and American Bar Association: Implementing the Gramm-Leach-Bliley Act: One Year Later (Feb. 15, 2001), https://www.federalreserve.gov/boarddocs/speeches/2001/20010215/default.htm [https://perma.cc/BH3C-NXCU].

91. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 40, at 71.

92. Letter from Christopher Cole, Exec. Vice President & Senior Regulatory Counsel, Indep. Cmty. Bankers of Am., to Kathy Moe, Reg'l Dir., Fed. Deposit Ins. Corp. S.F. Reg'l Office 4 (July 18, 2017), http://www.icba.org/docs/default-source/default-document-library/cl071817.pdf [https://perma.cc/YW8E-8EJQ].

93. *See generally Why the ICBA Doesn't Want Square to be a Bank*, *supra* note 59.

94. *See supra* Part I.

may have some merit in the context of a commercial behemoth such as Walmart, neither the size nor the structure of FinTech firms are capable of creating any disturbance in the competitiveness of the market. Furthermore, FinTech firms are mostly engaged in services similar or complementary to the banking and finance industries. A potential FinTech bank denying service to the customers of other FinTech firms would be very similar to a situation in which a bank denies servicing customers of another bank. This is not a matter specific to the mixing of banking and commerce and might better be addressed by antitrust laws. With respect to the advantages given to the parent company or the customers of the parent company, Sections 23A and 23B of the FRA prohibit the industrial banks from entering into certain transactions unless they conduct these transactions at arm's-length.[95]

On the other hand, some industry observers see benefits to mixing banking and commerce. These benefits are "economies of scale, . . . economies of scope, and enhanced product and geographic diversification."[96] In particular, innovations in financial technologies have a strong tendency to create economies of scope through a combination of financial services with e-commerce, data analytics, and the sharing economy.[97] Furthermore, lowering the costs for FinTech will have positive effects on access to credit. FinTech firms, in their unique situation, provide loans to consumers and small businesses who would typically have difficulty accessing credit. Also, the possibility of a one-stop shop for the customers would reduce transaction costs.[98] For example, Square provides point-of-sale hardware to small enterprises.[99]

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95. 12 U.S.C. §§ 371c, 371c-1 (2012). For an analysis of the firewall provisions, see *infra* Part II.B.

96. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 40, at 73.

97. Hiroshi Nakaso, Deputy Governor of the Bank of Japan, Remarks at the University of Tokyo - Bank of Japan Joint Conference in Tokyo on "FinTech and the Future of Money": FinTech–Its Impacts on Finance, Economies and Central Banking 3 (Nov. 18, 2016), https://www.boj.or.jp/en/announcements/press/koen_2016/data/ko161118a.pdf [https://perma.cc/8TYW-ZZEH]; Christine E. Blair, *The Future of Banking in America: The Mixing of Banking and Commerce: Current Policy Issues*, 16 FDIC BANKING REV. 97, 101 (2004).

98. Alexander Raskovich, *Should Banking be Kept Separate from Commerce* 12 (Econ. Analysis Grp., Discussion Paper No. 08-9, 2008), https://www.justice.gov/sites/default/files/atr/legacy/2008/09/05/236665.pdf [https://perma.cc/WYU2-5ZH9].

99. *Square Point of Sale*, SQUARE, INC., https://squareup.com/pos [https://perma.cc/VA3Y-FDKZ] (last visited Mar. 1, 2018).

The possibility of accessing Square's banking applications through the same platform would be convenient for the customers.

Still, significant concern remains regarding the access of commercial owners of industrial banks to the federal safety net. Industrial banks are covered by the federal safety net because they are insured by the FDIC and have access to the Federal Reserve's payments systems and discount window. The Garn-St. Germain Depository Institutions Act of 1982 made all industrial banks eligible for FDIC insurance.[100] Utah, as the only jurisdiction that charters ILCs, requires industrial banks to be FDIC-insured.[101] Any non-member bank can access the Board's payments facilities by virtue of holding balances at the Federal Reserve Banks.[102] The federal safety net—consisting of the deposit insurance, Fedwire, and discount window facilities— is claimed to be a subsidy given to the banking system because of banks' privileged function to provide liquidity in order to "protect depositors, stem bank runs, and lower the level of risk to the financial system from the insolvency of individual institutions."[103] Extension of the safety net would "make insured banks susceptible to the reputational, operational, and financial risks of their commercial affiliates."[104] If the federal safety net is subsidized, then parts of the federal safety net must be underpriced for the industrial banks.[105] Beyond that, if there are subsidies, there might be loopholes where the parent company finds an incentive to threaten the bank's solvency.[106]

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100. Pub. L. No. 97-320, § 703, 96 Stat. 1469, 1538–39 (codified as amended at 12 U.S.C. §§ 1813, 1815 (2012)).

101. Utah Code Ann. § 7-8-3(4)(b) (West 2017) ("An industrial bank may not conduct business under this chapter as an industrial bank unless the industrial bank obtains insurance from the Federal Deposit Insurance Corporation or a successor federal deposit insurance entity for any deposits received or held by the industrial bank.").

102. 12 U.S.C. § 342 (2012).

103. *Modernization of the Financial System: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Banking & Fin. Servs.*, 105th Cong. (1997), https://www.federalreserve.gov/boarddocs/testimony/1997/19970213.htm [https://perma.cc/XAU7-U8G6] (testimony of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System).

104. BD. OF GOVERNORS OF THE FED. RESERVE SYS. ET AL., *supra* note 41, at 33 (2016).

105. Randy Benjenk, *Quixotic Regulation: Section 23A of the Federal Reserve Act and Containment of the Federal Safety Net Subsidy*, 2 HARV. BUS. L. REV. 461, 469 (2012).

106. *See infra* Part II.B.

B. Elements of the Federal Safety Net

1. Federal Insurance

There are two types of protections under the federal safety net: explicit and implicit.[107] Explicit protection of the deposit insurance gives guarantees to households in case of bank failure.[108] Implicit protections subsidize the risks by decreasing the risk premiums charged on the transactions of the protected institutions by the markets.[109] This view presupposes that the market is inherently an equilibrium sustaining system whereas rational decision making agents price risk accordingly so long as there is perfect information and no external perturbation. The existence of the deposit insurance affects the information channel by making it harder for the creditors of the bank to price risk.[110] The credit terms of a high-risk bank would be similar to a lower-risk bank while the high-risk bank enjoys the benefits of the low-priced insurance premium.

In fact, from its inception until 1991, the FDIC was required to charge a fixed premium rate for all depository institutions, resulting in subsidization of the high-risk banks.[111] Section 302 of the Federal Deposit Insurance Corporation Improvement Act of 1991[112] changed this by requiring the FDIC to implement a risk-based assessment system that requires the depository institutions to pay insurance premiums according to the perceived risk these institutions constitute to the Depository Insurance Fund.[113] Since then, various researchers have found no evidence that deposit insurance is significantly underpriced.[114]

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107. FED. RESERVE BANK OF RICHMOND, PERSPECTIVES ON TOO BIG TO FAIL 1–2 (2017), https://www.richmondfed.org/-/media/richmondfedorg/research/our_perspectives/pdf/perspectives_too_big_to_fail.pdf [https://perma.cc/Z5ZU-7JBS].

108. *Id.*

109. *Id.* at 2.

110. *Id.*

111. Diane Ellis, Deposit Insurance Funding: Assuring Confidence 6 (Nov. 2013) (unpublished manuscript), https://www.fdic.gov/deposit/insurance/assuringconfidence.pdf [https://perma.cc/G2WM-GPHD].

112. Pub. L. No. 102-242, § 302, 105 Stat. 2236, 2345–49 (codified as amended at 12 U.S.C. § 1817(b) (2012)).

113. 12 U.S.C. § 1817(b) (2012).

114. Raskovich, *supra* note 98, at 6–7 (summarizing findings by application of the Black-Scholes formula to deposit insurance).

If the deposit insurance is priced fairly, it will not give any benefits to the insured bank.[115] Some commentators claim that it is impossible to fairly price the deposit insurance because the FDIC cannot always refuse coverage to riskier depository institutions and new banks carry risks that cannot be fully assessed.[116] In any event, some claim that in a perfect market, any benefits accrued from the mispriced deposit insurance would trickle down to the customers because of competition.[117]

Until now, financial start-ups have been avoiding establishing FDIC-insured banks. Between 2011 and 2016, there were only ten de novo bank applications.[118] That might be because the stringent requirements of the FDIC dissuaded start-ups from applying for bank charters,[119] or it might be that these start-ups could easily operate under state money transmitter or lender licenses without any federal insurance requirements.

Offering FDIC insurance to industrial banks may endorse risk-taking behavior with customer deposits and destabilize the financial system. However, the current regime for the money transmitters has its own risks. The example of PayPal Holdings, Inc. (PayPal) is illustrative. PayPal, one of the earliest FinTech firms originated from Silicon Valley, is not a state or national bank and operates under state money transmitter licenses.[120] While it does not take "deposits," customers can hold balances in their PayPal accounts.[121] These balances do not have federal insurance, and they merely "represent[] an unsecured claim against PayPal."[122] These

115. Joe Peek & James A. Wilcox, *The Fall and Rise of Banking Safety Net Subsidies*, *in* TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS 169, 175 (Benton E. Gup ed., 2004) ("A fair deposit insurance premium charged by a risk neutral government would equal the sum of expected deposit losses plus any administrative costs.").

116. RICHARD SCOTT CARNELL ET AL., THE LAW OF FINANCIAL INSTITUTIONS 223–24 (6th ed. 2017).

117. Raskovich, *supra* note 98, at 7.

118. *Oversight of the FDIC Application Process: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 114th Cong. 12 (2016) [hereinafter *114th Cong. Hearing*] (statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation).

119. *Id.* at 29–30 (statement of Matthew Browning).

120. *See PayPal State Licenses*, *supra* note 24.

121. *PayPal User Agreement*, PAYPAL, https://www.paypal.com/us/webapps/mpp/ua/useragreement-full?bn_r=o#5 [https://perma.cc/S3BD-JJXE] (last visited Mar. 1, 2018) ("Money that you receive from other PayPal account holders is held as a balance in your PayPal account.").

122. *Id.*

balances of the customers reached $15 billion in 2016.[123] In order to comply with the Californian Money Transmitter Laws, PayPal abandoned its previous practice of keeping the customer accounts in FDIC insured pass-through deposit accounts and had been investing these funds in liquid investments for its own benefit.[124]

Given PayPal's preeminence in the money transmission domain, in case of insolvency, it is not difficult to imagine the contagion that might affect the whole financial system. In fact, the only way to protect customers from a potential failure of PayPal would be federal deposit insurance, which is accessible only to the depository institutions. Even though FDIC insurance might reinforce the risk-taking behavior of the depository institutions, the FDIC's authority to reject the application of an institution that poses a significant risk to the deposit insurance stays as a safeguard against moral hazard.[125] In the circumstances similar to PayPal, it should be assessed whether the benefits of insuring such companies outweigh the possible adverse effects to the safety net.

2. Fedwire Services and Fed Funds

Industrial banks can access the Federal Reserve's payment services such as check clearing, electronic fund transfers, automated clearinghouse payments, and currency services.[126] As recipients of NOW deposits,[127] industrial banks are required to hold a certain amount of funds in Federal Fund Reserves.[128] Balances may "be checked against and withdrawn by

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123. The amount is stated under funds payable and amounts due to customers on the balance sheet. PayPal Holdings, Inc., Annual Report (Form 10-K) 60 (Feb. 8, 2017).

124. David Bergendahl, *Your PayPal Balance Isn't FDIC Insured: The Case for a New Model for Financial Startups*, MEDIUM (Sept. 21, 2014), https://medium.com/@dbrgndl/paypal-isnt-fdic-insured-non-banks-being-bankish-and-a-new-model-for-financial-startups-df6d16c2d4b [https://perma.cc/8F6Z-WQQE]; Izabella Kaminska, *Is It a Bank, a Money Transmitter, or a Silicon Valley Shadow Financier? No, It's Just Paypal!*, FIN. TIMES: ALPHAVILLE (Aug. 6, 2015), https://ftalphaville.ft.com/2015/08/06/2136828/is-it-a-bank-a-money-transmitter-or-a-silicon-valley-shadow-financier-no-its-just-paypal/ [https://perma.cc/M79D-98FK]; *PayPal User Agreement*, *supra* note 121.

125. Zachariah J. Lloyd, *Waging War with Wal-Mart: A Cry for Change Threatens the Future of Industrial Loan Corporations*, 14 FORDHAM J. CORP. & FIN. L. 211 (2008).

126. BD. OF GOVERNORS OF THE FED. RESERVE SYS. ET AL., *supra* note 41, at 32.

127. *See supra* note 40 and accompanying text.

128. 12 C.F.R. § 204.4(f) (2017).

[the depository institution] for the purpose of meeting existing liabilities."[129] Due to trust in the reserves and the payments system, banks use Fedwire services to make unsecured overnight loans to other depository institutions that need funding.[130] The Board's guarantee for the Fedwire transactions lowers transaction costs for the participants in the Federal Funds market and might behave as a subsidy to the payments system users.[131]

Additionally, there is the issue regarding the interest paid on reserves. The FRA was amended to allow the Federal Reserve to pay interest on balances held at Federal Reserves at a rate not "exceed[ing] the general level of short-term interest rates."[132] This is implemented as a part of the floor-based monetary policy operations because of the inability to lower the near-zero Federal Funds target rate.[133] Using this authority, the Federal Reserve has paid interest on excess and required banks to hold reserve balances since 2008.[134] As a part of the monetary policy, interest on excess reserves is paid to discourage depository institutions from lending overnight at rates lower than the excess reserve rate.[135]

However, participating in the Federal Funds market or earning interest on reserves is not always significantly profitable. In fact, some believe the reason behind the lack of de novo bank applications after the

129. 12 U.S.C. § 464 (2012).

130. For the history and the mechanics of the Fed Funds market, see Seth P. Maerowitz, *The Market for Federal Funds*, FED. RES. BANK RICHMOND: ECON. REV., July–Aug. 1981, at 3. *See generally* Gara Alfonso & Ricardo Lagos, *An Empirical Study of Trade Dynamics in the Fed Funds Market* 4-6 (Fed. Reserve Bank of Minneapolis Research Dep't, Working Paper No. 708, 2014), https://www.minneapolisfed.org/research/wp/WP708.pdf [https://perma.cc/K659-G579].

131. *See* Rob Tammero, *Private Equity Investment in Failed Banks: Controlling Risks to the Federal Safety Net*, 11 J. BUS. & SEC. L. 53, 63–64 (2010).

132. Financial Services Regulatory Relief Act of 2006, Pub. L. No. 109-351, § 201, 120 Stat. 1966, 1968–69 (2006) (codified at 12 U.S.C. § 461(b) (2012)).

133. *See generally* Marc Lavoie, *Changes in Central Bank Procedures during the Subprime Crisis and Their Repercussions on Monetary Theory*, 39 INT'L J. POL. ECON., Fall 2010, at 3, 10–11.

134. Reserve Requirements of Depository Institutions, 73 Fed. Reg. 59,482 (Oct. 9, 2008) (codified at 12 C.F.R. pt. 204 (2017)).

135. Press Release, Bd. of Governors of the Fed. Reserve, Board Announces That It Will Begin to Pay Interest on Depository Institutions' Required and Excess Reserve Balances (Oct. 6, 2008), https://www.federalreserve.gov/newsevents/pressreleases/monetary20081006a.htm [https://perma.cc/UH6U-H69L].

2008 Financial Crisis is the near-zero Federal Funds rate.[136] According to this view, profit margins of new banks without established lending portfolios are too reliant on the rate.[137] Indeed, it is found that new entrants to the banking system tend to hold more money in Federal Fund Reserves as compared to established banks.[138] Due to their lack of established portfolio to lend against, these banks are stuck with the low-interest rates.[139] Therefore, some investors might be dissuaded from participating in banking activities and instead invest in more profitable ventures. Accordingly, access to the payments system or the Federal Funds market may have a subsidy effect, but the effect might not be the same for the FinTech firms that aspire to enter the banking sector and the established players.

3. Discount Window Lending and Intraday Credit

The discount window facility is part of the Federal Reserve's "lender of last resort" function.[140] Through the discount window, depository institutions in need of liquidity can access Federal Reserve loans secured by adequate[141] collateral.[142] The Federal Reserve effectively conducts asset swaps that alter the mix of assets available for use by private market

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136. *114th Cong. Hearing*, *supra* note 118, at 3 (statement of Elijah E. Cummings, Ranking Minority Member).

137. *Id.*

138. Robert M. Adams & Jacob P. Gramlich, *Where Are All the New Banks? The Role of Regulatory Burden in New Charter Creation* 9 (Divs. of Research & Statistics & Monetary Affairs, Fed. Reserve Bd. Fin. & Econ. Discussion Series No. 2014-113, 2014), https://www.federalreserve.gov/econresdata/feds/2014/files/2014113pap.pdf [https://perma.cc/8CVK-7PPP].

139. *Id.* at 11, 12.

140. For the lender of last resort function of the Federal Reserve, see MARC LABONTE, CONG. RESEARCH SERV., RS21986, FEDERAL RESERVE: LENDER OF LAST RESORT FUNCTIONS (2007).

141. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FEDERAL RESERVE COLLATERAL GUIDELINES 4 (2017), https://www.frbdiscountwindow.org/~/media/Documents/FRcollguidelines.ashx [https://perma.cc/L3XG-WPWD] ("In general, securities must meet the regulatory definition of 'investment grade' at a minimum, and in some cases must be of 'AAA' rating quality (where indicated).").

142. *See Credit and Liquidity Programs and the Balance Sheet*, BOARD GOVERNORS FED. RES. SYS., https://www.federalreserve.gov/monetarypolicy/bst_lendingdepository.htm [https://perma.cc/U4ME-4YGP] (last visited Mar. 1, 2018).

participants.[143] The discount window facility usually lends at fifty basis points higher than the Federal Funds rate,[144] making it more expensive for the depository institutions to obtain.

A daylight overdraft (or Federal Reserve's intraday credit) has similar mechanics, but no collateral is needed.[145] Any time during the Fedwire operating day, if an institution's Federal Reserve account has a negative balance, the depository institution incurs daylight overdraft.[146] The Federal Reserve charges institutions with 50 to 150 basis point penalty fees if the overdraft is not collateralized.[147] If collateralized, there is no penalty fee.[148]

The discount window resembles a subsidy because it is in place to address liquidity requirements in times of distress for financial institutions when they are unable to borrow from the market without an increased risk premium. Therefore, for reputational reasons, depository institutions choose to access the lending facilities as a last resort. Further, healthy financial institutions can borrow cheaply in the Federal Funds market if they are not in a dire situation. A discount window is underpriced in times of financial uncertainty because institutions that borrow from the facilities would have very limited access to loans from market participants.[149] This might cause "moral hazard" in protected institutions as they may not take precautions to limit risks, such as

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143. BANK FOR INT'L SETTLEMENTS, COMM. ON THE GLOB. FIN. SYS., CENTRAL BANK OPERATING FRAMEWORKS AND COLLATERAL MARKETS 13–14 (2015), https://www.bis.org/publ/cgfs53.pdf [https://perma.cc/Y79M-34DM].

144. *See, e.g.*, *Current Discount Rates*, FED. RES. DISCOUNT WINDOW, https://www.frbdiscountwindow.org/en/Pages/Discount-Rates/Current-Discount-Rates.aspx [https://perma.cc/796D-QTZ8] (last visited Mar. 1, 2018) (quoting primary rate effective from December 14, 2017 as 2.00% while the Fed Funds Target rate is 1.25–1.50%).

145. *Frequently Asked Questions: Payment System Risk*, FED. RES. DISCOUNT WINDOW: PAYMENT SYS. RISK, https://www.frbdiscountwindow.org/Pages/Payment-System-Risk/Frequently_Asked_Questions.aspx [https://perma.cc/6N7G-C9AF] (last updated July 10, 2015).

146. *Id.*

147. *Id.*

148. *Id.*

149. Benjenk, *supra* note 105, at 472.

adequate capital or contractual safeguards, knowing that they will have access to liquidity through the discount window.[150]

Beyond the protections provided by the FRA against transferring these benefits to the parent company,[151] the BHCA sanctions the extension of intraday credit to the commercial affiliates of industrial banks. Any industrial bank that incurs overdraft on behalf of an affiliate will lose its exempt status, and the parent company will automatically become a BHC.[152] As a result, the parent company would likely be required to cease its commercial operations.[153]

C. Firewall Preventing the Extension of the Safety Net

Sections 23A and 23B of the FRA[154] function as a firewall to prevent the depository institutions from extending subsidies provided by the federal safety net to their affiliates. These provisions cover the transactions between a bank and its parent company or subsidiary (both defined as "affiliates").[155] Under Section 23A of the FRA, the aggregate amount of transactions a depository institution can engage in with the parent company or a subsidiary is limited to ten percent of the capital stock and surplus of the bank.[156] The total transactions with all affiliates and the bank cannot be higher than twenty percent of the capital stock and surplus.[157] In addition to these restrictions, there are certain qualitative limits on the transactions. Certain transactions involving the extension of credit to the affiliates need to be collateralized.[158] Even though this collateralization requirement does not apply to the purchase of assets, an additional restriction on the purchase of low-quality assets from the

150. *Cf.* FED. RESERVE BANK OF RICHMOND, *supra* note 107, at 2 ("The expectation of government support weakens the private sector's ability and willingness to limit risk, resulting in excessive risk-taking. As a result, an extensive safety net creates a need for robust supervision of firms benefitting from perceived protection.").

151. *See infra* Part II.C.

152. 12 U.S.C. § 1841(c)(2)(H) (2012).

153. *See supra* Part I.B.

154. 12 U.S.C. §§ 371c, 371c-1.

155. *Id.* §§ 371c(b)(1),1828(j)(1)(A).

156. *Id.* § 371c(a)(1)(A).

157. *Id.* § 371c(a)(1)(B).

158. *Id.* § 371c(c)(1).

affiliates contains the potential harm from the sale of bad loans or investments to the banks.[159]

Section 23B of the FRA requires most transactions between the bank and the affiliate to be at arm's-length.[160] A depository institution may engage in those transactions with the parent companies or subsidiaries only on the terms and conditions that are substantially the same as comparable transactions with nonaffiliated institutions.[161] If no such transaction exists, the transaction must be on the same terms offered to nonaffiliated firms.[162]

Sections 23A and 23B limit some transactions with third-parties. Section 23B also covers transactions with third-parties in which an affiliate has a vested financial interest.[163] Sections 23A and 23B treat transactions with unaffiliated third-parties as transactions engaged with affiliates "to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, an affiliate."[164] Furthermore, Regulation W tightens the limitations on transactions with third-parties. For example, the depository institution cannot purchase a low-quality asset from an affiliate if the bank did not commit to purchasing the asset "before . . . the asset was acquired by the affiliate,"[165] or it cannot issue credit cards to customers to purchase products and services from affiliates if the value of products and services purchased with the card is more than twenty-five percent of total purchases.[166]

There are some scenarios concerning possible leakage of the federal safety net to the commercial parents. For example, the subsidy effect can spread to the commercial subsidiary if the industrial bank uses the intraday credit or the discount window services to bail out its insolvent or illiquid parent company.[167] This would threaten the safety and soundness of the bank while the parent company keeps its losses limited to its

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159. *Id.* § 371c(a)(3), (b)(10).
160. *Id.* § 371c-1.
161. *Id.* § 371c-1(a)(1)(A).
162. *Id.* § 371c-1(a)(1)(B).
163. *Id.* § 371c-1(a)(2)(E).
164. 12 C.F.R. § 223.16(a) (2017).
165. *Id.* § 223.15.
166. *Id.* § 223.16(c)(4).
167. *Cf.* Spong & Robbins, *supra* note 46, at 59–60 (citing these as conflict of interest issues).

investment in the bank.[168] Second, in order to deceive the public about its financial situation and gains from the commercial operations, the parent company could shift losses to the subsidiary bank using any combination of transactions such as sales or lending.[169] The bank and the parent company could avoid the market discipline because the mispriced insurance might misguide the creditors when they assess the riskiness of the depository institution or the parent company. [170] This way, the parent company could gain an unfair advantage over its commercial competitors.

However, in these cases, the firewall provisions might provide adequate protection for the bank with quantitative and qualitative limitations on the extension of credit. Extending the credit to an affiliate, issuing letters of credit for the benefit of the affiliate, purchasing assets or securities, lending or borrowing securities to an affiliate, accepting securities issued by an affiliate to extend loans, and engaging in derivatives trade with the affiliate are all covered by the quantitative provisions.[171] First of all, the aggregate amount of these transactions between the bank and its affiliates cannot exceed twenty percent of the bank's capital,[172] thereby limiting the damage the bank—and the federal safety net—might endure if any other limitations on transactions fail. These covered transactions, together with activities involving the bank's sale of securities to an affiliate, fees the affiliate receives for its activities as the agent or broker of the bank, and transactions between the bank and third-party in which the affiliate has financial interest have to be conducted on terms that are substantially the same as comparable transactions with nonaffiliates.[173] A parent company seeking to enter into dealings that are detrimental to the bank would have significant difficulties because almost all possible transactions with the bank would have to be conducted on market terms. Additionally, in conjunction with the arm's-length provision, the requirement for credit transactions with the affiliates to be secured by sound collateral[174] would discourage a parent company from increasing the credit exposure of the bank.

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168. Christine E. Blair, *The Future of Banking in America: The Mixing of Banking and Commerce: Current Policy Issues*, 16 FDIC BANKING REV. 97, 106–07 (2004).

169. *Id.*

170. *Id.*

171. 12 U.S.C. § 371c(b)(7) (2012).

172. *Id.* § 371c(a).

173. *Id.* § 371c-1(a).

174. *Id.* § 371c(c).

D. CONSOLIDATED SUPERVISION

The magnitude of the risk may also depend on the regulatory safeguards present. Industrial banks, as FDIC-insured state non-member institutions, have the FDIC as their primary federal supervisor instead of the Board.[175] The Federal Reserve cited a lack of consolidated supervision of the parent companies of industrial banks as a source of risk in the extension of the safety net.[176] The Board's consolidated supervision for the BHCs includes an examination of:

> [T]he nature of the operations and financial condition of the bank holding company . . . the financial, operational, and other risks within the bank holding company system that may pose a threat to . . . the safety and soundness of the bank holding company or [its subsidiaries] . . . or the stability of the financial system.[177]

The scope of this examination is claimed to be more extensive than the approaches taken by the FDIC and state regulators, which concentrate only on the depository institution.[178]

The FDIC's view is that the authority it possesses over the industrial banks is sufficient to protect the industrial bank from the parent company.[179] Even though the FDIC does not have the explicit authority to supervise a parent company or force an injection of capital into a subsidiary if needed, the FDIC is authorized to examine the affairs of any affiliate of an industrial bank and the relationship between the bank and its affiliates.[180] The FDIC has the direct authority to initiate enforcement action against any affiliate of a bank that is determined to be an "institution-affiliated party."[181] Institution-affiliated parties include controlling stockholders, agents, and joint venture partners of a bank.[182] The FDIC examines the incorporation structure and the detailed

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175. This authority stems from the application requirements of these institutions for the federal insurance. 12 U.S.C. § 1815(a).

176. BD. OF GOVERNORS OF THE FED. RESERVE SYS. ET AL., *supra* note 41, at 33–34.

177. 12 U.S.C. § 1844(c)(2)(A).

178. BD. OF GOVERNORS OF THE FED. RESERVE SYS. ET AL., *supra* note 41, at 33–34.

179. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 40, at 47.

180. 12 U.S.C. § 1820(b)(4)(A).

181. *Id.* § 1813(u).

182. *Id.*

transactions between the parent company and the ILC.[183] Moreover, the examiners compare the terms of the affiliate transactions with the terms of third-party transactions.[184] In 2005, with some reservations, GAO found FDIC's supervision adequate for mitigating risk in good times.[185]

Furthermore, consolidated supervision might not guarantee bank stability. Despite the warnings of financial instability created by industrial banks, the lack of consolidated supervision did not cause a significant problem regarding the safety and soundness of industrial banks.[186] During the 2008 Financial Crisis, only two industrial banks failed.[187] The impact of the crisis weighed heavily on parent companies or affiliates of the industrial banks, such as Lehman Brothers and General Motors who filed for bankruptcy, yet the industrial banks themselves did not fail.[188]

Commercial firms are generally involved in unique and more complex transactions than supervisors are used to. In some circumstances, consolidated supervision might be burdensome and difficult for the supervisor to implement.[189] Federal Reserve officials acknowledged that consolidated supervision was insufficient to prevent the failures of some BHCs during the Financial Crisis.[190]

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183. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 40, at 48–49.

184. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-160, BANK HOLDING COMPANY ACT: CHARACTERISTICS AND REGULATION OF EXEMPT INSTITUTIONS AND THE IMPLICATIONS OF REMOVING THE EXEMPTIONS 26 (2012).

185. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 40, at 64–65.

186. *Cf.* Mindy West, *The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/industrial_loans.html (last updated June 25, 2004) [https://perma.cc/W9PU-W8UC] (explaining that most failed ILCs between 1985 and 2003 were newly entrants with an above-average risk profile).

187. *114th Cong. Hearing*, *supra* note 118, at 23 (statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation).

188. *Id.*

189. Spong & Robbins, *supra* note 46, at 59.

190. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 40, at 43.

III. ALTERNATIVE MODELS BEYOND INDUSTRIAL BANKS

A. NONMEMBER BANK SUBSIDIARIES

The FinTech firms seeking industrial bank charters might not want to cease their non-bank activities that are potentially impermissible under the BHCA.[191] For these firms, conversion of a FinTech firm to a state bank instead of directly controlling a bank might be another alternative solution to integrate their non-banking FinTech operations with the banking activities. Banks that are not controlled by another entity, as well as financial and operational subsidiaries of the banks are exempt from the BHCA provisions.[192] If these exempt nonmember banks are national banks, the OCC would be their primary supervisor.[193] If they are state-chartered banks, the primary federal supervisor would be the FDIC.[194]

The FDIC supervision does not mean that the state nonmember banks have unlimited powers. Section 24 of the Federal Deposit Insurance Act prevents state banks from engaging as principals in any activity that is not permissible for a national bank unless the FDIC "has determined that the activity would pose no significant risk to the Deposit Insurance Fund; and . . . the State bank is, and continues to be, in compliance with applicable capital standards prescribed by the appropriate Federal banking agency."[195] Parallel to this provision, subsidiaries of the state banks are restricted from engaging as principals in any activity that is neither permitted for a subsidiary of a national bank nor determined by the FDIC as posing no significant risk to the insurance fund.[196]

This framework entails some interesting possibilities for the nonbank activities. To determine whether an activity is permissible for national banks, the FDIC will defer to the OCC's interpretation of the national

191. *See supra* Part I.C.
192. 12 U.S.C. § 1841(a) (2012).
193. *See* CARNELL ET AL., *supra* note 116, at 96–97 (6th ed. 2017).
194. *See id.*
195. Pub. L. No. 102-242, § 303(a), 105 Stat. 2236, 2349 (1991) (codified at 12 U.S.C. § 1831a(a)).
196. 12 U.S.C. § 1831a(d)(1).

banking powers.[197] The OCC determined that "finder activities"—i.e., nearly all operations that involve bringing parties together to exchange goods or services—are part of the business of banking.[198] These activities include, but are not limited to, hosting commercial websites for small retailers,[199] providing links to websites for internet vendors,[200] marketing devices that enable customers to communicate with financial service providers.[201] The OCC's interpretation of permissible activities is potentially broader than the Board's permissible activities list for BHCs.[202] Given the structure of the Board's regulatory framework, it is not clear that that the Board would find some of these "finder activities" permissible under the Regulation Y scheme.[203]

Probably the most interesting consequence of these provisions is regarding the subsidiary activities authorized by the state laws that are not permissible for the national banks. The FDIC could still permit these activities as long as the activity is not determined to pose a significant risk to the insurance fund.[204] A quick glance at the list of investments approved by the FDIC shows that bank subsidiaries were allowed to engage as principals in a wide variety of activities not permissible for national

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197. *Decisions on Bank Applications: Investments & Activities*, FED. DEPOSIT INS. CORP. (July 25, 2012), https://www.fdic.gov/regulations/laws/bankdecisions/InvestActivity [https://perma.cc/9H5S-GJS8].

198. 12 C.F.R. § 7.1002 (2017).

199. Office of the Comptroller of the Currency Interpretive Letter No. 856, [1998–1999 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,313 (Mar. 5, 1999), https://www.occ.gov/topics/licensing/interpretations-and-actions/1999/int856.pdf [https://perma.cc/H2RE-ZD9H].

200. Office of the Comptroller of the Currency Conditional Approval No. 221 (Dec. 4, 1996), https://www.occ.treas.gov/topics/bank-operations/bit/opinions-letters/ca221.pdf [https://perma.cc/ZBZ3-BZML]; Office of the Comptroller of the Currency Interpretive Letter No. 611, [1992–1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,449 (Nov. 23, 1992).

201. Office of the Comptroller of the Currency, Interpretive Letter No. 875, [1999–2000 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81,369 (Oct. 31, 1999), https://www.occ.gov/topics/licensing/interpretations-and-actions/2000/int875.pdf [https://perma.cc/4XUV-BSEV].

202. *See supra* Part I.B.

203. John L. Douglas & Reuben Grinberg, *Old Wine in New Bottles: Bank Investments in Fintech Companies*, 36 REV. BANKING & FIN. L. 667, 684 (2016).

204. 12 U.S.C. § 1831a(a) (2012).

banks, including manufacturing cable installation tools,[205] renting cars,[206] building mausoleums, and selling crypts and niches.[207] Even though this permission has not been requested for technology investments in the recent times,[208] the FDIC has been historically supportive of the state bank endeavors in innovative fields.[209] For example, in the past, the FDIC allowed some subsidiaries of state banks to offer services in due diligence document retrieval,[210] personality traits analysis,[211] and data processing.[212] Some of these operations are similar to the activities permissible under the services exemption of the Federal Reserve.[213] The core difference of the FDIC exemptions from the services exemption is that there is no limitation on offering these services to third-parties.

This approach might be taken by FinTech firms to retain their non-bank services offered to third-parties, yet it may create some safety net issues that are not present in an industrial bank. Transactions between a bank and its nonbank subsidiary are exempt from the firewall provisions of the FRA.[214] Congress reasonably required the FDIC permit for nonbank activities to prevent exposure of the federal insurance to the risks these

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205. Bank of Kaukauna (Fed. Deposit Ins. Corp. July 27, 2000), https://www.fdic.gov/regulations/laws/bankdecisions/investactivity/kaukauna.html [https://perma.cc/HSS8-UKJZ].

206. FirstBank of P.R. (Fed. Deposit Ins. Corp. June 4, 1996), https://www.fdic.gov/regulations/laws/bankdecisions/investactivity/firstbankofpr.html [https://perma.cc/9UMF-D5NW].

207. Cmty. State Bank (Fed. Deposit Ins. Corp. June 27, 2005), https://www.fdic.gov/regulations/laws/bankdecisions/investactivity/communitystatebankaustin.html [https://perma.cc/P6ER-8736].

208. Douglas & Grinberg, *supra* note 203, at 706.

209. Arthur E. Wilmarth, JR., *Federal Preemption: The OCC's Preemption Rules Exceed the Agency's Authority and Present A Serious Threat to the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225, 261 n.142 (2004).

210. CityBank Lynnwood (Fed. Deposit Ins. Corp. Dec. 10, 2001), https://www.fdic.gov/regulations/laws/bankdecisions/investactivity/citybank.html [https://perma.cc/5GAT-6AGP].

211. Branch Banking & Tr. Co. (Fed. Deposit Ins. Corp. 1994), https://www.fdic.gov/regulations/laws/bankdecisions/investactivity/branchbanking.html [https://perma.cc/Z4TC-UT76].

212. Columbus Bank & Tr. Co. (Fed. Deposit Ins. Corp. 1994), https://www.fdic.gov/regulations/laws/bankdecisions/investactivity/columbusbanktrust.html [https://perma.cc/3NYQ-JTKT].

213. See *supra* Part I.B.

214. 12 U.S.C. § 371c(b)(2) (2012).

activities might entail, but the lack of a firewall might still exacerbate the moral hazard problems stemming from the leakage of the safety net to non-bank entities. A non-bank activity might not create undue risk per se, however, it might involve operations that transfer the risk of the commercial entity to the depository institution. The FDIC addressed this issue in some of its approvals of nonbank activities by making Sections 23A and 23B of the FRA applicable for the transactions between these subsidiaries and the state banks.[215] Provided that the FDIC retains this decision in the future, conducting these activities under subsidiaries will not pose a risk to the federal insurance any more than the industrial banks.

Furthermore, retaining the commercial entity as a subsidiary resolves some of the moral hazard issues industrial banks could be susceptible to. First, the commercial entity cannot shift losses to the bank for the purposes of limiting its liability because it would no longer hold shares of the bank. Second, the firewall provisions might be ineffective against transfers of the safety net benefits as dividend payments made to the parent company because dividend payments are not covered under Sections 23A and 23B of the FRA.[216] The reversed ownership structure of the bank and the commercial entity would prevent these transfers to the commercial entity that could normally take place in an industrial bank ownership hierarchy.

B. CREDIT CARD BANKS

A compelling reason for the FinTech firms to own a bank could simply be that they want to issue credit cards. This way they might streamline the payments of the loans, the credit cards, and offer credit cards to their existing customer base. Prominent credit card networks, such as Visa and Mastercard, require their members to have federal deposit insurance.[217] Many non-bank institutions—including FinTech

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215. *See, e.g.*, FirstBank of P.R. (Fed. Deposit Ins. Corp. June 4, 1996), https://www.fdic.gov/regulations/laws/bankdecisions/investactivity/firstbankofpr.html [https://perma.cc/9UMF-D5NW]; CityBank Lynnwood (Fed. Deposit Ins. Corp. Dec. 10, 2001), https://www.fdic.gov/regulations/laws/bankdecisions/investactivity/citybank.html [https://perma.cc/5GAT-6AGP].

216. 12 U.S.C. §§ 371c(b)(7), 371c-1(a)(2).

217. Andrew Kahr, *Why Allow Only Banks to Issue Credit Cards?*, AM. BANKER (Aug. 22, 2012, 11:26 AM), https://www.americanbanker.com/opinion/why-allow-only-banks-to-issue-credit-cards [https://perma.cc/6XP2-CSAF].

firms—have already entered into "Rent-a-Bank Identification Number" agreements with insured banks to issue credit cards.[218] These arrangements can be costly and increase the price of credit to consumers. Thus, simply decreasing the costs of the credit cards might be a strong reason for some of the firms to have an interest in ILCs.

Credit card banks might be a good alternative to the industrial banks if the FinTech firm is solely interested in credit card banking and not interested in deposit-taking activities. On account of sharing the same exemption from the BHCA definition of banks with ILCs, credit card banks can be owned by commercial entities.[219] Similar to the industrial banks, these credit card banks cannot accept demand deposits.[220] While the industrial banks can freely accept time deposits and extend loans, credit card banks can only accept savings or time deposits of more than $100,000, can manage only one office to accept these deposits and cannot engage in commercial loans besides credit card loans extended to small businesses.[221]

Even though commercial firms can own the credit card banks, this exemption from the BHCA did not give rise to a controversy similar to the one surrounding the industrial banks. This is possibly because credit card bank activities are designed to be highly restricted to credit card operations.[222] In addition to the restrictions of the firewall provisions of the FRA, the Board restricts some transactions where the credit card issued by the bank is used to purchase goods or services from the commercial entity.[223] These additional limitations have made these institutions' impact on the federal safety net minimal.

218. *See Credit Card Issuing Rent-a-Bins*, *in* FED. RES. DEPOSIT CORP., RISK MANAGEMENT EXAMINATION MANUAL FOR CREDIT CARD ACTIVITIES 120, https://www.fdic.gov/regulations/examinations/credit_card/pdf_version/ch14.pdf [https://perma.cc/DYR4-R8JD].

219. 12 U.S.C. § 1841(c)(2)(F).

220. *Id.*

221. *Id.*

222. Saule T. Omarova & Margaret E. Tahyar, *That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States*, 31 REV. BANKING & FIN. L. 113, 170 (2012).

223. 12 C.F.R. § 223.16(c)(4) (2017); *see supra* Part I.B.

CONCLUSION

The recent interest of FinTech firms in bank charters seems to originate from practical considerations and issues with their business models, rather than an intention to expand the federal subsidies to the commercial business. While these firms, if granted charters, will undoubtedly have access to some benefits of the federal safety net, there will usually be adequate protection to prevent these ILCs from benefitting their parent companies or subsidiaries. Meanwhile, accessing the federal safety net may decrease the costs of loans to the public, increase access to credit, and reduce the systemic risk. It should be assessed whether the benefits of the ILC charter to the public—such as greater convenience, increased competition, or gains in efficiency—outweigh the possible adverse effects.

These FinTech firms might have an interest in the industrial bank charters because they might require retaining their non-bank operations to preserve their competitiveness. Nevertheless, an industrial bank is not the only way for a FinTech firm to participate in the business of banking. Depending on their requirements, and the type of operations they may wish to pursue, these firms may engage in a broad range of non-bank activities through state non-member bank subsidiaries or credit card banks. Similar to industrial banks, these options do not constitute a significant threat to the safety net. Additionally, conducting non-bank operations through subsidiaries could even eliminate some moral hazard problems that might be observed in industrial banks. In order to encourage the innovative financial technologies, states might develop bank charters encompassing a broader list of permissible activities for non-bank subsidiaries.