Testimony of

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On behalf of

The National Association of Federally-Insured Credit Unions

"Banking Innovation or Regulation Evasion?
Exploring Modern Trends in Financial Institution Charters"

Before the

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Introduction

Good morning, Chairman Perlmutter, Ranking Member Luetkemeyer, and Members of the Subcommittee. My name is Carlos Pacheco, and I am testifying today on behalf of the National Association of Federally-Insured Credit Unions (NAFCU). I am the CEO of Premier Members Credit Union, headquartered in Boulder, Colorado. I have over 30 years of experience in the financial services industry at both banks and credit unions, including having served in my current CEO role for over 10 years. Thank you for holding this hearing today. We appreciate the opportunity to share our views on the trends in financial institution charters.

Premier Members Credit Union is a member-owned and relationship driven credit union that serves consumers and businesses in Colorado's Front Range. Premier Members has more than 77,000 members, $1.4 billion in assets, 15 retail branch locations and four locations in area high schools. Premier Members takes pride in giving back to the communities it serves, supporting a wide variety of activities and fundraising events for charitable organizations like United Way, Realities for Children of Boulder County, Impact on Education and many more.

Background on Credit Unions

Credit unions serve a unique function in the delivery of necessary financial services to Americans. Established by an act of Congress in 1934, the federal credit union system serves as a way to promote thrift and make financial services available to all consumers, many of whom would otherwise have limited access to financial services. Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes" (12 § USC 1752(1)). Congress established credit unions as an alternative to banks and to meet a precise public need, and today credit unions provide financial services to over 124 million people. Since President Franklin D. Roosevelt signed the *Federal Credit Union Act* (FCUA) into law over 85 years ago, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

1. Credit unions remain totally committed to providing their members with efficient, low-cost, personal financial services; and,

2. Credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism.

The nation's approximately 5,000 federally-insured credit unions serve a different purpose and have a fundamentally different structure than traditional banks. Credit unions exist solely for providing financial services to their members, while banks aim to make a profit for a limited number of shareholders. As owners of cooperative financial institutions, united by a common bond, all credit union members have an equal say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. These singular rights extend all the way from making basic operating decisions to electing the board of directors, something unheard of among for-profit, stock-owned banks. Unlike their counterparts at banks and thrifts, federal credit union directors generally serve without remuneration, epitomizing the true volunteer spirit permeating the credit union community. Credit unions are also limited by their field of membership on who they can serve.

As member-owned and relationship driven cooperatives, credit unions have been on the frontlines working with their members during these times of economic uncertainty. Credit unions have voluntarily implemented programs to protect their members' financial health, including skipping payments without penalty, waiving fees, low or no-interest loans, loan modifications and no interest accruals. The relief provided by Congress thus far during the pandemic has been helpful for credit union members. Still, the impacts of the pandemic are not over, and credit unions remain committed to ensuring we have the necessary tools to continue to support our members – consumers and small businesses – through this crisis.

As the Committee examines the emergence of new types of charters, we also believe it is important to take necessary steps to enhance existing charters, such as those for credit unions, to ensure that they can continue to serve and meet the needs of consumers and small businesses in an ever-changing financial services environment. From a credit union standpoint, this includes enacting H.R. 1471, the *Access to Credit for Small Businesses Impacted by the COVID–19 Crisis Act of 2021*, to make it easier for credit unions to help small businesses in need. Another aspect of this effort includes modernizing outdated requirements and governance provisions in the *Federal*

Credit Union Act, such as (1) expanding available investment options for credit unions to better serve their communities; and (2) allowing all types of credit unions to add underserved areas to their fields of membership in order to help increase financial services access to those in underserved populations. This also includes right-size regulation and examinations that do not overburden credit unions, especially while emerging competitors, such as fintech banks, could take advantage of flexibility from other regulators, or gaps in the regulatory system, that allow them to see less regulation and supervision than traditional institutions.

Fintech Presents Opportunities and Challenges

The growth of fintech in recent years offers new opportunities for the delivery of financial services. The use of financial technology can have a positive effect on credit union members. Credit unions have worked with fintech companies to improve efficiency in traditional banking, and many of the technologies that are commonplace today, such as credit cards and e-sign, would have likely qualified as "Fintech" when they were first introduced. Consumers today come to expect technological developments from their financial institution – from online banking to mobile bill pay. Many credit unions embrace innovations in technology in order to improve relationships with their members. While functional regulators such as the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) have been aggressive in pursuing chartering options in the fintech space, the National Credit Union Administration (NCUA) has traditionally taken a more conservative role in allowing new fintech opportunities for credit unions. Somehow a happy medium must be found.

The rapid growth of fintech can also present new threats and challenges. New entities are emerging in an environment that can be under-regulated. As such, NAFCU believes that Congress and regulators must ensure that when technology firms and fintechs compete with regulated financial institutions, they do so on a level playing field where smart regulations, oversight and consumer protections apply to all actors in that space. While many fintechs are still subject to various consumer protection and other laws, many are not subject to the examination authority of a federal regulator examining for safety and soundness, or subject to the same supervisory expectations as other players in the financial services marketplace. This creates cracks in the regulatory system that could pose risks to both the consumer and the financial system.

For example, fintech companies that specialize in lending, payments, or data aggregation present unique consumer protection concerns. A fintech company that permits consumers to consolidate control over multiple accounts on a single platform can elevate the risk of fraud and may not be subject to regular cybersecurity examination or comply with the same data privacy and protection expectations expressed by federal banking agencies who have interpreted the safeguard requirements of the *Gramm-Leach-Bliley Act* (GLBA). Some of these technologies serve essentially as "pass-through" entities that handle depository account information, but do not maintain the accounts. If they are compromised in a data breach, it is that consumer end point data from the depository account at a financial institution that may suffer the loss. The burden of the breach can then fall on the financial institution that holds the account, both to handle the loss and deal with the consumer. This poses a level of reputational risk for the financial institution. We have found that credit union members trust their credit union to help them when problems arise, and they turn to us because of our strong focus on member service – something many other entities do not have.

Although non-bank lenders are subject to consumer protection rules, the simultaneous connectivity and disaggregation of discrete services into monoline business models within the fintech marketplace can create supervisory challenges. The benefit of an examination-driven supervisory framework is that regulators will be able to detect and prevent harm to consumers before it occurs. The FTC's recent settlement with the operator of a mobile banking app that failed to provide its customers with timely access to funds illustrates the disadvantages of relying solely on the enforcement jurisdiction of the FTC to remedy the failures of under-regulated fintech companies.[1]

Additionally, consumers may not be aware that funds deposited with certain fintech companies are not insured the same way deposits at a credit union or bank are and could be subject to loss. This could cause consumer confusion, or even harm confidence in the financial system should one of

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[1] FTC, Mobile Banking App Settles FTC Allegations that It Misled Users about Access to Funds and Interest Rates (March 29, 2021).

these companies experience a massive data breach or other fraud that causes a loss of consumer funds. One example of a step Congress could take to help ensure a level playing field is to require companies to provide consumers with a clear, concise and prominent disclosure if funds are uninsured.

NAFCU has outlined some of the challenges and opportunities in this area in more detail in a whitepaper that we released in late 2019.

Technology Companies Pursuing Financial Charters

As this hearing is examining today, we have seen a recent trend in which fintech companies are enjoying unprecedented liberalization of bank chartering rules to either acquire or become banks. Recent developments including both the OCC's new chartering options and the FDIC's chartering and approval of deposit insurance for a new wave of Industrial Loan Companies (ILCs) also present problems. In each case, a nonbank company can potentially evade regulation under the *Bank Holding Company Act* (BHCA), either because of a statutory loophole unique to ILCs, or because the entity seeking a limited purpose charter will not accept deposits. Lack of BHCA coverage raises serious concerns regarding the quality and extent of supervision for these specialized banking entities. Chartering additional ILCs or granting new licenses to nonbank payments companies could also weaken the safety and soundness of the wider financial system.

In certain cases, specialized, limited purpose bank charters may allow a fintech to operate with national bank privileges but without the same prudential safeguards that apply to traditional banks and credit unions. While some may characterize these chartering options as innovative, they can ultimately become loopholes which invite unnecessary risk into the financial system and create an uneven playing field.

Industrial Loan Companies

An ILC charter can offer certain nonbank parent companies the opportunity to skirt registration as a bank holding company and avoid consolidated supervision by the Federal Reserve.[2] This reduced

[2] Cocheo, Steve, "Fintech Charters Signal a Tectonic Realignment in Banking," July 22, 2020.

oversight is further exacerbated by the fact that the FDIC lacks a complete range of statutory authority to fully supervise certain parent companies of ILCs.[3] As a result, the relationship between a nonbank parent and its ILC subsidiary lacks the degree of transparency and accountability intended by the BHCA while at the same time inviting potentially hazardous comingling of banking and commercial activities. In other words, the ILC charter frustrates a core principle of prudential regulation: that a bank's parent company should serve as a transparent source of strength rather than an opaque source of risk. Although the FDIC has attempted to patch up some of this risk with new regulation, the agency's December 2020 rule for ILC parent companies is not a substitute for BHCA supervision, and the new rule drew a dissenting vote from one FDIC Board Member who characterized the watered-down restrictions on ILC parent influence as essentially weak.[4]

NAFCU believes that the FDIC approving new ILC deposit insurance applications at this time of economic uncertainty could weaken the stability of the financial system, and we have urged the FDIC to suspend further chartering activity for at least three years so that a fully informed analysis of supervisory risks can be conducted. Furthermore, given technology companies' interest in acquiring banks, the FDIC should also take heed of the unique privacy risks that might exist should consumer financial records find their way into the hands of nonbank parent companies or their subsidiaries through affiliate data sharing arrangements. A moratorium would also give Congress appropriate time to consider whether the ILC charter sufficiently maintains the separation between banking and commerce and is conducive to advancing the goals of financial inclusion given the nonbank parent's limited accountability to its banking subsidiary.[5]

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[3] Under Section 10(b)(4) of the FDI Act, the FDIC is permitted to examine any insured depository institution, including an ILC, to examine the affairs of any affiliate, including the parent holding company, "as may be necessary to disclose fully (i) the relationship between the institution and the affiliate; and (ii) to determine the effect of such relationship on the depository institution." 12 U.S.C. § 1820(b)(4). However, this limited grant of authority is no substitute for the full range of examination powers necessary for consolidated supervision.

[4] Statement by FDIC Board Member Martin J. Gruenberg on the Final Rule: Parent Companies of Industrial Banks and Industrial Loan Companies at the FDIC Board Meeting (December 15, 2020).

[5] In contrast to BHCA banks, a non-BHC parent company would not be prohibited from commencing "new activities" if a subsidiary depository institution has a CRA rating that falls below satisfactory. See 12 CFR § 225.84.

The FDIC should be focused on helping ordinary consumers instead of devoting analytical and legal resources towards advancing the financial ambitions of technology giants.[6] To that end, we support a moratorium on the chartering of new ILCs, eliminating the BHCA loophole for current ILCs, and solidifying a core principle of banking regulation: that a bank's parent company should serve as a transparent source of strength rather than an opaque source of risk.

Special Purpose Fintech Charter

The emergence of new, fintech-powered business models has accelerated the disaggregation of bank services. This has not only increased competitive pressure but also challenged depository-centric models of financial supervision. The diversity of fintech companies and their role in the broader financial sector may necessitate reconsideration of existing models of regulation in the long run; however, an immediate focus for regulators and Congress must be to ensure that fintech companies are operating on a level playing field relative to traditional financial institutions, including credit unions. NAFCU has defined this focus in terms of compliance with federal consumer financial law, but adequate supervision is an equally important consideration.

Research suggests that fintech mortgage lenders may enjoy structural advantages as nonbanks; in essence, benefiting from reduced regulatory burden which corresponds with relaxed federal safety and soundness standards. One report presented at the FDIC's April 2019 Fintech Symposium posited that 60 to 70 percent of "shadow bank" (i.e., nonbank lender) growth is likely due to differences in regulation, and the rest due to advances in technology.[7] Other fintech companies may be enjoying reduced supervisory oversight even if they are subject to federal consumer financial law.

NAFCU recognizes that innovation depends on a fair, but flexible, regulatory regime for financial technology. Many credit unions partner with fintech companies to improve member service and historically these partnerships have proven invaluable to the growth and competitiveness of our industry. Accordingly, NAFCU has advocated for expanding opportunities for credit unions to

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[6] Hrushka, Ann, "Rakuten to continue ILC charter pursuit, subsidiary CEO says" (August 26, 2020), available at https://www.bankingdive.com/news/rakuten-to-continue-ilc-charter-pursuit-subsidiary-ceo-says/584189/.

[7] *See* Piskorski, Tomasz, Fintech and Shadow Banking (April 2019), available at https://www.fdic.gov/bank/analytical/fintech/presentations/piskorski.pdf.

access pilot programs or regulatory sandboxes to test new products or services. At the same time, we have cautioned that frameworks designed to encourage innovation must not favor certain market participants at the expense of others.

When the OCC first introduced its general plan for a special purpose charter for fintech companies, NAFCU recommended that the OCC retain the core features of a national bank charter; namely, capital and liquidity requirements. Our position then assumed what we believe now, which is that the recipient of a specialized charter must be supervised as if it were *bank*, even if its particular business model places greater emphasis on services other than deposit-taking or lending. In this regard, NAFCU remains skeptical of the OCC's assertion that it can offer a charter to a nonbank licensee which confers the benefits of national preemption and other privileges that have traditionally supported banks' deposit taking and lending roles.

In order to maintain safety and soundness within the broader financial sector, Congress should ensure that a fintech charter recipient is supervised as if it were bank, regardless of whether its particular business model places greater emphasis on services other than deposit-taking or lending. Congress should also clarify that any special purpose fintech charter that confers the benefits of national preemption or other privileges that have traditionally supported banks' deposit taking and lending roles, is bound by the same capital, liquidity, and consumer protection rules applicable to traditional banks and credit unions.

Payments Charter

In 2020, the OCC bypassed normal notice and comment rulemaking procedures to invite payments companies to apply for a limited purpose "payments charter." The payments charter has since drawn significant criticism from banks and credit unions alike and has inspired new litigation based on its core premise: that an entity choosing not to accept deposits can obtain the same privileges as a national bank.

One significant risk associated with the payments charter is the potential for reduced supervision of the bank applicant's holding company. By not accepting deposits, a payments charter recipient might not be regarded as BHCA bank, and its parent could avoid consolidated federal supervision by the Federal Reserve. Depending on the scale or risk of the holding company's activities—which might involve facilitating cryptocurrency transactions or issuing stablecoins per recent OCC guidance—lack of comprehensive Federal Reserve oversight could create additional risks for the American taxpayer if a specialized charter recipient fails because of weaknesses deriving from its parent's activities.

Furthermore, the potential for a payments charter recipient to apply for master account access at the Federal Reserve could inject novel risk into our nation's payments systems. A payments charter recipient that does not accept deposits will not be clearly bound to the capital and liquidity standards normally applicable to banks that receive federal deposit insurance. Easing these important standards for entities that might access Federal Reserve clearing and settlement systems could profoundly impact the stability of our nation's financial infrastructure.

National Trust Banks

In 2020, the OCC issued new interpretations of its rules for national trust charters, without soliciting public input through notice and comment rulemaking. In essence, the OCC has paved the way for trust banks to engage in novel fiduciary activities such as cryptocurrency custodial services. In conjunction with its recent guidance on cryptocurrency custody services, the OCC has also taken the position that a permissible fiduciary activity for a national trust bank is any activity that state law permits for a state trust company which comes into competition with a national bank.

Previously, the OCC had taken the more prudent approach of first examining whether the proposed fiduciary activity was in fact 'fiduciary' within the meaning of 12 U.S.C. § 92a. The practical consequence of this new interpretation is to relax standards for conversions of state trust companies into non-depository, national trust banks. The OCC has now received applications from state trust companies that are heavily engaged in cryptocurrency-related activities. While there may be a role for this, we believe Congress should not allow the OCC to promulgate new chartering standards for trust banks through legal interpretations that bypass normal notice and comment rulemaking processes.

Crypto Charters

As regulators begin to review offering cryptocurrency charters, we believe it is important that any actions go through a formal notice and comment rulemaking process to help ensure that all perspectives are heard and reviewed.

What Can Be Done

NAFCU believes that there are a number of steps that should be taken to address our concerns. First, it is important that existing charters, such as the credit union charter, keep pace with advances in technology and consumer preferences to ensure that credit unions have the tools to serve their members' needs, especially post-pandemic. Additionally, as noted above, we support a moratorium on new ILC charters and closing the BHCA ILC loophole and are pleased to see those addressed in the *Bank Charter Review Act* and the *Close the ILC Loophole Act*. Congress should also ensure that the data security and privacy requirements for financial institutions in the GLBA, including supervision for compliance, apply to all who are handling consumer financial information and that programs for implementing these requirements conform to the guidance developed by Federal Financial Institutions Examination Council (FFIEC)member agencies.

NAFCU also believes financial regulators have a role to play in the supervision and regulation of fintechs under their existing authorities. Congress should also be willing to step in and clarify the role of regulators when necessary. For example, NAFCU believes that the Consumer Financial Protection Bureau (CFPB) can play a role under its "larger participants" authority under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* to regulate and supervise technology firms and fintech companies that enter into the financial services marketplace. If the CFPB does not believe it has this authority currently, Congress should examine granting the Bureau explicit authority in this area.

Congress should also consider creating a FFIEC subcommittee on emerging technology (the subcommittee) to monitor the risks posed by fintech companies and develop a joint approach for facilitating innovation.

We would envision the subcommittee having the following under its charge:

a. To report its findings to Congress annually;
b. To define the parameters of responsible innovation to ensure consistent examination of emerging technologies;
c. To identify best practices for responsible innovation; and,
d. To recommend regulatory improvements to allow FFIEC-regulated institutions to adopt new technologies with greater legal certainty.

Conclusion

In conclusion, credit unions look forward to continuing to experience growth in the technology space as a way to better serve our members. We encourage the NCUA and other functional regulators to find a proper balance in this space. As technology companies expand, and new charters emerge to compete in the financial services marketplace, it is important that they compete on a level playing field of regulation and supervision – from data privacy and security to consumer protection. Finally, it is important that Congress ensures laws are modernized to allow regulated financial institutions, such as credit unions, to keep up and compete with technological advances.

I thank you for the opportunity to appear before you today and I welcome any questions that you may have.