Hearing on
"Banking Innovation or Regulation Evasion?:
Exploring Modern Trends in Financial Institution Charters"
Before the U.S. House of Representatives Committee on Financial Services,
Subcommittee on Consumer Protection and Financial Institutions

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Prepared Statement of

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Executive Summary

From 2018 to 2020, the FDIC and OCC embarked on a series of power grabs that conferred the powers and privileges of banks on nonbank commercial firms.

The 2020 FDIC reopening of deposit insurance to industrial loan companies ("ILCs") threatens to:

- ¶ create risks to financial stability;
- ¶ distort competition in commercial markets;
- ¶ distort competition in banking markets and promote greater risk-taking;
- ¶ generate conflicts of interest in lending; and
- ¶ compromise consumer protections.

The FDIC's ability to map and respond to these risks is limited by the fact that ILCs and the conglomerates that own them are not subject to consolidated supervision.

The OCC's new fintech charter contravenes the text, purpose, and structure of the National Bank Act and other core federal banking statutes. Conferring banking privileges on non-deposit taking firms provides them with competitive advantages over commercial rivals that distorts markets. The OCC's fintech charter seems designed mainly to preempt state financial laws without authorization from Congress. It would also open up exemptions from important federal financial laws for favored firms.

Congress should reverse these dangerous power grabs and close destructive loopholes in banking law by:

- ¶ ending the ILC exemption to the Bank Holding Company; and
- ¶ removing the Comptroller's ability to issue future charters to non-deposit taking firms.

Congress should reinforce the walls separating commerce from banking, which:

- ¶ guard against concentrations of financial, economic, and political power in the largest banking, retail, and tech conglomerates;
- ¶ prevent distortions and unfair competition in commercial markets;
- ¶ safeguard financial stability;
- ¶ reduce conflicts of interest in credit; and
- ¶ protect consumers.

These walls also prevent bank regulators from gaining unprecedented oversight power over vast swaths of American commerce. Without these walls, much of financial services and commerce could come to be dominated by Big Wall Street, Big Retail, and Big Tech conglomerates.

Mr. Chairman Perlmutter, Ranking Member Luetkemeyer, and Members of the Committee:

Thank you for inviting me to testify at today's hearing on "Banking Innovation or Regulation Evasion?: Exploring Modern Trends in Financial Institution Charters."

My testimony today will focus on actions taken by the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation from 2018 through the end of the Trump Administration to confer certain privileges and powers of banks on non-bank firms. I will discuss how these actions eroded the separation of banking and commerce, which is foundational to American banking law. I will also explain why this erosion creates grave concerns for:

¶ concentrating financial, economic, and political power;

¶ financial stability;

¶ consumer protection; and

¶ distorted competition both in non-banking and banking markets.

I am a law professor at the University of Colorado Law School. My teaching and research focus on banking and securities regulations. I have authored numerous articles on banking and securities laws, and financial crises. Much of my research focuses on the "shadow banking system," which describes a network of nonbank intermediaries that perform the same economic functions as banks, generate the same risks of financial crises as banks, but are not subject to the same regulations as banks.[1] I am also the co-author of a treatise on payment systems.[2]

Before joining the faculty at the University of Colorado, I was on the faculty of the University of New Mexico School of Law and served as a visiting professor at the University of Georgia School of Law. Before becoming an academic, I practiced for eight years at Cleary, Gottlieb, Steen, and Hamilton.

I have not received any Federal grants or any compensation in connection with this testimony, and I am not testifying on behalf of the University of Colorado or any other organization. The views expressed in my testimony are solely my own.

I. Overview

Over the past four years and accelerating in the last year of the Trump Administrative, the Office of the Comptroller of the Currency (the "<u>OCC</u>") and the Federal Deposit Insurance Corporation ("<u>FDIC</u>") took a series of dramatic actions to confer certain privileges and powers of federally regulated banks on non-bank firms. The most dramatic of these agency moves were the following:

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1 *E.g.*, ERIK F. GERDING, LAW, BUBBLES, AND FINANCIAL REGULATION, pt. IV (2014).
2 ERIK F. GERDING, NEGOTIABLE INSTRUMENTS UNDER THE U.C.C. (Bender). Professors Fred Hart and William Willier were the creators of this treatise.

¶ The OCC's invention of a "fintech charter" for non-banks in 2018[3] and its processing of applications for these charters starting in the summer of 2020[4] despite an order from a federal judge ruling that the OCC had exceeded its statutory authority[5] and an appeal in front of the U.S Court of Appeals for the Second Circuit;[6] and

¶ The FDIC both:

- ending a long moratorium and granted new applications for FDIC deposit insurance to industrial loan companies ("ILCs"), and

- issuing new rules to pave the way for more new ILCs.[7]

These regulatory actions combined with other 2020 actions by the two agencies that allowed banks to transfer immunities from state usury and consumer laws to nonbanks.[8] This is but a small sample of the wave of deregulatory actions taken by the OCC and FDIC in 2020 while the public and Congress were preoccupied with the pandemic and its economic fallout. Much of this deregulation benefitted nonbanks.[9]

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[3] Office of the Comptroller of the Currency, Policy Statement on Financial Technology Companies' Eligibility to Apply for National Bank Charters (July 31, 2018) *available at* https://www.occ.gov/news-issuances/news-releases/2018/pub-other-occ-policy-statement-fintech.pdf (last visited Apr. 8, 2021); Office of the Comptroller of the Currency, Comptroller's Licensing Manual Supplement: Considering Charter Applications From Financial Technology Companies (July 2018) *available at* https://www.occ.gov/publications-and-resources/publications/comptrollers-licensing-manual/files/considering-charter-apps-from-fin-tech-companies.html (last visited Apr. 8, 2021).

[4] Victoria Guida, *Top Regulator Pushes Ahead with Plan to Reshape Banking, Sparking Clash with States*, Politico (Aug. 31, 2020) *available at* https://www.politico.com/news/2020/08/31/currency-comptroller-reshape-banking-406393 (last visited Apr. 8, 2021).

[5] Vullo v. Office of the Comptroller of the Currency, 378 F. Supp. 3d 271 (S.D.N.Y. 2019).

[6] Lacewell v. Office of the Comptroller of the Currency, 19-4271-cv (2d.Cir.).

I was one of the signatories of an *amicus* brief supporting the district court opinion and opposing the OCC fintech charter. Brief of Thirty-three Banking Law Scholars as *Amici Curiae* in Support of Appellee in Lacewell v. Office of the Comptroller of the Currency, 19-4271-cv (2d.Cir.) *available at* https://justmoney.org/wp-content/uploads/2020/08/19-4271-Amicus-Brief-of-Banking-Law-Scholars.pdf (last visited Apr. 8, 2021) [hereinafter *Brief of Thirty-three Banking Law Scholars*].

[7] FDIC final rule, "Parent Companies of Industrial Banks and Industrial Loan Companies," 86 Fed. Reg. 10,703 (Feb. 23, 2021) *available at* https://www.fdic.gov/news/board/2020/2020-12-15-notice-dis-b-fr.pdf (last visited April 7, 2021).

[8] OCC final rule, "National Banks and Federal Savings Associations as Lenders," 85 Fed. Reg. 68,742 (Oct. 30, 2020) ("OCC True Lender rule"); OCC final rule, "Permissible Interest on Loans That Are Sold, Assigned or Otherwise Transferred," 85 Fed. Reg. 33,530 (June 2, 2020) ("OCC Usury Preemption Transfer Rule"); FDIC final rule, "Federal Interest Rate Authority," 85 Fed. Reg. 44,146 (July 22, 2020) ("FDIC Usury Preemption Transfer Rule").

[9] For example, in December 2020, the FDIC also issued a final rule allowing fintech and other firms to partner with national banks to provide them with deposits without triggering the restrictions of brokered deposit rules. This rule benefits both fintech firms that seek to supply banks with deposits and banks that would be otherwise precluded from accepting these sources of financing. The FDIC rule loosens requirements that Congress first created in the wake of the 1980s savings and loan crisis to restrict brokered deposits. FDIC final rule, "Unsafe and Unsound Banking Practices: Brokered Deposits and Interest Rate

Individually and together, these OCC and FDIC actions dramatically increased the ability of non-banks to enjoy the privileges and powers of federally regulated banks. These OCC and FDIC actions thus eroded the separation between banking and commerce that has been foundational to American banking law. Separating banking and commerce has numerous purposes, including guarding against excessive concentrations of financial, economic, and political power. Eroding the separation between banking and commerce poses risks to financial stability and consumer protection and threatens to:

¶ distort non-financial markets by allowing commercial firms that can obtain bank powers and privileges to compete unfairly with firms that cannot,

¶ distort banking markets by allowing non-banks to offer banking services without facing the same degree of supervision and regulation as banks, *which in turn would*,

¶ create incentives for banks to take more risk or lobby for deregulation.

The FDIC's reopening of ILC applications and access to federal deposit insurance and the OCC's fintech charter represent power grabs by federal bank regulators that could give them oversight over a vast domain of non-bank financial services and even non-financial commercial activity. Not only are the FDIC and OCC ill-equipped to conduct this oversight, the expansion of their oversight into realms of commerce and traditional provinces of state law would give them power far beyond what Congress intended.

It is not clear that these OCC and FDIC actions would result in the positive effects cited by their architects. There are indeed deep and unmet market and community needs to which banks or fintech companies can respond. However, rather than the "Pandora charters" promoted by the FDIC and OCC, Congress and regulators should explore other measures to meet these needs. The Pandora charters undermine fundamental public policies and threaten to further entrench the largest commercial firms at the expense of smaller commercial firms and community banks.

Among the immediate steps I recommend below are the following:

¶ Congress should end the ILC exemption to the Bank Holding Company Act. I therefore support the "Close the ILC Loophole Act" being considered by this Subcommittee;

¶ If ending the ILC exemption now is infeasible, I support a long moratorium on the FDIC approving deposit insurance. I therefore support the Bank Charter Review Act should the Close the ILC Loophole Act not pass; and

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Restrictions," 86 Fed Reg. 6,742 (Jan. 22, 2021) ("FDIC Brokered Deposit Rule"). Brokered deposits present more liquidity risks to banks that traditional deposits because depositors may be more likely to move money in a brokered deposit to another bank. Congress's concern was that troubled banks might use brokered deposits to fund risky investments and that depositors switching to other banks could more easily precipitate a bank run. Congressional Research Service, FDIC Proposes Changes to Brokered Deposit Regulation (Jan. 6, 2020) *available at* https://crsreports.congress.gov/product/pdf/IN/IN11209 (last visited Apr. 12, 2021).

¶ Although I believe federal courts will strike down the OCC fintech charter, to prevent adventurism by future Comptrollers, Congress should amend the National Bank Act to prohibit any future OCC charters of non-deposit taking firms.

The remainder of this report proceeds as follows:

¶ Part II examines the FDIC move to reopen deposit insurance for new ILCs;
¶ Part III examines the OCC fintech charter;
¶ Part IV explains the reasons that Congress has long separated banking and commerce;
¶ Part V discusses the institutional problems when Congress undermines clear categories of financial institution charters;
¶ Part VI sets forth first principles for proper roles for state regulators;
¶ Part VII lays out my recommendations for more immediate action by Congress;
¶ Part VIII argues for alternative, longer term approaches to the banking needs of underserved communities; and
¶ Part IX outlines several issues adjacent to nonbank bank charters for future consideration by this Subcommittee.

II. FDIC Reopens Deposit Insurance to ILCs in 2020

In 2020, the FDIC began approving applications for FDIC deposit insurance to new ILCs. This ended a long moratorium, which lasted over a decade, which was imposed first by prior FDIC leadership and later by the Dodd-Frank Act. This moratorium followed the controversy when Walmart sought to create an FDIC-insured ILC in 2005 and 2006.[10]

In December 2020, the FDIC issued a final rule[11] setting forth the conditions it will impose and the commitments it will require from ILCs to receive deposit insurance from the agency. The financial and legal communities see this as a major development that paves the way for more non-bank firms – including not just specialized "fintech" firms, but also large tech and platform companies like Amazon and retail conglomerates – to own ILCs and gain access to federal deposit insurance.[12]

In 2020, the FDIC began accepting applications from new ILCs for deposit insurance. The agency granted deposit insurance to two ILCs, one owned by the payments company Square and another by Nelnet, a financial conglomerate focused on student loans. Other companies, including

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[10] For an analysis of the Walmart controversy, see Arthur E. Wilmarth, Jr., *Wal-Mart and the Separation of Banking and Commerce*, 39 CONN. L. REV. 1539 (2007).
[11] *Supra* note 7.
[12] *E.g.*, Jesse Hamilton, *Could Amazon Start a Bank? The FDIC has Opened the Door*, CHICAGO TRIB. (Dec. 16, 2020) *available at* https://www.chicagotribune.com/business/ct-biz-amazon-facebook-bank-loans-fdic-20201216-bd2glh3nlzbxxlevrxeiwg43n4-story.html (last visited Apr. 7, 2020); Scott A. Coleman & James Kim, "FDIC Issues Final Rule on ILC Deposit Insurance Applications," BallardSpahr LLP Consumer Finance Monitor (Dec. 28, 2020) *available at* https://www.consumerfinancemonitor.com/2020/12/28/fdic-issues-final-rule-on-ilc-deposit-insurance-applications/ (last visited Apr. 7, 2021).

the giant Japanese online retailer Rakuten (called the "Amazon of Japan"), are in various stages of the FDIC application process.[13]

After providing some history and background of ILCs, I examine below how the ILC exemption to the Bank Holding Company Act:

- Poses threats to financial stability;
- Creates an uneven playing field among commercial firms;
- Creates potential conflicts of interest in lending;
- Distorts banking markets; and
- Creates potential for abuses of consumers.

Regulators cannot adequately detect or counter these threats because ILCs and the conglomerates that own them are not subject to consolidated supervision.

A. History/Background on ILCs

Modern ILCs scantly resemble their progenitors, Morris Plan banks, which were small early 20th century lending institutions designed to provide credit to industrial workers who were not served by established depository banks.[14] ILCs have become FDIC-insured financial institutions, some of which are quite large and have expansive and complex nationwide operations. Some ILCs have engaged in subprime lending and securitization activities.[15]

Thanks to a 1987 amendment to the Bank Holding Company Act, ILCs are exempt from the definition of "bank." This exemption has several significant consequences including the following:

> *ILCs are exempt from restrictions that separate banking from commerce:* The Bank Holding Company Act generally prohibits commercial firms from owning banks and banks from owning commercial enterprises;[16]

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13 Brendan Pedersen, *Rakuten Mounts Third Attempt for Industrial Bank Charter*, AMER. BANKER (Jan. 19, 2021) *available at* https://www.americanbanker.com/news/rakuten-mounts-third-attempt-for-industrial-bank-charter (last visited Apr. 11, 2021); Wilmarth, *The FDIC Should Not Allow Commercial Firms to Acquire Industrial Banks*, 39 BANKING & FIN. SVCS. Pol'y Rep. No. 5 at 1-2 (May 2020) *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3613022 (last visited Apr. 11, 2021).

14 For a history of Morris Plan Banks, see MEHRSA BARADARAN, HOW THE OTHER HALF BANKS: EXCLUSION, EXPLOITATION, AND THE THREAT TO DEMOCRACY 94-99 (2015).

15 *See* Wilmarth, *The FDIC Should Not Allow Commercial Firms to Acquire Industrial Banks*, *supra* note 13, at 6.

16 Saule T. Omarova & Margaret E. Tahyar, *That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulations in the United States*, 31 REV. BANKING & FIN. L. 113, 119, 159-160 (2011-2012).

ILCs fall outside Federal Reserve consolidated supervision: Unlike banks, the Federal Reserve cannot exercise consolidated supervision over ILCs, nor can it impose capital requirements on ILCs.[17]

I discuss the important difference between *consolidated* supervision of an entire conglomerate versus ordinary supervision of a single financial institution entity in more detail below.

These exemptions mean that regulatory and supervisory duties fall primarily on the FDIC and the state regulator that charters an ILC.[18] Utah has chartered most existing ILCs, with a half dozen other states either having chartered an ILC or having statutes that authorize this type of charter.[19]

The Industry Transforms After the 1987 Bank Holding Company Act

ILCs first became eligible for federal deposit insurance in 1982. When Congress amended the Bank Holding Company Act of 1987, ILCs were still "small locally-focused institutions that offered deposit and credit services to lower- and middle-income consumers."[20] At that moment, ILCs held a combined $4.2 billion in assets, with the largest ILC having assets of $420 million.[21] In 1993, the Congressional Research Service found that ILCs remained minor to the entire U.S. financial system.[22] However, two developments in the 2000s marked the massive transformation of ILCs into significant parts of American finance: the application of Walmart for an ILC charter in 2005 and the global financial crisis in 2007 and 2008.

The Walmart Storm

Walmart's 2005 application for a Utah ILC license and ultimate FDIC insurance ignited a political and legal firestorm. The Walmart controversy previewed many of the concerns that apply to the FDIC's current reopening of ILC applications. Compared to the original small, local nonbank banks, ILCs owned by large commercial conglomerates posed more significant risks to financial stability and the FDIC's insurance fund, to fair competition with commercial firms without nonbank banking licenses, and to the risk-taking within the regulated banking sector.[23] Ultimately, Walmart withdrew its application, and the FDIC under Chair Sheila Bair imposed the start of a moratorium on new ILC applications for deposit insurance.[24]

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17 GENERAL ACCOUNTING OFFICE, CHARACTERISTICS AND REGULATION OF EXEMPT INSTITUTIONS AND THE IMPLICATIONS OF REMOVING THE EXEMPTIONS at 19 (Jan. 19, 2012) *available at* https://www.gao.gov/assets/gao-12-160.pdf at 12, 24-25 (last visited Apr. 10, 2021) [hereinafter *GAO 2012 Report*].

18 For the historical evolution of ILCs via federal statutes, state chartering of ILCs, and FDIC insurance, see Omarova & Tahyar, *That Which We Call a Bank*, *supra* note 16, at 158-163.

19 Congressional Research Service, Industrial Loan Companies (ILCs): Background and Policy Issues at 2-3 (Sept. 9, 2020).

20 *See* Wilmarth, *The FDIC Should Not Allow Commercial Firms to Acquire Industrial Banks*, *supra* note 13, at 2.

21 *Id.*

22 *Id.*

23 *See* Wilmarth, *Wal-Mart and the Separation of Banking and Commerce*, *supra* note 10.

24 Jonathan Birchall, *FDIC Declares Moratorium on Wal-Mart Bank*, FIN. TIMES (July 28, 2006) *available at* https://www.ft.com/content/52f38e24-1e75-11db-9877-0000779e2340 (last visited April 13, 2021).

ILCs in the 2008 Financial Crisis

The size and importance of modern ILCs to the financial system became more than just theoretical with the eruption of the global financial crisis in 2007 and 2008. Indeed, the crisis revealed the threats that ILCs pose to financial stability and to the FDIC's fund. In the global financial crisis, many parent companies did not serve as "sources of strength" for the ILCs that they owned. To the contrary, many prominent nonbank financial firms that owned ILCs failed or required substantial government assistance to remain afloat. The following chart summarizes the crisis fate of six prominent corporate owners of ILCs:[25]

Owner of ILC	Fate during 2008 Financial Crisis
CIT Group	Filed for bankruptcy in November 2009; Federal government suffers total loss of emergency investment.
GE Capital Corporation	Federal Reserve purchases $16 billion of GE Capital commercial paper; FDIC guarantees $70 billion of newly issued debt securities.
General Motors Acceptance Corporation (GMAC)	Emergency conversion into bank holding company; $40 billion in governmental financial assistance in form of TARP equity investments, FDIC debt guarantees, Federal Reserve purchases of commercial paper and loans.
Goldman Sachs	Emergency conversion into bank holding company; TARP capital infusions; FDIC debt guarantees; Federal Reserve purchases of commercial paper and emergency loans.
Merrill Lynch	Government backstop to Bank America to induce emergency purchase of Merrill Lynch in September 2008; TARP equity investments, government asset and debt guarantees, Federal Reserve purchases of commercial papers and emergency loans to support Bank of America and Merrill Lynch.
Morgan Stanley	Emergency conversion into bank holding company; TARP capital infusions; FDIC debt guarantees; Federal Reserve purchases of commercial paper and emergency loans.

Scholars have concluded that the five firms above that survived the 2008 global financial crisis would have failed but for the extraordinary government support they received.[26]

The costs that ILCs imposed on the FDIC and federal government generally did not stop there. Other, less famous, ILC parents also went bankrupt or survived only because of emergency government interventions. For example, Fremont General filed for bankruptcy in June 2007 (after the FDIC ordered it in the prior year to cease subprime mortgage lending). Fremont General's ILC

25 *See* Wilmarth, *The FDIC Should Not Allow Commercial Firms to Acquire Industrial Banks*, *supra* note 13, at 4-6.
26 *E.g.*, *id.*

assets were the subject of any emergency sale to a newly formed ILC.[27] Prior to the financial crisis, many owners exploited their ILCs FDIC-insured deposits to support their operations. For example, Merrill Lynch offered customers "sweep accounts" to transfer funds from uninsured accounts to FDIC-insured ones, increasing the potential risk to the FDIC insurance fund.[28] Two scholars described how securities firms owning ILCs used this kind of practice to support their securities businesses:

> This allowed securities firms, in effect, to get cheaper financing of their activities and to develop formidable in-house lending capability to support their traditional securities underwriting and dealing and investment advice business. Ownership of ILCs allowed securities firms to become a one-stop-shop for all of their customers' financing and investment needs, significantly increasing their profitability and permitting them to compete more successfully with commercial banks. Indirectly, it also contributed to the growth of available credit outside the traditional banking system.[29]

This captures the essential elements of the threats that ILCs can pose to financial stability: conglomerates can use government-subsidized financing of an ILC to fund risky operations elsewhere in the corporate group, including risky capital market activities.

Some may question whether the practices and crisis fates of these financial firm owners of ILCs during the global financial crisis shed any light on the potential weaknesses of commercial firms that might apply to own an ILC. It is important to remember that neither General Electric nor General Motors began as financial firms. Instead, over time, these conglomerates used their ILCs to transform themselves radically, away from their industrial roots. During Jack Welch's tenure as CEO starting in 1981 General Electric gradually morphed into a "closet bank," becoming one of the seven largest financial institutions in the United States.[30] GE Capital was ultimately designated as a systemically important financial institution by the Financial Stability Oversight Council.[31] The ILC form represented an important piece of GE's financialization.[32]

It also proves difficult to articulate a clear dividing line between financial and nonfinancial owners of ILCs; the General Accounting Office noted the difficulty in making even this analytic distinction between types of owners.[33] A legally workable distinction between financial and nonfinancial owners would prove much more difficult.

B. Concerns with ILCs and the Expansion of ILCs

[27] *Id.* at 6.
[28] *Id.*
[29] Omarova & Tahyar, *supra* note 16, at 164-165.
[30] *GE Breaks Up; Electric Shock; An Iconic Firm Abandons Its Finance Business*, ECONOMIST (Apr. 10, 2015); Peter Eavis, *In G.E. Sale, End to Age of Hubris*, NY TIMES at B3 (Apr. 11, 2015).
[31] Financial Stability Oversight Council, Basis of the Financial Stability Oversight Council's Final Determination Regarding General Electric Capital Corporation, Inc. (July 8, 2013) *available at* https://home.treasury.gov/system/files/261/General%20Electric%20Capital%20Corporation%2C%20Inc.pdf (last visited Apr. 10, 2021).
[32] *See generally GE and Industrial Loan Companies: Parting Company*, ECONOMIST (June 27, 2009)
[33] *GAO 2012 Report*, *supra* note 17, at 19.

The transformation of ILCs into complex financial institutions and the growth in the size and number of ILCs raises multiple concerns about the nature of the ILC exemption. The expansion of ILCs:

¶ Poses threats to financial stability;

¶ Creates an uneven playing field for other businesses;

¶ Generates potential conflicts of interest in lending; and

¶ Creates the potential for consumer abuses.

Most basically, ILCs are subject to inadequate supervision.

I begin with the last concern because it is essential to understanding the scope of all other concerns and threats. If regulators cannot adequately supervise a financial institution, they cannot adequately understand the extent to which it faces financial risks, poses threats to financial stability, would distort competition in commercial or banking markets, or affects consumer welfare. Without adequate supervision, regulators and policymakers are flying at least partially blind.

The Importance of Consolidated Supervision: ILCs are subject to FDIC supervision but not *consolidated* supervision by the Federal Reserve as are bank holding companies. The difference between supervision of an entity and consolidated supervision is critical. The FDIC scrutinizes an ILC and, to a lesser extent, certain affiliates within the ILC's corporate group with which it contracts. By contrast, consolidated supervision by the Federal Reserve encompasses the entire financial conglomerate. The Federal Reserve explained the risks of a lack of consolidated supervision of ILCs thus:

> … the ILC exemption creates special supervisory risks because an ILC's parent company and nonbank affiliates are not subject to consolidated supervision. Lack of consolidated supervision is problematic because the organization may operate and manage its businesses on an integrated basis, and, in the Federal Reserve's experience, risks that cross legal entities and that are managed on a consolidated basis cannot be monitored properly through supervision directed at any one, or even several, of the legal entity subdivisions within the overall organization. Moreover, history demonstrates that financial distress in one part of a business organization can spread, sometimes rapidly, to other parts of the organization.[34]

Managers of conglomerates can engage in complex intragroup transactions and even play games in ways that disadvantage an ILC subsidiary or allow the conglomerate to exploit the ILC's FDIC

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[34] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FEDERAL DEPOSIT INSURANCE CORPORATION, & OFFICE OF THE COMPTROLLER OF THE CURRENCY, REPORT TO THE CONGRESS AND THE FINANCIAL STABILITY OVERSIGHT COUNCIL PURSUANT TO SECTION 620 OF THE DODD-FRANK ACT at 33-34 (Sept. 2016) *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160908a1.pdf (last visited Apr. 10, 2021).

deposit insurance. This is what securities firms did in the run-up to the global financial crisis. I explain this "subsidy transfer" and "leakage" problem further below.

For now, metaphors might help explain the limitations of supervision of an ILC compared to consolidated supervision. If supervision examines the health of an elephant and looks at how it touches other elephants in its immediate vicinity, consolidated supervision can see the risks to the elephants from the movement of its entire herd.[35]

Supervision of commercial entities: Even with its more limited supervisory scope, the FDIC faces daunting obstacles in supervising ILCs. No bank regulator has deep expertise or capacity to understand commercial entities. Even understanding complex *financial* operations and products beyond traditional depository banking presents serious challenges for regulators. Furthermore, ILCs, their parents, and their affiliates span a wide range of business models and industries. Student loan companies (like Nelnet) differ from payment companies (like Square), which in turn are very different animals than online retailers (Rakuten) and brick-and-mortar retailers (Walmart). Even consolidated supervision would struggle with *commercial* conglomerates.

Supervision of vast commercial enterprises raises the risk not only of weak regulators, but also of regulators that are too powerful. Giving any regulator authority over the financial and business decisions of a large swath of American enterprise should concern policymakers.

Risks to the FDIC fund; financial stability risks: Proponents of ILCs argue that large commercial parents could serve as "sources of strength" for ILCs, and that commercial operations could provide valuable diversification to protect nonbank banks.[36] The record of the stability of ILCs depends on the time horizon being considered.[37] As noted above, parents and affiliates of several prominent ILCs did not serve as sources of strength during the financial crisis of 2007 and 2008. Instead, these conglomerates required billions of dollars of extraordinary government assistance, including by the FDIC.

There have been other periods of instability for ILCs. Between 1985 and 2003, 21 ILCs failed. Many of these failures took place in Californian in the late 1980s and 1990s. Two ILC failures, in 1999 and 2003, imposed "material losses" on the FDIC fund.[38] It is not only the failure of an ILC that creates financial stability risks. By engaging in subprime lending and participating in

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[35] Alternatively, one could compare FDIC supervision to studying only the strands of a spider web connecting to an ILC, while consolidated supervision by the Federal Reserve would examine the entire web with all its interconnections.

[36] *GAO 2012 Report*, *supra* note 17, at 23.

[37] Arguments in favor of lowering walls that segment financial services – for example rules separating banking from commerce or separating banking, securities, and insurance business – often cite the enhanced stability to a firm that comes from diversified business lines and investments across very different markets. With diversification, however, also comes the possibility of creating transmission lines for financial contagion to spread from one affiliate in a conglomerate to another or among different financial markets. *See generally* Erik F. Gerding, *How Law Improved the Transmission Lines between Real Estate and Banking Crises*, 50 GA. L. REV. 89 (2015).

[38] Government Accountability Office, Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority at 59-60 (Sept. 2005) *available at* https://www.gao.gov/assets/gao-05-621.pdf (last visited Apr.14, 2021) [hereinafter GAO 2005 Report].

complex and opaque financial markets (including but not limited to securitization), ILCs have contributed to the buildup of systemic risk in financial markets.[39] The historical clustering of ILC and parent failures raises the possibility that the financial stability risk posed by ILCs may follow cycles or increase suddenly due to herd behavior.

Moreover, individual ILCs and their owners and the makeup of the overall ILC industry can change dramatically over time. FDIC approvals of ILCs based on applicants as they conduct business today may not fully capture risks as ILCs individually or collectively evolve. But how are regulators to adequately understand this evolution and adjust deposit insurance premiums or prudential regulation accordingly in the absence of consolidated supervision?

Distorted competition: As I explain below, the retailers, tech firms, and other commercial conglomerates most likely to succeed in obtaining an ILC charter and FDIC insurance are larger, established enterprises. FDIC insurance and other powers and privileges of banking would give conglomerates owning an ILC a competitive advantage over firms without an ILC. In short, the growth of ILCs threatens to distort competition in commercial markets far beyond the banking sector. The FDIC could take steps to price deposit insurance to counteract, at least in part, any subsidy. As I note below, however, risk-based pricing of deposit insurance has had mixed success.

Moreover, understanding the extent to which an ILC is conferring upon its conglomerate a subsidy and whether and how the conglomerate may be transferring and exploiting that subsidy requires consolidated supervision of the entire conglomerate.

Conflicts of interest: Scholars have also expressed concern that ILCs create conflicts of interest. For example, conglomerates could cause ILCs to extend risky loans to consumers or underprice them to the detriment of the ILC. ILCs also face strong incentives to make loans that favor purchases of their products and services, not competitors.[40]

Consumer Protection: These incentives to push the products and services of the conglomerate may also adversely affect consumer welfare. It is not clear that the FDIC has given enough consideration to how conglomerates might use their ILCs to engage in predatory consumer lending or to support predatory sales. Professor Adam Levitin cautions about the risks of commercial firms using bank operations to exploit consumers:

> The rise of a major consumer finance industry means that there are new reasons to be concerned about the separation of banking and commerce. Even if the corporate lending market is sufficiently regulated and competitive to ensure that bank-commerce affiliations do not distort the market, it is not clear that sufficient regulation exists in the consumer finance market. Retailers with major credit card operations present new regulatory challenges. To what extent should retailers be allowed to price their sales in order to drive their credit operations' profits? There is a long tradition of retailers offering purchase-money financing for their own wares. But this is not the same as retailers selling wares at reduced prices in order to exploit consumers' cognitive biases and uncapped interest rates. It is hard to know

[39] Wilmarth, *The FDIC Should Not Allow Commercial Firms to Acquire Industrial Banks*, *supra* note 13, at 4-8.
[40] *Id.* at 8-9.

> when the tail starts wagging the dog, but at some point a danger of predatory (and anticompetitive) sales emerges.[41]

Consumer protection risks may mushroom when layered on top of the capacities that many technology firms have in gathering data on consumers and altering the daily mix of information that consumers receive.

Distorted competition in banking: Granting ILCs the power and privileges of banking without all the supervision and capital and full prudential regulations that apply to banks may also distort *banking* markets. As explained below, this concern goes beyond ILCs having an unfair competitive advantage over banks; undermining the bank franchise would encourage greater bank risk-taking. It would also spur banks to push for banking deregulation, including of the rules that restrict them from owning commercial enterprises and engaging in nonbanking business. Moreover, the financial institutions most likely to suffer from distorted competition are the smallest community banks and credit unions.

Commitments to access: If one side of the ledger in granting ILCs points to risks, it is also important to scrutinize the purported benefits of ILCs. As noted above, ILCs were originally invented to serve the unmet banking needs of industrial workers. Modern ILCs may have a much different range of customers than their ancestors. If new ILCs are permitted and justified based on increasing access to the unbanked and underbanked, Congress should insist that ILC commitments to the FDIC, as well as FDIC regulations and supervision, ensure that these ILCs are actually focused on serving communities most in need, particularly communities that still suffer from the ravages of redlining and racial discrimination and other urban and rural communities without adequate banking.

III. The OCC FinTech Charter

In contrast to a century of ILCs and their precursors, the OCC's fintech charter has an incredibly short history. It also has very little supporting legal basis or policy analysis. In July 2018, the OCC released a "Policy Statement" of just over three pages announcing that a new policy that the OCC would issue charters to fintech companies even if they did not take deposits. This was accompanied by a 20 page (including cover page and table of contents) supplement to the Comptroller's Licensing Manual entitled "Considering Charter Applications From Financial Technology Companies." The Comptroller evidently did not feel it was necessary to engage in notice-and-comment rulemaking let alone to seek statutory authority from Congress to take the radical step of issuing a brand new type of charter to firms that do not take deposits.

A. The OCC contravened federal banking statutes and exceeded its authority.

The OCC's fintech charter contravenes the purpose and plain textual meaning of the National Bank Act, the 150-plus year old federal statute that created national banks and gives the OCC the authority to issue charters for them. The National Bank Act permits the OCC to charter

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[41] Adam Levitin, *Payment Wars: The Merchant-Bank Struggle for Control of Consumer Payment Systems*, 12 STAN. J. L. BUS. & FIN. 425, 458 (2007).

only institutions that take deposits, with limited exceptions expressly created by Congress.[42] The OCC fintech charter also runs counter to the text, structure, and purpose of other core federal banking statutes, including the Federal Deposit Insurance Act, the Bank Holding Company Act, the Banking Act of 1933, and the Federal Reserve Act. All of these statutes rest on the fundamental assumption that national banks must be depository institutions.[43]

B. The harm in conferring bank powers and privileges via the fintech charter.

The harm from the OCC fintech charter goes beyond an agency exceeding its authority from Congress (which is offense enough). The OCC fintech charter would confer upon non-depository institutions certain powers and privileges of banks, without regulations governing this new category of institution or conditioning its powers. This contrasts with the hundreds of OCC provisions in the Code of Federal Register, decades of OCC Bulletins and Circulars, numerous OCC Interpretations and Actions, and two dozen licensing manual booklets that govern deposit-taking firms chartered by the OCC under explicit statutory authority from Congress.

Congress created national bank charters only for depository institutions because it was delegating to these firms the sovereign power of creating money and thus affecting the nation's money supply.[44] National banks increase the money supply by creating deposits. In exchange for receiving this sovereign power, national banks become subject to a host of prudential and consumer regulations. They also receive certain powers and privileges to enable them to perform their money creating function while not destabilizing the economy via bank runs or bank failures. These powers and privileges include the following:

¶ access to emergency loans from the Federal Reserve via the discount window (with the Federal Reserve acting as liquidity-provider-of-last resort);[45]

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[42] In 1978, Congress amended the National Bank Act to authorize the OCC to charter non-depositor trust companies. Pub. L. 95-630, Title XV § 1504, 92 Stat. 3713 (Nov. 10, 1978) (codified at 12 U.S.C. § 27(a)). Congress made this change in response to a federal court case that ruled that the OCC did not have the authority under the pre-1979 National Bank Act to charter non-depository trust companies. Nat'l State Bank of Elizabeth v. Smith, No. 76-1479, 1977 U.S. Dist. LEXIS 18184 (D.N.J. Sep. 16, 1977) (unpublished opinion) *rev'd,* Nat'l State Bank of Elizabeth v. Smith, 591 F.2d 223 (3d Cir. 1979) (citing retroactive effect of 1978 amendments to National Bank Act).

[43] For a detailed analysis of how the OCC fintech charter contravenes the National Bank Act and these other statutes, see *Brief of Thirty-three Banking Law Scholars*, *supra* note 6.

[44] *See generally* Robert C. Hockett & Saule Omarova, *The Finance Franchise*, 102 CORNELL L. REV. 1143 (2017); MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION (2015); CHRISTINE DESAN, MAKING MONEY: COIN, CURRENCY, AND THE COMING OF CAPITALISM (2014); Lev Menand, *Why Supervise Banks? The Foundations of the American Monetary Settlement*, __ VAND. L. REV. __ (forthcoming 2021).

[45] *See* 12 U.S.C. § 347b(a); BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM PURPOSES & FUNCTIONS at 41-44 (10th ed. 2016).

- ¶ master accounts with the Federal Reserve[46] (via which the Federal Reserve has traditionally enacted monetary policy);[47]

- ¶ access to the Federal Reserve's payment system;[48]

- ¶ access to the Federal Reserve's securities custody services;[49] and

- ¶ voting rights in electing the directors of the 12 district banks of the Federal Reserve.[50]

OCC fintech charters open the door for non-depository firms to receive many of these same powers and privileges without these firms:

- ¶ serving the vital function of creating deposits and thus money; or

- ¶ being subject to the full panoply of prudential and consumer regulations that govern national banks and other regulated depository institutions.

This is no small matter. For example, access to emergency loans and to the Federal Reserve's payments system would confer on these non-depository firms major competitive advantages over their commercial rivals. As explained below, granting certain commercial firms the power and privileges of banks would distort nonbanking markets and entrench the favored recipients.

C. This is about preemption of state laws.

Even being charitable, contravening the core federal banking statutes and over a century of practice limiting OCC charters to only depository institutions with a four page "Policy Statement" seems to be a stunt. However, it would be a stunt with significant consequences.

Creating a charter for a new class of firm without any clear limitations on what those firms can do seems to be a naked attempt simply to offer those firms preemption of a host of state laws. The OCC fintech charter would preempt state regulations on supervision, prudential regulation, and consumer protection that would otherwise govern the firms being chartered.

Preemption of state financial laws should be done by Congress not by the OCC in a four page "Policy Statement." Federalism is serious business even if some businesses seriously do not like federalism. Furthermore, the OCC's (and other federal bank regulators') preemption of state laws has had disastrous consequences in the past; the preemption of state laws that protected

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[46] *See generally* Board of Governors of the Federal Reserve System, Reserve Maintenance Manual "Account Structure" (Nov. 19, 2018) *available at* https://www.federalreserve.gov/monetarypolicy/reserve-maintenance-manual-account-structure.htm (last visited Apr. 12, 2021); Board of Governors of the Federal Reserve System, Federal Reserve Account Structure, Transaction Settlement and Reporting Guide (Nov. 2017) *available at* https://app.frbservices.org/assets/resources/rules-regulations/operating-circular-1-accnt-structure.pdf (last visited Apr. 12, 2021) (describing master accounts);

[47] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM PURPOSES & FUNCTIONS at 38-40 (10th ed. 2016).

[48] *Id.* at 42-46, 131-133.

[49] *Id.* at 132.

[50] 12 U.S.C. § 304.

consumers from financial predation contributed to the severity of the 2007-2008 financial crisis.[51] As explained below, there are other, less destructive ways to help payments firms and other fintech companies who face a patchwork of state money transmission and other financial regulations.

D. The OCC fintech charter would open up exemptions for firms from important securities and other federal laws.

The OCC's fintech charter also opens potential exemptions for commercial firms from a host of important federal securities laws that protect investors. For example, the Securities Act of 1933 contains exemptions from registration requirements for securities issued or guaranteed by national banks.[52] This, in turn, removes important civil antifraud liability provisions.[53] Congress crafted these exemptions because deposit-taking national banks are subject to an entire architecture of federal prudential regulations that protects the safety and soundness of those firms.[54] Again, the OCC has not subjected to firms that would enjoy a fintech charter to any of these prudential regulations.

Exemptions from registration would leave investors and the broader public with inadequate public information about those firms receiving OCC fintech charters. Exemptions from federal securities laws would not only give these newly chartered firms advantages over other commercial firms, it would also chip away at essential investor protections and the disclosure that gives the public and policymakers confidence in securities markets.

The damage to federal securities laws might not end there. If the OCC fintech charter is allowed to stand, there are few constraints on the OCC's ability to grant charters to financial intermediaries that would otherwise be subject to federal investment company laws, such as the Investment Company Act of 1940.[55] In short, the OCC's fintech power grab threatens to intrude not only upon state laws but also on federal laws that protect investors and promote financial stability.

The OCC fintech charter creates further uncertainty in still other areas of federal law. "Banks" are exempted from the Bankruptcy Code, but the Code does not define the term "bank." The OCC fintech charter sows confusion as to whether firms receiving a fintech charter are subject to federal bankruptcy laws. This uncertainty works to the detriment of creditors.

Rather than attempt to plug the holes created by the OCC's fintech charter in federal laws and fix the problems creates by state preemption, Congress should end the OCC's adventure into novel charters of non-depository firms.

E. The fintech charter opens up the ability of the OCC to charter a vast range of commercial enterprises and federalize corporate law

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51 Arthur E. Wilmarth, Jr., *The Dodd-Frank Act's Expansion of State Authority to Protect Consumers of Financial Services*, 36 J. CORP. L. 893,897-919 (2011).
52 15 U.S.C. § 77c(a)(2).
53 Sections 11 and 12(a)(2) of the Securities Act create liability only for registered or public offerings.
54 IFLR, Frequently Asked Questions about Section 3(a)(2) Bank Note Programs at 1, *available at* https://www.iflr.com/pdfsiflr/faqs-section-3a2-bank-note-programs.pdf (last visited Apr. 13, 2021)
55 *See Brief of Thirty-three Banking Law Scholars*, *supra* note 6, at 29-30.

If allowed to stand, the OCC's position on the fintech charter would impose few limits on it to charter other commercial enterprises. This would potentially unleash OCC power over vast swaths of American commerce. It would also federalize much of corporate law, which has historically been the domain of state law.[56] There are certainly arguments for federalizing corporate law, but that decision rests with Congress.

IV. Why Separate Banking from Commerce?; The Costs of Blurring the Boundaries

Telescoping outwards from the problems with the specific agency actions discussed above – the FDIC endowing new ILCs with deposit insurance and the OCC fintech charter – it may prove useful to outline the overarching policy concerns behind separating banking from commerce. Historically, policymakers, financial firms, lawyers, and scholars have focused much more on the question of why banks should be restricted from owning or conducting nonbanking commercial businesses. The partial repeal of the Glass-Steagall Act and bank regulators giving banks greater flexibility in conducting nonfinancial activities –both of which were to my mind unwise – have also opened another Pandora's Box, allowing more commercial firms into banking.

Many of the same concerns that animate keeping banks out of commerce also justify keeping commercial firms out of banking. Most broadly, commercial firms should be kept out banking because of the fears of three types of concentrations: concentrations of credit, concentrations of economic power, and concentrations of political power. More specifically, giving commercial firms the powers and privileges of banking raises concerns of:

¶ *Distorting competition in commercial markets;*

¶ *Threatening financial stability;*

¶ *Distorting competition in banking markets and encouraging excessive risk-taking;*

¶ *Creating conflicts of interest;* and

¶ *Exploiting consumers.*

I discuss each of these concerns below.

A. Concentrations of credit

Fears of a handful of banks dominating credit markets animates restrictions on banks owning commercial enterprises. This same concern increasingly applies to commercial firms entering banking. The entry of commercial firms might *increase* competition with banks. However, commercial firms enjoy advantages that could drive smaller community banks and credit unions out of business. The advantages of big retail and technology conglomerates include:

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56 *Id.* at 23-27.

Large retailers could easily create vast branch networks: Walmart's latest annual report notes that each week it serves "over 240 million customers who visit approximately 11,400 stores" in addition to its growing online sales.[57]

Tech firms could push out banking services via smartphone apps or otherwise bundle them with existing online services. Imagine the ease with which Amazon could market banking services to consumers on its platform.

Tech firms have advantages in new technologies including artificial intelligence and machine learning, consumer interfaces, data management, cloud computing, and mobile payments.[58]

These advantages are not necessarily bad considered in isolation. Indeed, many would redound to the benefit of consumers by offering greater speed and convenience.

The risk, however, is that the same high levels of concentration that afflict certain retailing and tech markets would cross over into financial services markets. A handful of tech firms could dominate credit markets. In a not-implausible nightmare scenario, banking could devolve into an arena in which the principal players are Big Wall Street, Big Retail, and Big Tech or some alliance among the three.

B. Concentrations of economic power

Conferring upon commercial firms the powers and privileges of banking could also lead to concentrations of economic power in commercial markets outside of banking and financial services. As noted several times in this testimony, larger commercial firms with more economic, legal, and political resources are more likely to obtain nonbank bank charters than smaller retailers and startup tech firms. These conglomerates could then leverage banking powers and privileges to undercut rivals and entrench market dominant positions.

As discussed below, regulators would have difficulties detecting and counteracting the explicit and implicit government subsidies that may come with these powers and privileges. Regulators face difficulties in ensuring that commercial conglomerates do not transfer and exploit these subsidies among their various affiliates. These difficulties compound when bank regulators must supervise far flung commercial enterprises. *They become possibly insurmountable in the absence of consolidated supervision* – the ability of regulators to monitor the conglomerate as a whole.

This raises the specter of Big Tech, Big Retail, and Big Wall Street exercising dominance not only in financial services but also across many different sectors of American commerce. These fears become particularly salient in the retailing, tech, and payments industries.

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57 Walmart Inc. Form 10-K for the Fiscal Year Ended January 31, 2021 at 6 *available at* https://www.sec.gov/ix?doc=/Archives/edgar/data/104169/000010416921000033/wmt-20210131.htm (last visited Apr. 13, 2021).

58 Wilmarth, *The OCC's and FDIC's Attempts to Confer Banking Privileges on Nonbanks and Commercial Firms Violate Federal Laws and Are Contrary to Public Policy*, 39 Banking & Fin. Svcs. Pol'y Rep. No. 10, at 10 (Oct. 2020) *available at* https://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=2780&context=faculty_publications (last visited Apr. 11, 2021).

Entrenching already entrenched giant retailers and tech firms: Conferring banking powers and privileges on non-banks will compound existing antitrust concerns surrounding the largest retailers and tech firms. Small and mid-sized retailers face particular vulnerabilities at this historical moment; we do not know the long run impacts on smaller firms due to the pandemic. In short, granting bank powers and privileges on nonbanks would be "disruptive," but there is a substantial risk it would favor already large commercial firms and permanently tilt the landscape of American commerce further in their favor.

Putting the thumb on the scales of payment networks: Even without affording banking powers and privileges to non-banks, competition concerns are endemic to the world of payment networks. This owes to the fact that payment networks exhibit "network effects." In other words, a particular payment platform becomes increasingly economically valuable when more consumers and merchants use it.[11] Bank regulators should not compound competition concerns and put their thumbs on the market scales by affording select non-bank payment providers with the powers and privileges of banks.

Antitrust deference must be removed: Moreover, various doctrines and regulatory practices in antitrust law work to blunt antitrust review in banking and other regulated financial services sectors.[59] When seen charitably, these doctrines and practices stem from beliefs that antitrust law should not frustrate carefully designed legal regimes that meet other public policy goals, such as promoting financial stability. Yet the recent OCC and FDIC actions do not appear carefully designed and risk undermining fundamental public policies that animate banking law, including safeguarding financial stability and protecting consumers. *Accordingly, if the FDIC is permitted to continue to approve ILCs or the OCC is allowed to issue fintech charters, Congress should explicitly remove any presumptions or obstacles that make courts, antitrust regulators, or financial regulators deferential when reviewing competition concerns involving non-bank firms with bank charters.*

C. Concentrations of political power

Since the earliest days of the republic, one of the most fundamental concerns of banking law has been the capacity of concentrated banking power to lead to concentrations of political power.[60] This concern remains even as the debates have shifted over the decades. Highly concentrated and politically influential commercial industries could amass even greater political power when afforded the privileges that come with bank charters – regardless of the name of those charters. Concerns with agglomerations of political power become even more pressing when technology firms wield enormous influence over the day-to-day, moment-to-moment information individuals receive about politics, as well as about products and services and daily life. Adding bank powers to the capacities of these firms only compounds democratic concerns.

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[11] *See generally* RONALD J. MANN, PAYMENT SYSTEMS AND OTHER FINANCIAL TRANSACTIONS 299 (5th ed. 2011); Mark Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CAL. L. REV. 479 (1998). *See generally* James Surowiecki, *Bitcoin would be a Calamity, not an Economy*, 121(3) MIT TECH. REV. 28, 28-9 (May/June 2018).

[59] For a history of weaknesses in antitrust scrutiny of banking and bank mergers, see Jeremy C. Kress, *Modernizing Bank Merger Review*, 37 YALE J. ON REG. 435 (2020).

[60] For a classic account of the early history of politics and banking, see BRAY HAMMOND, BANKS AND POLITICS IN AMERICA FROM THE REVOLUTION TO THE CIVIL WAR (1957).

Political power can be concentrated in another dimension. Giving bank regulators potentially vast oversight authority over commercial enterprises should scare policymakers concerned with overreach by financial regulators, not to mention any citizen interested in limits on government authority. The separation of commerce and banking constrain not only the power of banks and the power of commercial conglomerates, but also the powers of government officials.

D. Distorting competition with commercial firms

Conferring banking powers and privileges on non-banks threatens to distort not just banking but also commercial markets by creating an uneven playing field. Non-banks who could access the special privileges of banking – including deposit insurance, access to the Federal Reserve discount window, and exemptions from a host of federal and state laws – could use these privileges to undercut rivals. These non-banks would wield unique legal powers and may enjoy a lower cost of capital thanks to government loans and guarantees both explicit (*i.e.*, deposit insurance) and implicit (*e.g.,* too-big-to-fail status).

Subsidy transfers and subsidy leakage: Part, but not all, of the competitive advantage that non-banks would enjoy by virtue of licenses that grant them power and privileges of banks stems from subsidies that come from deposit insurance and access to emergency government loans. Deposit insurance and access to liquidity from the government as lender-of-last-resort represent essential pillars of banking; they mitigate the risk of bank runs, which can trigger broader panics and financial crises. Bank regulators and central banks have long recognized that these subsidies need to be countered to mitigate moral hazard. However, these subsidies *also* need to be countered in order to prevent distortions in the marketplace. This second concern – preventing competitive distortion -- becomes paramount when walls separating banking and commerce crumble and banks start commercial activities or commercial firms begin banking.

The problem is that regulators and central banks face massive challenges in negating these subsidies and have a checkered record in their attempts. For example, Congress has required that the FDIC price its deposit insurance according to the riskiness of individual banks.[61] However, the FDIC has struggled to price deposit insurance premia for systemic risk.[62] As detailed above, the FDIC, other bank regulators, and the Treasury Department provided billions of dollars in emergency support to the parents of multiple FDIC-insured ILCs. During the crisis, the losses to the FDIC's fund became so severe that the agency needed to take emergency steps to restore fund levels.[63]

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[61] FDIC Improvement Act of 1991, Section 302(a), Pub. L. No. 102-242, 105 Stat. 2236. For a history of risk-based pricing for deposit insurance premia, see Federal Deposit Insurance Corporation, Staff Studies Report No. 2020-01
A History of Risk-Based Premiums at the FDIC (Jan. 2020) *available at* https://www.fdic.gov/analysis/cfr/staff-studies/2020-01.pdf (last visited Apr. 7, 2021).

[62] For one analysis of the challenges of pricing deposit insurance, see Viral V. Acharya et al., *Systemic Risk and Deposit Insurance Premiums*, Fed. Res. Bank N.Y. Econ. Pol'y Rev. at 89 (Aug. 2010) *available at* https://www.newyorkfed.org/medialibrary/media/research/epr/10v16n1/1008yoru.p (last visited Apr. 7, 2021).

[63] FEDERAL DEPOSIT INSURANCE CORPORATION, CRISIS AND RESPONSE: AN FDIC HISTORY, 2008–2013 at 155-161 (2017)

Federal bank regulators has also struggled and often failed with efforts to contain subsidies to bank affiliates operating within large financial conglomerates. The Federal Reserve has struggled to create and police effective "firewalls" or other institutional mechanisms to prevent subsidy transfers within bank holding companies.[64] It is thus difficult to imagine the FDIC or OCC succeeding in preventing complex *commercial* conglomerates from transferring and exploiting subsidies from chartered affiliates to other companies under their corporate umbrella. Large commercial firms could then use these subsidies to undercut rivals. As noted above, ILCs operate outside Federal Reserve *consolidated* supervision, and even bank regulators with supervisory powers face daunting challenges in overseeing the operations of complex commercial firms, particularly technology firms. Subsidies to bank affiliates within conglomerates inevitably leak.

Moreover, many government subsidies in banking and financial services are *implicit* or created by market expectations despite government disavowals. Too-big-to-fail status represents just one example. There is a long academic literature on how market expectations can create implicit deposit insurance and how difficult it is for governments to counter these expectations.[65] Implicit subsidies would provide commercial firms with additional advantages over competitors.

Market distortions, at their worst, can contribute to entrenched monopolies or oligopolies.

E. Financial Stability

Conferring banking power and privileges on commercial conglomerates also creates risks to financial stability. As noted above, there are arguments that commercial firms would serve as "sources of strength" for financial affiliates and provide diversification. However, the failures of, and massive government assistance given to, parents of ILCs during the global financial crisis of 2007-2008 provides a cautionary tale. Moreover, the business models of commercial firms do not remain fixed at the time they might receive banking powers and privileges. General Electric became increasingly a bank and less of an industrial company. In the absence of consolidated supervision, bank regulators would have little early warning of systemic risk building up inside a commercial conglomerate with banking powers and privileges.

F. Distorting Banking Markets

Granting non-banks the powers and privileges of banking without subjecting them to the same supervision and regulation of banks threatens to distort and destabilize banking markets. These distortion would have repercussions for financial stability and for the communities that banks serve.

ILCs provide a telling example: they have access to FDIC deposit insurance like banks yet fall outside consolidated supervision by the Federal Reserve. As noted above, effective consolidated supervision and prudential regulation provide essential mechanisms to mitigate the moral hazard that comes with deposit insurance, access to central bank loans and liquidity, and other privileges of banking. Moreover, effective supervision and prudential regulation is necessary to counteract any

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64 *See, e.g.*, Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683 (2011).
65 *E.g.*, DAVID HOELSCHER ET AL., THE DESIGN AND IMPLEMENTATION OF DEPOSIT INSURANCE SYSTEMS AT 2 (Dec. 2006).

subsidy, explicit or implicit, that comes with these privileges. Granting nonbanks banking privileges without effective supervision and regulation creates a competitive advantage for nonbanks.

Risk-taking by banks: These distortions created by regulation do not merely offend market principles. They also threaten to destabilize banking markets by creating incentives for banks to take additional and excessive risks to compete with privileged but less-regulated nonbanks. This is not mere speculation, but rather a core axiom from banking economics. Gary Gorton explains:

> "The history of banking in the United States implicitly revolves around a conflict between charter value, which creates an incentive for banks not to become too risky, and competition, which creates risks. If a bank is deemed insolvent, it loses its charter . . . so the higher a bank's charter value, the higher the incentive it has to avoid risk. But as companies without bank charters compete with banks by offering the same services, the value to a bank of having a charter decreases, and to compete and stay afloat, a bank must take on more risk."[66]

Competition between lightly regulated non-banks with banking privileges and banks has contributed to destructive spirals of competition, which in turn have resulted in excessive risk-taking and cheap credit and ignited financial crises.[67]

Favoring the biggest banks and tech firms: Competition from nonbanks with banking powers and privileges may prove particularly devastating for smaller community banks and credit unions, who already face daunting competition from the largest banking conglomerates. It is not the mission of government to shelter smaller banks from all the gales of competition and technological change. However, Congress should consider the effects on underserved communities nationwide that rely on community banks and credit unions.

A healthy and diverse banking ecosystem – that provides broad access to deposits, credit to households and small business, and payments services – would include entities with a range of sizes, organizational forms, clienteles, and missions.[68] One example of the benefits of a diverse ecosystem: research has shown that banks with certain organizational forms, such as cooperatives and mutuals, take less investment risk and offer more consumer-friendly terms when compared to investor-owned banks organized as corporations.[69] Federal bank regulators should work towards fostering diversity among sizes, types, and community missions of banks. They should avoid steps that would

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[66] GARY GORTON, MISUNDERSTANDING FINANCIAL CRISES: WHY WE DON'T SEE THEM COMING 126-7 (2012).

[67] *E.g.*, Erik F. Gerding, *Deregulation Pas de Deux: Dual Regulatory Classes of Financial Institutions and the Path to Financial Crisis in Sweden and the United States*, 15 NEXUS 135 (2010). For an analysis of the interplay of competition and prudential bank regulation, see Prasad Krishnamurthy, *George Stigler on His Head: The Consequences of Restrictions on Competition in (Bank) Regulation*, 35 YALE J. ON REG. (2018).

[68] *See generally* Marc Schneiberg, *Toward an Organizationally Diverse American Capitalism? Cooperative, Mutual, and Local, State-Owned Enterprise*, 34 SEATTLE U. L. REV. 1409 (2011); Marc Schneiberg, *Organizational Diversity and Regulatory Strategy in Financial Markets: Possibilities for Upgrading and Reform*, 18 N.C. BANKING. INST. J. 141 (2013).

[69] *E.g.*, Erik F. Gerding, *Remutualization*, 104 CORNELL L. REV. 797, 821 (2020); Ryan Bubb & Alex Kaufman, *Consumer Biases and Mutual Ownership*, 105 J. PUB. ECON. 39, 39-42, 46 (2013).

accelerate banking consolidation and dominance by a handful of banking, retail, and tech conglomerates.

Consolidated Supervision: The distortive impacts of nonbanks enjoying banking powers and privileges could be partially ameliorated by bank regulators subjecting nonbanks to appropriately intensive supervision. There are serious obstacles, however, to this occurring. Some obstacles arise because of legal regimes: ILCs enjoy FDIC deposit insurance without the consolidated supervision that the Federal Reserve exercises over bank holding companies. Other obstacles are practical: as specialized bank regulators, the OCC and FDIC face daunting challenges in overseeing the complex global business operations of retail and technology conglomerates.

Still other obstacles are structural: even aside from concerns with revolving doors, races-to-the-bottom, and interest group clientelism, regulators already face disincentives to regulate strenuously firms upon whom they depend for licensing fees.[70] Federal regulators already struggle mightily with supervising *financial* conglomerates,[71] and bank supervision as a regulatory tool now faces a sustained attack by banks and their lawyers.[72] All these problems began before adding additional responsibilities on bank regulators to supervise commercial firms.

V. Slippery Slopes and the Value of Traditional Institutional Categories

One of the lessons of the evolution of ILCs is that technological and market developments can radically transform statutory categories of banks far beyond what Congress may have intended. The number, size, and types of firms taking advantage of nonbank charters can evolve over time.

It is difficult for regulators to make legally defensible distinctions that would allow Rakuten but not Amazon or Square but not Google to gain nonbank charters. Moreover, lawyers use their craft, with the help of ambitious regulators looking to deregulate, to expand statutory and regulatory loopholes to enhance the powers of their clients and reduce regulatory constraints. Much of this can occur in the murky waters of informal agency actions, such as agency interpretations and policy statements.[73] The OCC fintech charter provides a prime example of this. Informal agency actions are not always ideal; they can frustrate Congressional and public oversight of agency decisions that favor particular industries at the public expense.

Deregulation of one category of firms inevitably leads to rivals in another legal category pushing for deregulation of their own sector. Faced with competition from nonbanks that enjoy

70 *E.g.*, Arthur E. Wilmarth, Jr., *The Financial Services Industry's Misguided Quest to Undermine the Consumer Financial Protection Bureau*, 31 REV. BANKING & FIN. L. 881, 912-13 (2012). *Cf.* Binyamin Appelbaum, *By Switching Their Charters, Banks Skirt Supervision*, WASH. POST, Jan 22, 2009 at A1.

71 Lev Menand, *Too Big to Supervise: The Rise of Financial Conglomerates and the Decline of Discretionary Oversight in Banking*, 103 CORNELL L. REV. 1527 (2019).

72 *See, e.g.*, Lev Menand, *Why Supervise Banks? The Foundations of the American Monetary Settlement*, __ VAND. L. REV. __ (forthcoming 2021) (describing how mixing banking and commerce undermined supervision and the "desupervision" movement).

73 Earlier work of Saule Omarova has explored how agencies and incrementally expand bank powers. Saule T. Omarova. *The Merchants of Wall Street: Banking, Commerce, and Commodities*, 98 MINN. L. REV. 265 (2013 (permitting expansion of banks into physical commodities and energy businesses); Saule T. Omarova. *The Quiet Metamorphosis: How Derivatives Changed The "Business of Banking"*, 63 U. MIAMI L. REV. 1041 (2009) (permitting bank expansion into derivatives business).

bank powers and privileges without bank-level supervision and regulation, banks and bank holding companies will inevitably push for deregulation. In particular, banks may push for greater permission to enter into commercial activities. This would accelerate already dangerous trends by which regulators have incrementally expanded bank's nonfinancial activities in ways that have flown under the public's radar. Federal bank regulators have used interpretations and other formal and informal administrative law mechanisms to expand the activities that qualify as the "business of banking" or are "incidental" to financial activities.[74]

This dynamic can devolve into spirals of regulatory arbitrage and deregulation in which competing categories of financial institutions alternately sidestep rules or push for their repeal.[75] Clear categories that define banks with few exceptions and exemptions and strictly delimit bank powers have multiple benefits, including:

- ¶ Allowing market participants and policy makers to more easily understand the financial system, identify problematic subsidies to financial institutions, and map systemic risk;

- ¶ Reducing regulatory arbitrage that undermines prudential and consumer regulations and distorts competition;

- ¶ Settling expectations of market participants; and

- ¶ Setting guardrails on the powers of regulators.

Clarity and simplicity have strong value in financial regulation

VI. **The Role of State Regulators**

The details of federalism in banking law can be messy and difficult to understand. The FDIC chartering of new ILCs and the OCC's creation of a fintech charter seem to cut in opposite directions with respect to state regulators. The FDIC action grants more power to those states, particularly Utah, that charter ILCs, while the OCC's fintech charter would operate to preempt many state consumer protection and other laws.

Articulating three first principles may help make sense of how Congress should act to ensure an appropriate role for states to regulate both banks and commercial firms offering bank-like services.

First, state regulators play the most productive roles in banking law when they address concerns, like consumer protection, that directly affect their residents. State law become less justifiable when they affect a financial institution's operations in other states – for example, when

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74 *See sources supra* note 73.

75 ERIK F. GERDING, BUBBLES, FINANCIAL REGULATION, AND LAW ch. 6 (2014) (detailing spirals of regulatory arbitrage and deregulation; Erik F. Gerding, *Deregulation Pas de Deux: Dual Regulatory Classes of Financial Institutions and the Path to Financial Crisis in Sweden and the United States*, 15 NEXUS 135 (2010)

national banks can "export" usury laws of the state where they are chartered.[76] Legislators and regulators of Utah are not accountable to the citizens of Rhode Island.

Second, state law and state regulators work better when they set floors rather than ceilings with respect to consumer protection and financial stability. Allowing state laws to create ceilings can spark races-to-the-bottom, which can be particularly destructive in the case of prudential regulation. The fallout from the failure of a bank – by whatever name – does not respect state boundaries.

Third, even in cases where a particular kind of chartered firm has operations with impacts that cross state borders there may still be a valuable role for state regulators for frontline supervision, examination and enforcement with respect to smaller firms or local operations. Federal regulators face resource constraints that can hamper effective supervision, examination, and enforcement. The federal securities regulatory regime for investment advisers offers one model in that it assigns registration and examination authority with respect to smaller advisers to state regulators.[77]

VII. Immediate Recommendations for Congress

Unfortunately, regardless of who are the immediate next heads of the OCC and FDIC, Congress has no assurance that future agency heads will faithfully follow statutory limitations on chartering nonbanks or endowing them with the powers and privileges of banking. The former heads of the OCC and the current head of the FDIC believe (in the case of the OCC, mistakenly) that they have the statutory authority to confer fintech charters and ILC deposit insurance. If it wants to stop these Pandora charters, Congress has no choice but to legislate.

Moratoriums, such as those in the Dodd-Frank Act on granting deposit insurance to new ILCs, function mainly as stop gap measures. Moratoriums expire, which then permit future agency power gabs at the expense of Congress, states, financial stability, consumers, and the separation between banks and commerce. *I would therefore support the Close the ILC Loophole Act being considered by this Subcommittee first and then the "Bank Charter Review Act" only if the Subcommittee deems the other bill infeasible.*

Accordingly, I recommend that Congress take the following clear and decisive steps:

A. Congress should end the ILC exemption and subject existing ILCs to the Bank Holding Company Act.

The expansion of ILCs, their drift from their original mission, and the risks they pose described above all argue for the elimination of the ILC exemption to the definition of "bank" in the Bank Holding Company Act. The FDIC should not grant deposit insurance to new ILCs and

76 The Supreme Court's decision in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.* (39 U.S. 299 (1978)) enabled national banks to charter in states with very permissive usury rules and then charge higher credit card interest rates to customers in other states.

77 U.S. Securities & Exchange Commission, General Information on the Regulation of Investment Advisers (Mar. 11, 2011) *available at* https://www.sec.gov/divisions/investment/iaregulation/memoia.htm (last visited Apr. 14, 2021).

existing ILCs should be subject to the Bank Holding Company Act and consolidated supervision by the Federal Reserve.

I therefore support the "Close the ILC Loophole Act" that Representative Garcia has introduced and which was referred to this Committee. The bill contains provisions to allow for an orderly end to this exemption. I have not seen evidence that the end of this exemption will disrupt credit markets or cause undue concentrations that would adversely impact borrowers. In 2012, the GAO found that:

¶ The relatively small market shares of ILCs and other categories of nonbanks exempt from the Bank Holding Company Act meant that removing the ILC and other exemptions from the Bank Holding Company Act would have only a limited potential impact on the overall credit market;[78] and

¶ Removing the Bank Holding Company Act exemptions, including the ILC exemption, "would likely not affect concentration in overall credit markets.[79]

In other words, credit would continue to flow from other financial institutions, who would not enjoy market dominant positions if exempt nonbanks completely exited the market.

This GAO study is now almost 9 years old (which does argue for an updated study, such as that required by the proposed Bank Charter Review Act). However, the fact that ILCs can grow rapidly underscores a crucial lesson for Congress: if new ILCs enter the marketplace and receive FDIC insurance or if the OCC fintech charter is allowed to proceed, significant growth among these nonbanks may make it increasingly difficult to address problems in these markets.

B. Congress should preclude the OCC Fintech charter and underscore that the OCC may only charter deposit-taking entities.

I believe it is clear that the OCC fintech charter runs counter to the National Bank Act and the text, purpose, and structure of other federal banking statutes. I also believe federal courts will ultimately invalidate this OCC action. Nevertheless, in order to preclude aggressive statutory interpretations and power grabs by future Comptrollers, Congress should make a crystal clear amendment to the National Bank Act removing the ability of the Comptroller to issue any new charters to entities that do not take deposits.

VIII. Longer-term Approaches to Market Needs

Payment companies that have or may seek ILC or fintech charters are often responding to legitimate market needs and not just seeking to engage in regulatory arbitrage. However, Congress can help payment companies meet challenges in the regulatory environment and fill the unmet financial services needs of communities in alternative ways without conjuring the host of policy concerns raised by conferring banking powers and privileges on commercial firms.

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78 *GAO 2012 Report*, *supra* note 17, at 36-37.
79 *Id.* at 38-41.

A. The patchwork of state money transmitter statutes

Payments companies face the difficulty of complying with state money transmitter statutes in each state in which they conduct business. 49 states,[80] the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands have money transmission statutes or regulations requiring licenses for money transmission. I have examined dozens of state money transmitter statutes.[81] Some are extremely hard to understand. However, these statutes as a whole do play important roles in combatting money laundering, protecting consumers, and ensuring the solvency of payment providers.

Instead of allowing a blanket preemption of these state laws thanks to the OCC fintech charter, Congress would promote the use of uniform statutes like the Uniform Money Services Act (2000). The impetus for these statutes, after all, was the federal antimony laundering regime.[82] Even should Congress chose to federalize money transmission laws, it should consider the valuable role that state regulators can play in creating floors (not ceilings) for consumer protection and in examining smaller financial firms.

B. Unbanked/underbanked communities and public options

Many communities face problems accessing banking services, including basic payments services. No Americans should have to turn to predatory businesses for basic services like cashing a paycheck or sending small amounts of money to relatives. Transaction fees can eat away at funds working families need.

But conferring bank charters, powers, and privileges on nonbanks is far from the only solution to these unmet needs. Congress should consider whether public options can help underserved communities. Postal banking,[83] "fed accounts for all"[84] and a "people's ledger"[85] represent just some of the proposals in the marketplace for ideas. A full consideration of the relative advantages and drawbacks of different public options is beyond the scope of this testimony.

However, the urgency of the need became stark during the pandemic. The federal government lacked the infrastructure to deliver relief payments quickly and electronically to households and small businesses. Mailing physical stimulus checks and delivering support to small businesses via an elaborate bank-centered program created delays in economic relief reaching communities. European countries were able to make payments, including payroll support payments to small businesses, electronically.[86] Investments in public financial infrastructure are just as necessary as investments in physical infrastructure.

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[80] Montana does not have a money transmission statute.
[81] GERDING, NEGOTIABLE INSTRUMENTS, *supra* note 2, at ch. 28.
[82] 18 U.S.C. § 1960. *See* GERDING, NEGOTIABLE INSTRUMENTS, *supra* note 2, at § 28.01.
[83] Mehrsa Baradaran, *It's Time for Postal Banking*, 27 HARV. L. REV. F. 165 (2014).
[84] Morgan Ricks et al., *FedAccounts: Digital Dollars*, 89 GEO. WASH. L. REV. 113 (2021).
[85] Saule T. Omarova, *The People's Ledger: How to Democratize Money and Finance the Economy*, _ VAND. L. REV. __ (forthcoming).
[86] *E.g.*, United Kingdom BDO, Coronavirus Job Retention Scheme: Everything You Need to Know *available at* https://www.bdo.co.uk/en-gb/insights/tax/employer-essentials/coronavirus-job-retention-scheme#How%20will%20CJRS%20payments%20be%20paid%20to%20us? (last visited Apr. 11, 2021).

C. Costs to merchants of payment networks

Interchange fees imposed by the two main credit/debit card networks impose significant costs on merchants. Merchants have had little ability to negotiate these fees given the market dominance of Visa and Mastercard. Forming an ILC could help a large retailer like Walmart recoup some of these interchange costs. However, again, owning an ILC is only a viable option for large retailers. Technological change or the emergence of rival payment networks may reduce impact of interchange fees on merchants.[87] Congress and regulators could also revisit the regulation of interchange fees which began with the Durbin Amendment to the Dodd-Frank Act.[88]

IX. **Related Issues for the Subcommittee's Future Agenda**

Finally, I would like to take this opportunity to lay out a few additional issues for future consideration by this Subcommittee that are adjacent to the topic of conferring bank powers and privileges on nonbanks.

First, customers with certain kinds of accounts with payment providers may not understand that monies in those accounts do not enjoy federal deposit insurance. As noted above, it may prove difficult to disabuse consumers of even misconceived expectations of deposit insurance.[89]

Second, nonbank conglomerates with "bank" affiliates, particularly technology firms, may have tremendous ability to exploit customer/consumer data. Combining their normal data collection practices with the power and privileges of banking may create new risks for data privacy and data exploitation. One of the bright spots of the Gramm-Leach Bliley Act was the enactment of early, albeit incomplete, privacy protection provisions.[90] These provisions apply, however, only to "financial institutions."[91] To the extent Congress permits bank regulators to confer the power and privileges of banking on nonbanks, entire nonbank conglomerates should be subject to strict data privacy rules.

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87 *See generally*, Adam J. Levitin, *Payment Wars*, 12 STAN. J. L. BUS. & FIN. 425 (2007).

88 For a description of the Dodd-Frank provisions on interchange fees and competitive practices by payment networks, see GERDING, NEGOTIABLE INSTRUMENTS, *supra* note 2, at §§ 19.21, 20.04.

89 Adam J. Levitin, *Pandora's Digital Box: The Promise and Perils of Digital Wallets*, 166 U. PA. L. REV. 305, 344-345 (2018).

90 This resulted in the GLB Data Privacy Rule, which is codified at 16 C.F.R. pt. 313.

91 16 C.F.R. § 313.1. The rule defines "financial institution" as follows:

> "… any institution the business of which is engaging in financial activities as described in section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k)). An institution that is significantly engaged in financial activities is a financial institution." 16 C.F.R. § 313.3(k)(1).