FinTechs Begin to Seek Industrial Loan Charters; Community Banks Push Back

Overview: As FinTech firms continue to mature both in terms of product sophistication and user adoption, they are continually looking for ways to level the playing field with traditional financial institutions. In recent weeks, two prominent FinTech companies – Social Finance, Inc. (SoFi) and Square – have applied to the Federal Deposit Insurance Corporation (FDIC) for federal charters as Industrial Loan Companies (“ILCs”), which would allow them to become depository institutions. These applications have garnered criticism from community bankers and their supporters in Congress, who question whether providing such charters would actually put community bankers at a disadvantage relative to FinTechs and lead to increased consumer harm.

One of the greatest regulatory challenges that FinTech firms face is complying with the patchwork of state licensing and regulatory requirements from which depository institutions are largely exempt. Accordingly, FinTech firms have historically partnered with traditional banks to potentially relieve themselves of this regulatory patchwork.

This bank partnership model is not free from risk, however, as evidenced by the landmark Madden vs. Midland Funding case, in which the U.S. Court of Appeals for the Second Circuit unzipped a bank partner relationship, deciding that the secondary market loan purchaser (and not the bank) was the “true lender.” The Madden decision has sent shockwaves through the marketplace, as many non-financial entities reevaluate whether their relationships with bank partners are as advantageous as originally intended. This is a significant reason why FinTech firms are beginning in earnest to consider mechanisms to become banks themselves, in an attempt to reduce the risk that complicated third party bank partnerships may create.

The ILC charter being sought by SoFi and Square was developed about a century ago to enable (otherwise non-financial) commercial enterprises to get into banking and operate “traditional” depository institutions. Today, most ILCs are chartered under Utah state law (due to favorable terms in that law), and upon approval by the FDIC, deposits held by ILCs are eligible to receive FDIC deposit insurance. Historically, the ILC charter was the preferred vehicle for automakers and other equipment manufacturers to offer financial services to their customers through captive financial subsidiaries. In recent years, however, the ILC charter has become attractive to large retailers and technology firms alike.

A key benefit of obtaining an ILC charter is that, unlike other financial holding companies, the parent companies of ILCs are not subject to the Federal Bank Holding Company Act, which imposes significant requirements on the parent company. As such, ILCs are relieved of supervision by the Federal Reserve Board. This issue underlies some of the FinTech industry’s concerns with the OCC’s recent proposal to create a special purpose national bank charter for FinTech firms, under which FinTechs seeking such a charter would be subject to the same
regulatory oversight as national banks, generally. It is not all that surprising, then, that a FinTech company would view the ILC charter as an attractive route to becoming a bank, capable of accepting FDIC-insured deposits and avoiding both state licensure and supervision of its parent company by the Board.

**Outlook:** The appetite for FinTechs to move into the ILC space faces resistance. Community bankers and consumer advocates, along with their allies in Congress, have questioned whether the emergence of FinTech ILCs would create an uneven playing field. In particular, critics have expressed concern that a new class of under-regulated financial companies will emerge that enjoy an unfair advantage compared to those traditional financial institutions that are subject to Federal Reserve oversight. Critics further claim that a lack of prudential oversight would pose safety and soundness risks to the financial system, as well as increased risks of consumer harm.

In a recent letter, the top Democrat on the House Financial Services Committee, Rep. Maxine Waters (D-CA), requested that FDIC Chairman Martin Gruenberg convene a public hearing regarding the SoFi ILC application to address prudential and consumer protection issues. Channeling views expressed by community banks and consumer advocates, Rep. Waters raised doubts as to whether ILC-chartered FinTech companies will reinvest in low and moderate income communities on a national scale, rather than primarily serving higher income and business customers. Rep. Waters also noted that there has been widespread support in Congress in recent years for curtailing the ability of commercial companies to start or acquire ILCs, including enactment of a now-expired three-year moratorium on approval of deposit insurance for ILCs, contained in the Dodd-Frank Act.

Notwithstanding these criticisms, it appears that the proverbial horse may be already out of the barn, as we can expect an increasing number of FinTech companies to line up to obtain traditional bank charters – whether under the OCC’s special purpose national bank charter program or via ILC charters.

At this point, the real question(s) may not be IF we will see a FinTech operating under a bank charter in the near term, but “when,” “which FinTech,” and “which charter?”

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