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Innovation and Financial Technology: Rethinking the Banking & Commerce Split

Utah: A Single Courageous State Chartering a Course to Financial Innovation

Good morning. It is an honor to be here today speaking at the UAFS & NAIB Annual Convention. I am particularly honored that so many of you have stuck around after the golf tournament and other fun events to attend this final Friday morning session and to listen to me speak for a few minutes about the future of banking innovation and financial technology, and Utah's primary role in that future. I hope my remarks will justify missing a morning outside enjoying Park City.

For much of my legal career, I have focused on the question of what activities a bank should be allowed to engage in. Although this is a seemingly simple definitional question, setting the parameters of permissible banking activity has been one of the most pivotal and vexing issues in U.S. banking law since even before the establishment of the dual-banking system. The push and pull between

state and Federal law regarding this question has, and continues to, fundamentally shape the arc of financial services and technological innovation in our country.

As someone who has personally been on the receiving end of this push and pull between state and Federal banking regulation, and who, by the way, has the battle scars to prove it, let me tell you that the role of banking and technological innovation in our society is one of the great national debates of our time. Early in my career, I litigated one of the seminal bank powers cases, *Watters v. Wachovia,* where the Supreme Court upheld the OCC's adoption of a regulation allowing national banks to establish operating subsidiaries that operated on the same terms and conditions (including the same preemption protection) accorded to national banks.[1] More recently, as the Acting Comptroller of the Currency for much of 2017, I led the agency's efforts during that time in developing special purpose "fintech" charters for non-depository financial technology companies engaged in the business of banking. In consideration of my efforts, I found myself the subject of lawsuits filed by the Conference of State Bank Supervisors and the New York Department of Financial Services challenging the OCC's authority to grant these "fintech" charters. Let me tell you, there is nothing more effective to focus the mind on a particular issue than being sued by an organization whose members include the financial regulators of all the states in the Union.

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[1] See Watters v. Wachovia Bank, N.A., 550 U.S. 1 (2007).

The role of financial innovation and banking has cropped up in the national conversation most recently following Comptroller Otting's announcement that the OCC would begin accepting applications for so-called "fintech charters," which coincided with the U.S. Department of Treasury's endorsement of the development of a fintech charter. I applaud Comptroller Otting in taking this important step to encourage openness and dynamism in the administrative state, and to promote Federal banking regulation that can evolve in tandem with developments in the financial and technology sectors. I wish him and the OCC well, both in the endeavor of assessing the very first fintech charter applications, as well as in defending against the inevitable lawsuits that will follow the Comptroller's recent announcement. While the Federal fintech charter holds great promise, Utah's industrial loan company (ILC) charter continues to hold a uniquely important role in the future of financial innovation.

To my mind, the ability of banking organizations to provide financial services that keep up with technological advances, whether facilitated through a new fintech charter or the ownership of an ILC, implicates fundamental questions of political rights and freedoms. The path towards innovation is deeply interwoven with the concepts of liberty and freedom. Innovation needs freedom to grow. Like a flame without air, the entrepreneurial spirit cannot thrive without a regulatory framework that permits experimentation and allows for the combination of

technologies into something larger than the sum of its parts. But innovation does not just *need* freedom—innovation *empowers* freedom. Financial innovation, in particular, enables personal empowerment and economic opportunity, by improving banking services, expanding access to credit, including access in underserved communities, and delivering better and more affordable products and services in sustainable ways.

However, innovation, like all change, is often resisted by the status quo. The history of economic development can be viewed through the lens of established market participants resisting new entrants that seek to innovate. Regulation, and financial regulation in particular, has in the past been used as a tool to protect existing market participants and to attempt to scuttle change and innovation. Unfortunately, the history of financial regulation has often been a history of governments picking winners and losers. The strength of the U.S. banking sector in recent decades is owed, in large part, to lawmakers and regulators that have remained open to change and pushed the limits of our regulatory framework to allow banking activities to evolve.

The history of the U.S. state bank charter can illuminate the pitfalls that face financial innovation going forward. In the late 1700s, the decision to grant a bank charter, and the unique and special power it provided to make loans and take

deposits, was often a political decision;[2] one that allowed politicians to control political spoils by granting the special and unique rights that came with having the power of a bank to their political allies. Following the laws of supply and demand, by keeping access bank charters limited, the value of such charters increased, and powerful elites could therefore extract rents from the granting of the charters.

The politics of banking continued with restrictions on interstate banking, as many states prohibited out-of-state entrants into their markets. These laws were primarily designed to protect and support the local, state banks already in existence from competition and entrench their market shares. By keeping new entrants out of the banking market, these laws kept the market to local monopolies or oligopolies.[3] The advent of bank holding companies was primarily an attempt to avoid interstate banking restrictions, by facilitating so-called "chain banking" across state lines. This worked until Congress enacted the Bank Holding Company Act primarily to stop chain banking. The BHC Act was borne out of a desire to prevent the concentration of power into large banking conglomerates and, at the same time, defend the power of local state banking elites.[4]

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[2] See Charles W. Calomiris, U.S. Bank Deregulation in Historical Perspective, Cambridge University Press (November 2, 2006).

[3] These restrictions on interstate banking were further solidified by the McFadden Act, which applied interstate banking restrictions on national banks.

[4] Saule T. Omarova and Margaret E. Tahyar. "That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulations in the United States." Cornell Law Faculty Publications. Paper 1012. 2012 (http://scholarship.law.cornell.edu/facpub/1012).

The other driving force behind the U.S. bank regulatory framework has been the doctrine of separating banking and commerce. The Banking Act of 1933 separated commercial and investment banking by prohibiting banks from dealing and underwriting in securities and from affiliating with companies engaged in securities dealing or underwriting. The Banking Act of 1933 was largely motivated by findings from the Pecora Investigation in 1932, which asserted that conflicts of interest between banks and affiliated underwriters were a major contributor to the Great Depression. Although recent scholarship calls the Pecora Investigation's findings into doubt, almost 100 years later, our banking system is still deeply impacted by this legacy.[5] As I have noted in other remarks, the true motivation behind the adoption of the separation of banking and commerce may be better understood as a power struggle between large industrial conglomerates that sought to hurt their market rivals and limit competition.[6] The separation of banking and commerce was further engrained in BHC Act, whose focus over time shifted from restricting interstate banking to prohibiting bank holding companies and their subsidiaries from engaging in non-banking activities. Although these

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[5] See, e.g., Stephen K. Halpert, "The Separation of Banking and Commerce Reconsidered," 13 J. Corp. L. 481 (1988). Eugene Nelson White, "Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks." Explorations in Economic History 23. (1986). See also Randall S. Kroszner and Raghuram G. Rajan, "Is the Glass-Steagall Act Justified?" American Economic Review 84, no. 4 (1994), and George J. Bentson, The Separation of Commercial and Investment Banking, London: Macmillan Press. 1990.

[6] Keith A. Noreika, "Remarks before the Clearing House Annual Conference, 2017," November 8, 2017, available at: https://www.occ.gov/news-issuances/speeches/2017/pub-speech-2017-134.pdf.

restrictions were loosened somewhat in 1999 by the Gramm-Leach-Bliley Act, bank holding companies are still restricted from engaging in non-financial commercial activities.

So after almost 250 years of U.S. banking history, where does that leave us? We have a system of laws where a bank holding company cannot own a car wash or a movie theater, but it can own a derivatives broker-dealer. A bank holding company can own gold, silver, palladium and copper, but most other elements on the periodic table are completely off limits (absent special grandfather rights for a few institutions). A national bank can perform certain insurance activities in a town of less than 5,000 persons, but it better stay out of a town of 5,001 persons. I, in my own individual capacity, can own a bank and any other business I want, but it is illegal if I do so through most corporate structures. We have a hodge-podge of banking restrictions that lack a clear, guiding principle.

As I have noted previously, the arguments for maintaining the separation of banking and commerce should be subject to close scrutiny.[7] Arguments that this separation is needed to protect the Federal public fisc and prevent an unfair advantage to non-bank affiliates of federally insured banks ignore that the statutory restrictions in sections 23A and 23B of the Federal Reserve Act effectively already serve this purpose. Arguments that this separation makes banks safer ignore the

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[7] Id.

benefits that banking institutions gain from diversification,[8] and fail to appreciate that there is nothing inherently safer about separating banking and commerce. During 2008, the large New York firms that failed were generally the ones that did *not* own regulated banks – many of the firms that survived were those that owned both traditional banks and investment banking operations. Arguments that this separation stops antitrust concerns ignore the fact antitrust laws are fully applicable to banking organizations. Actually, banks are subject to more antitrust scrutiny than most other industries, as they are subject to antitrust laws administered by not only the Department of Justice, but also by the Federal Reserve, the OCC, and the FDIC.

There are also political economy arguments – that the separation of commerce and banking is meant to prevent the aggregation of power and influence of large corporations that threaten democracy. If this is truly the goal, I'll simply remind people that Apple is now worth over $1 trillion dollars. Even if large companies were a threat to democracy—a questionable premise in its own right—separating banking and commerce is clearly not an effective limit to stopping corporate growth. Whatever its purported goals, I come back to the inevitable conclusion that our banking system engrains a series of laws that ossified over time

[8] Nisreen H. Darwish, "The Mixing of Banking and Commerce: A conference summary." Chicago Fed Letter 244a. November 2007; Larry D. Wall, Alan K. Reichert, and Hsin-Yu Liang, "The Final Frontier: The Integration of Banking and Finance – Part 2, Risk and Return Using Efficient Portfolio Analysis." Economic Review 93, no. 2. Federal Reserve Bank of Atlanta (2008).

without a singular purpose other than to protect established market players and prevent competition from new entrants.

This short history lesson brings me back to the importance of the Utah ILC. As Louis Brandeis famously remarked, "It is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."[9] Utah has been, and continues to be, one of the most courageous states when it comes to bank regulation. Industrial Banks have their historical roots in the early 20th Century, when these institutions provided small, unsecured loans to low-income industrial workers. From the very beginning, industrial loan companies were designed to provide access to credit to underserved communities that were unable get loans from traditional banks. These banks grew out of the Morris Plan Banks, the first of which was founded by Arthur J. Morris in Virginia in 1910.

Today, NAIB reports that for the past 15 years, ILCs have consistently outperformed all other FDIC insured institutions, with higher tier 1 capital levels, higher return on equity, and higher return on assets, than other FDIC regulated insured depository institutions.[10] Industrial banks offer many of the same or

[9] New State Ice Co. v. Liebmann (1932).

[10] NAIB, Industrial banks, a History of Stability & Strength, http://uafs.net/wp-content/uploads/2018/02/NAIB_StabilityStrength_042017_v1.4.pdf.

similar products and services as commercial banks, and are subject to many of the same prudential and consumer requirements and level of supervision as commercial banks.

The functions of ILCs have evolved over time, and their history has not been without controversy. But throughout the years, the ILC charter has stood resilient. Due in large part to the efforts of Senator Jake Garn, industrial loan companies became eligible for deposit insurance in 1982 and, in 1987, ILC holding companies were effectively carved out of the BHC Act and the Federal Reserve's jurisdiction.[11] These changes unlocked the potential of this charter because, for the first time, Federal law allowed companies to own an industrial bank with deposit insurance and not be otherwise restricted in its commercial activities. The number of ILCs skyrocketed following these statutory changes, with the GAO estimating that the ILC industry grew by over 3,500 percent from 1987 to 2004.[12] In 2005 and 2006, applications to acquire ILCs by large commercial firms sparked opposition from existing market players that resisted increased competition from new market participants – competition which would ultimately have benefitted consumers of commercial and banking services alike – and the granting of new ILC charters was put on hold through a series of moratoriums.

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[11] *See* Garn-St. Germain Depository Institutions Act of 1982; Competitive Equality Banking Act of 1987.

[12] United States Government Accountability Office, "Industrial Loan Corporations: Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority" (September 2005).

However, another chapter in the history of ILCs has turned and we stand today in a truly exciting time. FDIC Chairman McWilliams indicated earlier this year before the Senate Banking Committee that the FDIC will move swiftly in considering applications for new ILC charters,[13] which opens the possibilities of the future of fintech and innovation. With the growth of ILC charters, fintech companies will be able to develop ways to operate synergistically with affiliated ILCs and to find ways to deliver existing and new financial products and services more effectively, more cheaply, and to a wider-customer base.

Now with all the press surrounding the OCC's announcement regarding fintech charters – do ILCs still have a place in financial innovation? To this, I answer a resounding yes. The Federal fintech charter, for all of its potential, is limited in certain respects, for instance, in its ability to take insured deposits. Its powers will also be limited to "paying checks" and "lending money," as interpreted by the OCC under the National Bank Act. Notwithstanding the potential for broad regulatory interpretation, these activities are ultimately limited to stay within the "business of banking."

In this regard, I would like to raise – as a final note – a unique FDIC authority that rarely gets discussed in the context of fintech development. The FDIC has the power today, under 12 USC 1831a(a), to permit an insured non-

[13] John Heltman, Four takeaways from grilling of FDIC, Fed nominees on Hill, American Banker, January 23, 2018.

member bank to engage in *any* activity permitted under state law, so long as the activity does not pose significant risk to the Deposit Insurance Fund and the bank meets applicable capital standards.[14] Unlike the federal fintech charter, the FDIC could permit an industrial bank to engage in activities beyond the "business of banking," if these federal requirements are met and if permitted by state law. In this way, the FDIC, together with a courageous state, has the potential to free an industrial bank to responsibly innovate banking services, not just among affiliated entities, but within the banking entity itself.

Thank you for having me here today. Utah has been a steadfast and courageous example throughout my lifetime in the cause of financial innovation. And I sincerely hope that the best is yet to come. I would now be happy to answer a few questions.

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[14] The FDIC, together with the Federal Reserve, has the same authority with respect to state member banks.