Innovation: Opening the Door for Regulatory Engagement

By Thomas A. Brooks, Joann Needleman / Oct 26, 2018

Since Donald Trump took office the hot topic has been “deregulation”. However, contradicting this ideal are efforts by financial regulators to incorporate the use of financial technology by financial institutions and fintech entities in order to provide innovative products and services to businesses and consumers. In order to achieve these initiatives, the agencies are taking a new and more welcoming approach.

The Bureau’s Office of Innovation

Mick Mulvaney, the Acting Director of the Bureau of Consumer Financial Protection (“Bureau”), jumped on the innovation bandwagon by tapping Paul Watkins to lead the Bureau’s Office of Innovation. Watkins came from the Arizona Office of the Attorney General, where he was in charge of the office’s newly authorized fintech initiatives. He developed the FinTech Regulatory Sandbox, the first in the United States, that offered innovative financial companies with limited access to the marketplace, in exchange for limited regulatory oversight of its products and services during a testing period. One of the many objectives of the Bureau under the Dodd-Frank Act was to ensure that markets for consumer financial products and services operate transparently and efficiently to facilitate access and *innovation*. [Emphasis added]. See 12 U.S.C § 5511(b)(5). The Bureau's Office of Innovation replaces Project Catalyst which intended to allow the Bureau to collaborate with start-ups and non-profits to foster innovation. To facilitate that partnership, the Bureau offered a “No Action Letter”, a statement from the agency that allows financial innovators to market products and services without fear of enforcement. However, these No Action Letters were non-enforceable and non-transferrable, and they could be revoked at any time. Under Project Catalyst only one No Action Letter was issued.

The Office of Innovation clearly is taking a different approach. First, the Bureau’s website indicates that it is in the process of revising the No Action Letter policy “in order to increase participation by companies seeking to advance new products and services.” Second, it re-instituted the trial disclosure program which was dormant for the most part under the prior Bureau administration. A notice and comment period on the Bureau’s proposal to develop a “disclosure sandbox” and to streamline the application process to encourage more companies to conduct trials has just ended. Finally, the Bureau is interested in partnering with companies to improve financial regulation that could better foster consumer-friendly innovation.

OCC and Special Purpose National Bank Charters

In July of this year the Office of the Comptroller of Currency ("OCC") advised that it would begin accepting applications for special purpose national bank (“SPNB”) charters from non-depository fintech companies. The benefits of obtaining an SPNB charter can be substantial. Its primary advantage is that it would eliminate multi-state bank examinations in exchange for one rigorous OCC examination. It also would make it easier to export interest rates nationwide, consolidate compliance functions and eliminate a physical presence that many states require, all of which improve profitability. This new national bank charter may also bring with it a certain status or cache, perhaps allowing the entity better access to capital to fund operations and growth since it will not have access to low cost deposits that are otherwise available to traditional banks. Clearly the OCC is recognizing that companies that engage in the business of banking in new and innovative ways should have the same opportunity to obtain a national bank charter as companies that provide banking services through more traditional means.

SEC’s Strategic Hub for Innovation and Financial Technology ("FinHub")

Recently, the Security and Exchange Commission ("SEC") launched FinHub, a website devoted to facilitating the SEC’s public engagement with innovators, developers, and entrepreneurs. A link to the website can be found here. Particular areas of interest are blockchain/distributed ledgers, digital marketplace financing, automated investment advice and artificially intelligence and machine learning. The website provides pertinent regulations, investor information, opportunities for comment and empirical data. FinHub is a logical step in the engagement process by providing interested participants an opportunity to do their due diligence prior to reaching out to the Commission. SEC Chairman Jay Clayton is quoted as saying, “The SEC is committed to working with investors and market participants on new approaches to capital formation, market structure, and financial services, with an eye toward enhancing, and in no way reducing, investor protection,"

FDIC

While there has been no official announcement of FDIC’s efforts to encourage banks to engage in the use of technology to provide innovative services to customers, Chairman Jelena McWilliams told a bank conference recently that the FDIC will set up an office of innovation to foster a more welcoming environment for banks to adopt financial technology changes. She especially noted that innovative technology is happening outside the reach of community banks because they do not have the resources to adopt innovations nor the ability to effectively institute compliance mechanisms that would be needed to obtain approval from their regulators.

McWilliams believes that the FDIC has the ability to approach innovations in the financial services industry in three ways. The first is through the use of an industrial loan company, which is a specialized bank that is chartered by a state and supervised by the FDIC. Neither it nor its parent is regulated by the Federal Reserve Board. This would allow a fintech commercial entity to own or become an ILC, accept deposits and obtain FDIC deposit insurance, the latter deemed advantageous over an OCC-chartered special purpose national bank.

The second area where technological innovation can be fostered is how the FDIC regulates banks' third-party vendor relationships. If a bank does not have the resources to invest in financial innovation, it can partner with fintech entities. However, these partnerships require a bank to utilize resources in order to properly manage that third party relationship, including the development of a risk management and compliance program. Finally, the FDIC is considering working with technology companies to improve processing, service and efficiency at the banks themselves. In this approach, banks would not contract out the services it provides to its customers, but would engage third party technology providers to help it develop its own products and services to offer to its customers.

Engaging with financial regulators requires a well-thought out strategy with well-defined objectives that will require concessions from each party. For regulators, the relaxing of regulatory expectations will have its limits. For financial institutions and fintech entities it will mean sticking your head out of the proverbial foxhole in order to advance state-of-the art ideas to retain and welcome new customers. It will be a delicate balance, but now more than ever, regulators want to invite the financial services industry to join in the conversation.

If you would like more information about engaging with regulators on innovation services and products, please contact Joann Needleman and Tommy Brooks.

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