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COMMENT**

COMMENT ON THE PROPOSED RULE REGARDING RECEIVERSHIPS FOR UNINSURED NATIONAL BANKS

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Proposed Rule Regarding Receiverships for Uninsured National Banks

Agency: Office of the Comptroller of the Currency, Department of the Treasury

Proposed: September 13, 2016

Comment period closes: November 14, 2016

Submitted: November 14, 2016

Docket Number: OCC-2016-0017

RIN: 1557-AE07

INTRODUCTION

Thank you for the opportunity to comment on the Office of the Comptroller of the Currency's (OCC) proposed rule regarding receiverships for uninsured national banks.¹ The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment, therefore, does not represent the views of any particular affected party or special interest group, but it is designed to assist the OCC in establishing a rule that will help

1. 81 Fed. Reg. 62835, 62837 (proposed September 13, 2016) (to be codified at 12 C.F.R. pt. 51).

enable needed innovation in financial services for the benefit of the public, including, as the OCC notes, expanding access and opportunity to those underserved by the status quo.²

The OCC, which has the power to act as receiver for nondepositories, is wisely considering what form its role as a receiver might take. The OCC has asked, among other things, whether using the National Bank Act receivership framework for innovative “fintech” companies poses unique challenges.³ The answer to this question is yes. The unique risks posed or avoided by fintech firms distinguish them from traditional depository institutions in important ways. The OCC’s treatment of these firms should take those differences into account so that the OCC’s policies protect customers without undue regulatory burden.

Given the OCC’s commendable interest in innovation, this letter focuses primarily on emerging and innovative fintech firms. However, its arguments may also have implications for more traditional nondepository firms or depository firms that adopt innovative new business processes that lessen or remove the risk to their deposits.

This letter raises the following points for the OCC’s consideration:

- A proper conception of “safety and soundness” recognizes that risks are different in the fintech sector than in the depository context, failure of some firms is inevitable, and such failure can even be salutary, as long as the firm can execute a plan to protect customers during the wind-down period.
- The nature of fintech firms’ relationships with their customers makes the wind-down process easier for these firms than for depository institutions.
- Rather than assuming it must take an active role in receivership, the OCC should consider firms’ resolution and transition plans, both at the chartering phase and in its subsequent monitoring of firms. This may allow firms to resolve themselves through traditional bankruptcy provisions while protecting their customers.

FINTECH FIRMS ARE DIFFERENT

As the OCC correctly points out, the different nature of nondepository institutions means they are subject to different risks than depository firms.⁴ It can be argued that the failure of a traditional depository institution is inherently disruptive to customers and potentially to the general public. Whatever one thinks of that argument in the context of depository institutions, the failure of a nondepository fintech bank would not pose the same inherent risk of disruption. New special-purpose banks operating in the lending or payments space present

2. Office of the Comptroller of the Currency, *Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective*, March 2016, 2.

3. 81 Fed. Reg. 62837.

4. “Because of the fundamentally different business model of national trust banks, compared to commercial and consumer banks and savings associations . . . national trust banks face very different types of risks.” 81 Fed. Reg. 62837.

unique concerns.⁵ Their regulation, including the definition of what constitutes “safety and soundness,” should reflect that.

Understanding that a well-regulated system can tolerate failure is important. Failure and innovation go hand in hand. Innovative approaches to meeting financial needs are by definition less well understood and riskier than traditional methods. Innovative firms may be more prone to failure than traditional firms. However, denying innovative firms access to a national charter and thereby impeding efficiency and competitive equality would be counterproductive for the public. The key is insuring that innovative firms can fail in a way that protects their customers. As the next section discusses, the way these firms work facilitates effective failure management.

FINTECH FIRMS’ CUSTOMER RELATIONSHIPS ARE DIFFERENT

Given the likely nature and business model of many nondepository fintech banks, their customer relationships are generally more transitory than the customer relationships of traditional banks. For example, the relationship between a nondepository fintech payments bank and its customer can last only as long as necessary to transfer the money, and the relationship between a lender and borrower will last the life of the loan. By contrast, a traditional depository institution, because it holds a customer’s demand deposits, has an inherently ongoing and indefinite relationship with the customer.⁶ In light of the episodic nature of many fintech firms’ customer relationships, the most important thing the OCC can do to protect the public is require that firms have plans and the necessary resources to wrap up or transfer operations smoothly in the event of failure. By making certain that firms develop and maintain this capability, the OCC can limit its receivership obligations.

A nondepository lender funds its loans with money obtained from willing investors who understand they are putting their money at risk and are purchasing an interest in a loan or, in the case of a balance-sheet lender, in the lender itself.⁷ Investors who provide this capital understand that the money will not be available on demand and that the investment will lose value if borrowers default. The greatest risk to investors is not that the borrower will default or that the investment will lose its value; these risks are an inherent and understood part of the transaction for which the investor is compensated. Instead, the greatest risk is that the platform’s failure will disrupt the servicing of the loan, preventing borrowers from fulfilling their obligations or investors from receiving the funds to which they are entitled. Ensuring that the lender has a credible and workable plan to allow the existing loans to continue being serviced by another party will protect its customers—both borrowers and investors.

5. Other business models may present different challenges. While this comment does not address these issues directly, the principles embodied here can be broadly applied.

6. A customer’s repeated use of the same fintech bank over time to send multiple transfers or take several loans is generally best understood to be multiple discrete relationships rather than an ongoing indefinite one. However, in some cases a customer may use a service for recurring payments, and the ability of firms to ensure continuity after they fail—including having funds to manage a wind-down that provides enough time for customers to adapt and having provisions to facilitate payments that a customer cannot reasonably switch to a new service by the time they are due—should be a factor monitored by the OCC.

7. US Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, May 10, 2016, 5–6.

Similarly, nondepository fintech payments firms present different risks than traditional depository banks. These firms are able to move money between parties nearly instantly without using deposits as a temporary buffer, and some of these firms are able to ensure that only transactions certain to be completed are initiated.⁸ As a result, payments will not be “stranded” if the firm suffers a disruption; the only transfers that happen are those that will happen nearly instantly and successfully. To protect these firms’ customers, the OCC should focus on ensuring they have the necessary resources and procedures to cease taking in new business and complete any outstanding transactions in the event of a disruption or failure.

Innovative nondepository firms could pose risks to customers, but these risks and the strategies for mitigating them are different than they are in the traditional bank context. In the case of a failing lender, the ability to smoothly transition the servicing of existing loans to another party can protect borrowers and lenders from disruption. Likewise, a payments provider that facilitates nearly instantaneous transfers and initiates transactions only if they are certain to go through can take steps to avoid exposing customers to the risk of their funds being trapped if the firm shuts down.

THE OCC’S LIMITED RECEIVERSHIP ROLE FOR FINTECH FIRMS

As the OCC considers granting charters to innovative nondepository institutions, it should not primarily focus on whether a firm might fail. Instead, the OCC should consider whether the firm has a credible plan to mitigate consumer risk in the event of failure and the ability to execute that plan. Factors to be considered could include the firm’s plan for an orderly wind-down to provide customers with sufficient time to adapt; relationships with backup service providers willing and able to take over managing the existing products after the firm shuts down; the plan for communication to customers so customers are able to manage their interests if the firm winds down; the firm’s ability to fund an orderly shut-down; and the technical and personnel capabilities on which the firm and its partners would draw to manage a shut-down. In addition to evaluating the above and other relevant factors during the initial charter application period, the OCC should continually assess these ready-for-failure factors as a key part of its examinations of nondepository banks.

The OCC may need to step in as receiver to wind down a firm’s operations in some cases. The OCC’s job will be easier if firms have a credible resolution plan and procedures. If the OCC is appropriately diligent in monitoring a firm’s plans and capabilities before the firm becomes distressed, a receivership might not be necessary at all. A properly prepared firm would be able to resolve all customer business and shut down under traditional bankruptcy provisions. This possibility is especially likely if the firm is able to cease operations without open obligations, such as unsettled payment obligations in the case of a payments firm.

8. See, e.g., Marcel T. Rosner and Andrew Kang, “Understanding and Regulating Twenty-First Century Payment Systems: The Ripple Case Study,” *Michigan Law Review* 114 (2016): 661. (“Ripple eliminates the risk that payments will not reach the targeted payee once the payer initiates the transaction. . . . Either the entire transaction happens or none of the steps happen at all.”)

Proper planning could spare the OCC a long and expensive receivership. Even if the OCC ultimately needs to step in as receiver, an existing and credible plan will provide the OCC with a clear strategy and process to resolve the firm with a minimum of delay and cost.

CONCLUSION

The rise of innovative nondepository financial institutions presents significant potential benefits to the public, including greater access to and inclusion in the financial system. But as with other forms of progress, the rise of these new financial-service providers poses some risks. The OCC should craft its charter and receivership criteria for these new entities with a recognition of the differences between these firms and traditional depository firms. Some of these firms will fail if they do not meet market needs and customer demands. The OCC should avoid applying unnecessarily burdensome or inapt requirements that do nothing to further customer protection. Instead, the OCC should focus on ensuring that failure will be orderly. Laying the groundwork for “responsible failure” should be a key part of the OCC’s commitment to fostering innovation.