Bauerle's Bank Notes

Summoning the Future: Part 1

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2017 will likely to be the year in which the number of fintech companies surpasses the number of banks. Startups now number more than 5,000 in the U.S. alone, banks slightly more than 6,000. How many of the startups succeed, and which ones do, will consume their investors' attention. Every one of them, however, aims to cannibalize legacy banks' business by doing it faster, cheaper, better.

As if to mark the occasion, the federal regulator of national banks, the OCC, last month announced plans to accept applications from fintech companies for limited purpose national bank charters. Banks that limit their business to trust activities or credit card lending are present day examples of limited purpose banks.

The OCC's move is a double policy reversal. In regulatory precincts, fintech was long viewed as being of marginal importance. PayPal's meteoric rise caught the OCC by surprise, according to those we know in the agency. The financial crisis of 2008 led the OCC to impose an unofficial moratorium on issuing new national bank charters: the bar was set so high nobody could clear it. Last month's announcement rolls back both agency positions.

Whether fintech companies will care to have national bank charters is unknown. In all events, momentum is growing in the battle royal over the ways and means of banking in the digital economy. Gulliver vs. the Lilliputians. Legacy banks are Gulliver in some aspects of the contest and Lilliputians in others. Ditto for fintech. Central to the conflict are innovation and regulation.

The Right to Innovate

Doug Leone of Sequoia Capital Partners frames Silicon Valley's meta-narrative as "a disturbing story with the elements of a fairy tale."

This tale begins in another age (which happens to be the future), and features a lowborn hero who knows a secret from his hardscrabble experience. The hero encounters royalty (the V.C.s) who test him, and he harnesses magic (technology) to prevail. The tale ends in heaping treasure chests for all, borne home on the unicorn's back. [i]

It is not accidental that voyagers in this quest narrative perceive themselves as beset by adversaries. Another venture capitalist observed,

'Silicon Valley's V.C.s are all techno-optimists. They have the arrogant belief that you can take a geography and remove all obstructions and have nothing but a free flow of capital and ideas, and that it's good, it's very good, to creatively destroy everything that has gone before.' Some Silicon Valley V.C.s believe that these values would have greater sway if their community left America behind. . . . The game in Silicon Valley is . . . not ferocious intelligence . . . or even wealth . . . . It's prescience. And then it's removing every obstacle to the ferocious clarity of your vision: incumbents, regulations, folkways, people. Can you not just see the future but summon it?[ii]

The right to innovate is embedded in Article I of the U.S. Constitution. It predates the Bill of Rights. The Patent and Trademark Office confers limited monopoly rights on inventors whose creations the PTO judges worthy of patent protection. The law encourages them to exploit their inventions for financial gain. These bedrock principles contradict the impulse to regulate, embodied in the OCC's fintech initiative.

The Duty to Serve

Consequential inventions serve public purposes. Otherwise, the PC, the router, the Internet and the iPhone would not be common currency today. Inventions that become ubiquitous benefit from public investment that dwarfs venture capitalists' "heaping treasure chests." Cold War federal spending put telecommunications satellites in Earth orbit, IBM mainframe computers on every college campus, and created the Internet. Securing Middle Eastern oil reserves and the U.S. civilian population has recently propelled large-scale public investment in networks, routers, robotics and biometric authentication.

With public utility, and funding, comes legal regulation. Public and private interests are identified, prioritized and harmonized (mostly). Human nature prefers to set one's own rules. Life in a pluralistic society requires empowering others to set rules for all to follow.

To date, fintech inventors have dodged the costs of the public infrastructure on which the success of their innovations depends. The legacy banking system provides, and pays for, the backbone over which PayPal transferred $87 billion in Q3 2016. That represents a 25% increase over Q3 2015 and a near doubling since Q1 2014. Banks, their customers and shareholders absorb the cost of combating money laundering, terrorist financing and cyber crime. Loan-originator LendingClub is a complete stranger to the Community Reinvestment Act. Brick and mortar banking, including transactions in currency, is an unheralded back-up system in the event of a cyber attack on the nation's Internet-enabled banking system or electric power grid. The cost of that back-up system today is borne 100% by legacy banks, their customers and investors.

As fintech companies' importance and influence grows, they must embrace their duty to serve the public interest, and the accompanying costs. Because it deals only with the chartering process, the OCC's initiative is just one step on a journey of a thousand miles. What legislators and the public that elects them must address is the equitable allocation of costs of creating a safe, sound and secure digital financial economy that serves businesses and consumers well.

Because they are the epicenters of finance and technology innovation, New York and California also have an important role to play. The New York Department of Financial Services has staked out a leading role in defining cyber security requirements for financial intermediaries. It has also signaled its refusal to be sidelined by the OCC's fintech national bank charter initiative. (The OCC touts federal law preemption of state banking laws as a major benefit of fintech companies' acquiring national bank charters.) A California legislator recently requested a copy of our July/August column for the Banking Law Journal, titled "Embracing Differential Regulation." Our argument that one-size-fits-all regulation is obsolete is apparently gaining at least a modicum of attention in Sacramento.

Synthesis

Venture capitalists inebriated by hubris imagine they can summon the future. Realists craft the future, creatively, deliberately and with concern for the interests of others. In our opinion, the OCC's gambit to regulate fintech companies by chartering them as limited purpose national banks is a lead balloon. Most fintech companies aspire not to be banks, but to leech off them. Most tech pioneers, like PayPal billionaire Peter Thiel, would rather die than live through the process of acquiring a national bank charter.

Needed instead is a comprehensive approach that more fully accounts for what is taking place.

- The faster, cheaper, better outcomes technology enables will continue to cause fintech company valuations to dwarf legacy bank valuations. PayPal is Exhibit A. That is a competitive problem for banks both operationally and in the capital markets.

- To function, Fintech companies must access the banking system. That dependency, rather than bank charter authority, should be the regulators' point of entry for extending their regulatory franchise to fintech enterprises.

- Business and consumers depend on (and take for granted) a safe and sound banking system. That is a public imperative that must be served.

- Fintech failures will occur. Some will be spectacular. LendingClub's fall from grace in 2016 is a preview. Cyber security failures are commonplace in the wider economy. In the banking system, that is a politically and economically unacceptable condition that will also give traction to regulators' agenda.

- As the proliferation of mobile banking shows, fintech and legacy banks will converge. Survivors will emerge from both camps.

In our next installment, we will offer specific suggestions of how these conditions can inform a comprehensive approach to regulating digital financial services.

We thank our readers for their attention and our clients for their patronage. To readers who are not clients, we extend an invitation to become one in the New Year. We wish for all good health and good fortune in 2017.

[i] T. Friend, "Tomorrow's Advance Man: Marc Andreessen's Plan to Win the Future," The New Yorker, May 18, 2015, p. 58

[ii] Id. at 62.