



SDBA Business Development Bank Working Group Report – October, 2018

What is a Business Development Bank (BDB) per SB184?

A BDB created by SB184 **is authorized** to:

- Extend only commercial loans over \$5,000.
- Require and obtain collateral or security interest in real or personal property
- Provide management/consulting services to customers either directly or indirectly through affiliated or unaffiliated business entities. Services could include financial, economic, accounting, employee benefit, data processing or similar matters.
- Accept savings and time deposits in any amount not less than \$100,000.
- Exercise any other power that is related to, incidental to, or usual to the business of banking.

A BDB **cannot**:

- Provide fiduciary, executor, administrator, guardian, conservator, trustee or attorney-in-fact services.
- Provide trust services.
- Make loans for any non-commercial, personal, family or household purpose.
- Accept deposits other than savings/time deposits greater than \$100,000 or any public deposits.
- Provide money transmission services.
- Provide safe-deposit box rental.
- Offer branch bank or drive-up bank services.

Who are the interests pushing for enactment?

The moving force behind SB184 in 2018 was Sioux Falls-based Expansion Capital Group, a company that has operated as a SD-licensed money lender since 2013 making higher-risk loans via the internet to small businesses located primarily outside of South Dakota. Their borrowers typically have little if any collateral to pledge as security to finance a business startup or expansion and likely have been turned down by traditional financial service providers. While Expansion Capital is the face of SB184 in South Dakota, other fintech companies throughout the U.S. might consider doing business under a South Dakota BDB charter.

Why this limited purpose charter?

The principals at Expansion Capital want to collaborate with traditional lenders and believe that banks might be more willing to do so if they were are chartered bank rather than a licensed money lender.

High-rate loans issued under a limited purpose bank charter approved by both the SD Division of Banking and the FDIC might be subject to less interest rate-related litigation or administrative challenge than similar loans issued by a licensed money lender.

SDBA's Business Development Work Group

During the 2018 session, the SDBA's Board of Directors voted to oppose SB184 due to a number of uncertainties that could not be resolved during the short duration of session days remaining after SB184 had been introduced. Once informed of the SDBA's position, the bill's prime sponsor elected to withdraw the legislation without debate. As part of that bargain, the leadership of the SDBA and the supporters of SB184 agreed to continue dialogue about the BDB concept in advance of the 2019 session.

In June, the SDBA Board authorized the Chairman to appoint and lead a working group to broaden discussion among SDBA members. In July, SDBA Chairman Karl Adam (First Dakota National Bank, Pierre SD) appointed the following bankers to that group:

SDBA Board Members

SDBA Chairman Karl Adam – First Dakota National Bank, Pierre
SDBA Chairman-Elect Shawn Rost – First Interstate Bank, Rapid City
Jeff Davis, Bryant State Bank
David Nelson, First Fidelity Bank, Platte
Rick Nath, Citibank, Sioux Falls

SDBA Members at large

Kevin Tetzlaff, First Bank & Trust, Brookings
Jody Bender, U.S. Bank, Rapid City
Chris Ekstrum, The First National Bank in Sioux Falls
David Ebbers, Reliabank Dakota, Watertown
Lynn Peterson, CorTrust Bank, Yankton
Monte Troske, Farmers State Bank, Turton
Robert Fouberg, Dacotah Bank, Aberdeen

Primary goals of the working group were to:

- Broaden the base of industry discussion about the business development bank charter by sharing information and gathering feedback from a diverse group of SDBA members by size, location and business model.
- Summarize feedback into a report that will help the members of the SDBA Board better understand the market effects and policy implications associated with potential enactment of SB184.

BDB Work Group Findings

South Dakota's bankers are keenly aware of the growing presence of non-bank firms that specialize in the online delivery of financial services in the consumer and business lending marketplace, sometimes referred to as "shadow banking". Likewise, bankers have not forgotten the role that lightly or largely

unregulated financial firms played in the runup to the financial crisis that spawned the great recession and contributed greatly to Congress' passage of H.R 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

To some degree, banker concerns with the concept of a new, business development bank charter as contemplated in SD SB184, relate to difficult lessons learned from passage and subsequent regulators' implementation of the Dodd-Frank Act. Complex, costly regulations that perhaps were meant to apply only to large, complex banks have been applied in accordance with the law to the entire spectrum of traditional, community banks. Similar concerns about unknown, unintended consequences significantly influenced banker views of SB184.

Banker Concerns

Reputation risk to traditional banks

For the past 5 years, Expansion Capital has been making higher-risk, higher-rate loans to small businesses, operating as a SD licensed money lender. Other companies in this segment of the financial services marketplace operate under similar state licensing regimens or perhaps as unlicensed, unregulated entities. Bankers are concerned that passage of SB184 could, to some degree, "legitimize" their business model. Traditional bankers who have experienced negative impacts associated with a financial crisis and recession not of their making have concerns about reputational risks associated with high risk, small business lending by firms entitled to use the term "bank" in their business name.

Level playing field

Over the past quarter century, bankers have witnessed what can happen when well-intended laws have been stretched to create significant competitive advantages for some entities in the financial services marketplace, particularly federal credit unions and the federal Farm Credit System. Aggressive, growth-focused company management and expansion-enabling federal regulators combined to create tax-subsidized, regulation-lite, direct competitors for traditional banks. While South Dakota's bankers might have more confidence in the approach the SD Division of Banking would take as the primary regulator of BDBs, concerns do exist about regulatory uncertainties and the potential development of an unlevel playing field between traditional, full-service banks and BDB's.

The issue of mission creep was raised with the SD Division of Banking. Below is that dialogue:

SDBA: At this point, bankers have a pretty fair understanding of what Expansion Capital wants to do under SB184. That said, they have all watched what growth focused credit unions and farm credit system lenders have become under the watchful eye of their regulators; original mission and authorities be damned. Hence the bankers are not comfortable with what passage of SB184 might lead to down the road. Any insights or feedback on that front would be much appreciated.

SDDOB: *As I have said at every opportunity on this topic, Expansion Capital could apply for a full commercial bank charter and deposit insurance tomorrow with or without the passage of legislation like SB 184. If an entity were established and approved under a structure like that contemplated in SB 184, they would need to operate within the authorities and restrictions in the bill, or apply for a full bank charter, which would include a new round of notice and opportunity for comment. Either way, any BDB*

would be a regulated bank as defined in Title 51A and would be subject to the tax imposed in SDCL Chapter 10-43 and Federal Income Tax.

Bankers also raised questions about the degree to which BDBs would be subject to regulations designed to assess a bank's commitment to financial inclusion efforts (e.g Community Reinvestment Act). The development and rapid growth in the use of on-line banking products and services is putting traditional methods used to grade CRA compliance to the test. In April 2018, the U.S. Treasury Department released new recommendations to reform the CRA, outlining proposed changes to the CRA's performance evaluation criteria and the federal banking agencies' approach to examining banks' CRA performance. Even though SB184 doesn't specify whether BDBs would be subject to CRA or any other measures relating to financial inclusion, the SD Division of Banking has taken the position that BDBs would be subject to all bank regulations that go along with having deposits insured by the FDIC, including the CRA.

Regulatory Uncertainty

SB184 does not prescribe any minimum capital requirements or liquidity standards. As is the case for traditional state chartered banks, those standards and requirements are left to the discretion of the bank regulators (SD Division of Banking and FDIC). Bankers wonder whether minimum capital requirements for a BDB would be lower, higher or equal to those required of a full-service, traditional bank. Bank regulators at both the state and federal level typically do not offer opinions or guidance on such matters until they receive an application for a charter.

Bankers also questioned whether a BDB would be subject to capital-based lending limit restrictions like commercial banks. Initial feedback provided by the SD Division of Banking held:

As introduced in SB 184 earlier this year, all prudential standards, powers, and authorities in SDCL Title 51A would apply to a Business Development Bank (BDB), including the lending limits/restrictions in Chapter 51A-12. Also, as provided in ARSD 20:07:10:05 any bank chartered in SD would need to obtain FDIC insurance and would therefore have a primary federal regulator.

As described earlier in this report, SB184 lists both authorized and prohibited activities for a BDB. Again, credit unions and Farm Credit System lenders provide shining examples of what can happen when regulators fail to enforce statutory limitations. SDBA asked the Division who ultimately has the authority / responsibility to impose regulatory sanctions on a BDB that might stray from its' original mission or intent? The Division responded as follows:

The SD Division of Banking would be the chartering authority and primary regulator for any BDB chartered under a structure like that in SB 184 and since this limited purpose bank would be a creature of state law, I would view it as our responsibility to monitor and enforce compliance with Title 51A and any limitations in the Decision & Order approving such application. We also work closely with our federal counterparts on both state and federal requirements and restrictions.

Competition for Deposits

Expansion Capital specializes in lending to higher-risk small businesses. To compensate for that risk, their loans typically carry higher rates of interest (APR ranges of 25% to 40%). As a licensed money

lender, Expansion Capital currently funds those loans from a variety of sources that are typically more costly than bank deposits. SB184 would allow Business Development Banks to accept time deposits in denominations of \$100,000 or greater. Like their loans, Expansion Capital would solicit those types of deposits on-line, whether direct or through brokers.

Higher-interest rate lenders could tend to bid up the price of deposits needed to fund their loans. Bankers expressed concerns about the impact that BDB's deposit gathering activities might have on deposit pricing in local markets. If traditional banks find it necessary to increase their deposit rates, that increased cost of funds eventually would likely be reflected in interest rates charged to their customers for consumer, home mortgage and business / commercial loans.

SDBA raised the topic of liquidity concerns with the South Dakota Division of Banking. Below is that dialogue:

Question: At a time when liquidity may be a growing concern for bank regulators (and bankers), do regulators have concerns about the potential for stiff competition for deposits coming from BDBs and resulting impacts on cost of deposits for traditional community / commercial banks?

Answer: *I do have some concern about liquidity and funding but more so regarding how certain banks manage their liquidity and also regarding the availability of deposits down the road in our more rural communities. Beyond that, it is difficult to speculate on how much of an impact this type of charter would or would not have on liquidity in a market like Sioux Falls or in South Dakota generally. If there is one such bank chartered, it would probably be difficult to see or feel much of an impact, but if there are 20 of them lending across the country, maybe the impact would be noticeable. Again, I really have no way to predict how the funding side would work without seeing a specific business plan to understand the proposed use of brokered, listing service, and reciprocal deposits in relation to total deposits sought.*

Landscape Outside of South Dakota

OCC's Specialty Charter for Fintech Firms vs. Conference of State Bank Supervisors

On July 31, 2018, the OCC announced that it would consider applications for special purpose national bank charters from companies engaged in the business of banking other than taking deposits. In the eyes of the OCC, a fintech firm that makes loans, processes payments and takes deposits is a traditional bank, not a special purpose bank. The Conference of State Bank Supervisors has announced that it intends to sue the OCC for a second time over differing views of legal authorities conveyed to the OCC under the National Banking Act. In particular, CSBS will challenge the OCC's interpretation that the Act allows them to charter as a bank any entity that performs any one of these three core bank functions, not all three.

SD Division of Banking and OCC vs. SB184

Deliberations over the concept of a state-chartered business development bank by SDBA members should not exclusively or perhaps even primarily revolve around regulators' views of development in the fintech marketplace. That said, it is important to understand areas of similarity and difference in the regulators' views.

- The OCC believes that non-depository financial service providers should be able to apply for a national specialty bank charter. OCC believes any business that takes deposits is a bank.
- The SD Division of Banking believes that non-depository specialty lenders like Expansion Capital are appropriately classified as licensed money lenders. Like the OCC, the Division believes any business that takes deposits is a bank.
- SB184 proposes a special purpose, business development bank charter. The legislation **enables, but does not require BDBs** to accept certain deposits. SD Division of Banking rules require deposit insurance prior to the acceptance of deposits. For that reason, the Division would require a prospective BDB to apply for deposit insurance with the FDIC at the same time the company filed an application for a BDB charter with the state. If the FDIC would deny such an application, the Division would want to know that before granting a charter. SDBA will work to better understand any nuances of the Division's position on BDBs and deposit taking authorities.

It is important to note that any formal position taken by the SD Division of Banking on a 2019 version of BDB legislation will be determined by the new administration that will take office in January, 2019.

Delaware – SB211

Principals at Expansion Capital worked to introduce business development bank-enabling legislation in the Delaware legislature in 2018. Though different in form, the Delaware bill was very similar in substance to SD SB184. The Delaware bill ultimately failed to gain legislative approval due in no small part to circumstances similar to South Dakota - late bill introduction, late banker engagement and resulting uncertainty among and opposition by members of the Delaware Bankers Association.

Conclusions

Deliberation by bankers working in traditional, full service banks about the future of lightly or largely unregulated fintech firms' entry into various segments of the financial services marketplace will continue, both at the state and national levels. Whatever position the SDBA decides to take on a 2019 version of SB184 will be subject to considerable scrutiny, both within and outside South Dakota.

Expansion Capital will tell policy makers that they want to expand their online, small business lending activity and is willing to subject itself to more regulation, not less. Other competing companies may choose to follow their lead or may choose a completely different path.

The SDBA has 4 policy options to consider regarding BDB enabling legislation.

1. **Support** – Traditional banks interested in extending credit to higher risk small businesses can do so with or without passage of SB184. They could develop their own automated underwriting and loan servicing processes or could collaborate with existing licensed money lenders. Those facts, coupled with previously mentioned concerns and uncertainties appear to work against any thought of providing SDBA support for passage of SB184.

That said, it is important to understand that support for SB184 could come from pro-business groups such as state or local chambers of commerce and the National Federation of Independent Business. It is also possible that a group like the AARP could see more competition for bank deposits as good for their members.

2. **Oppose** – Considering the various concerns and uncertainties raised by member bankers, one could argue that it would be appropriate for the SDBA to oppose SB184. Members of the South Dakota legislature from both political parties view themselves as pro-business, pro-economic development policy makers. It is likely that SDBA opposition could be viewed as self-serving and anti-competitive - bankers depriving struggling small-business startups of needed capital. Bankers and trade association lobbyists have long complained about lightly-regulated, untaxed competition. The proponents of SB184 already pay taxes in SD and are asking for more regulation, not less. A case could be made by the supporters of BDBs, that bankers are being inconsistent and don't know what they really want.

Additional opposition to SB184 would likely come from interest groups and individual legislators that supported Initiated Measure #21 in 2016 and previous legislative attempts to cap allowable interest rates on short term consumer loans. Any alliance between the SDBA and those parties of interest could be awkward.

3. **Neutral** – While the supporters of SB184 would very much like SDBA members to view the concept of a business development bank in a positive light, they don't want to face industry opposition in the legislative process. Even if the membership and the Board would decide to take a hands-off approach on SB184, there is strategic drawback associated with taking a neutral position on any bills under consideration by the SD legislature: neutral parties don't get a seat at the legislative table. There is no place for commentators in the committee hearing process.
4. **Amend** – taking the position that a 2019 version of SB184 needs changes keeps the SDBA at the table during legislative discussions. If the SDBA leadership believes changes should be made, it would be appropriate to discuss them with BDB supporters prior to the 2019 session.
 - a. **Deposit Taking** - One possible amendment to consider discussing with the proponents of SB184 and the SD Division of Banking would be to remove all deposit-taking authority for a BDB. That would eliminate bankers' concerns about deposit pricing and would address a possible inconsistency on the part of the Division. It is important to remember the Division's position on SB184 in 2018. Because SB184 never had a committee hearing, the Daugaard administration never established an official position. Director Afdahl recommended a "watch" position on SB184, meaning he felt the Division could administer the bill as proposed. But the Director has since suggested that a non-depository lender is a money lender, not a bank. Perhaps the Division would want to mandate deposit taking for a business development bank (change may to shall) or would oppose the use of the term "bank" as proposed in SB184. That said, given the ongoing legal action between the OCC and the Conference of State Bank Supervisors (Director Afdahl will be the volunteer CSBS Chairman beginning in May, 2019), consistency between OCC and State bank supervisory positions may not be a priority.

- b. Financial Inclusion** – The OCC has indicated that it will require some recipients of a national, specialty bank charter to comply with some CRA-like, financial inclusion standards. SDBA could argue that a business development **bank** should be subject to similar requirements. Language could be developed to affirm that responsibility.

- c. Affirm BDBs subject to taxation** – The SD Division of Banking and the SD Department of Revenue hold that any institution operating under SDCL Title 51A are obligated to pay SD’s bank franchise tax per SDCL Chapter 10-43. That said, SDBA could advocate that a “business development bank” be added to the definition of a financial institution subject to the tax per SDCL 1-43-1(4).