

Statement by Martin J. Gruenberg, Member, FDIC Board of Directors; Application for Federal Deposit Insurance: Square Financial Services, Inc., Salt Lake City, Utah

Last Updated: March 18, 2020

The FDIC Board today is considering an application from Square, Inc. (Square) of San Francisco, California for Federal deposit insurance. The application is for a de novo industrial bank to be named Square Financial Services, chartered in Utah and wholly owned by Square. Since a substantial portion of Square's activities are not financial in nature, it does not qualify for status as a bank holding company and ownership of a commercial bank. However, the Bank Holding Company Act provides an exception for owning an industrial bank without becoming a bank holding company.¹

Under Section 5(a) of the Federal Deposit Insurance Act, the FDIC Board of Directors is authorized to approve or deny applications for Federal deposit insurance.² Pursuant to a resolution adopted in September 2007, the FDIC Board has reserved the authority to act on applications for Federal deposit insurance from proposed industrial banks and industrial loan companies³, leading to the Board's consideration today of this application.

For the reasons outlined below, this application fails to meet the statutory requirements, including source of financial strength, for deposit insurance. As a result, I will vote against approval of this application.

Overview of Square, Inc.⁴

Square began operations in 2009 as a payment services provider using proprietary software and hardware to enable businesses to accept card payments using a mobile device. Square has since expanded its business services to include point-of-sale payments, inventory management, website development and support, payroll processing, and financing.

In 2014, Square began making cash advance loans to merchants who use Square as their card payment service provider. In 2016, the cash advance program was replaced by a small-dollar, unsecured commercial loan product called Flex Loans. Square established a new subsidiary, Square Capital, to facilitate the loan product through an unaffiliated bank in Salt Lake City, Utah. The unaffiliated bank originates the loans and promptly sells them to Square Capital.

Flex Loan borrowers are predominantly small businesses with annual sales of less than \$100,000 with periodic financing needs of less than \$10,000. Borrowers are spread geographically and across many industries.

Square Capital does not charge interest on the outstanding balance of a Flex Loan. Instead, an upfront fee, ranging from 10 percent to 16.5 percent is charged. The resulting effective cost of

credit to the borrower is over 30 percent, which is characteristic of sub-investment grade business loans. The average amount of a Flex Loan is \$6,000. Based on historical reporting, the industrial bank would be expected to sell a large majority of loan originations to outside investors and, consequently, would be reliant on gains on loan sales for profitability.

Flex Loan underwriting is primarily automated and model-based, using the merchant's payment processing data rather than traditional underwriting criteria.

Square proposes to establish an industrial bank to replace the role of the unaffiliated third-party bank in its commercial lending operations, thereby eliminating the fees paid outside the organization. No branches are anticipated. Upon opening, the industrial bank would originate Flex Loans to be sold directly to institutional investors. The industrial bank would use Square Capital's models for underwriting.

Source of Financial Strength

Section 38A of the Federal Deposit Insurance Act includes the following requirement:

"If an insured depository institution is not the subsidiary of a bank holding company..., the appropriate Federal banking agency for the insured depository institution shall require any company that directly or indirectly controls the insured depository institution to serve as a source of financial strength for such institution."⁵

The law also states:

"...the term 'source of financial strength' means the ability of a company that directly or indirectly owns or controls an insured depository institution to provide financial assistance to such insured depository institution in the event of the financial distress of the insured depository institution."⁶

For a number of reasons, Square, Inc., the parent of the proposed industrial bank, Square Financial Services, fails to meet the source of financial strength requirement.

First, since Square, Inc. was established in 2009, it has never been profitable. According to its SEC filings, Square, Inc. lost money in every year of its operation except 2019, when it barely broke even.⁷ This is despite the fact that Square has benefitted from a growing economy during most of its existence. Square has yet to demonstrate its viability during a downturn in the economic cycle. In fact, it has failed to demonstrate its viability during the upside of an economic cycle.

Second, Square, Inc., is reliant on an originate to distribute business model which is highly vulnerable to an economic downturn. If investor demand for the bank's loans diminishes in an unfavorable business environment, its liquidity and capital positions would be quickly and seriously impacted.

Third, the viability of the proposed industrial bank would be entirely reliant on the parent. The loan customers of the proposed bank would predominantly be merchants that use the parent's

payment network. Loan underwriting would be dependent on the payment data and models owned by the parent. Repayment of loans would be made directly from merchant transaction funds processed through the parent's payment system. Depositors in the proposed bank would be expected to come largely from merchants and others related to the parent.

As a practical matter, the operations of the proposed bank would be deeply connected to the operations of the parent. In an economic downturn, both would likely experience stress at the same time, which would impair the ability of the parent to serve as a financial source of strength when it is most needed.

Statutory Factors and FDIC Conditions

In addition to the "source of financial strength" requirement, Section 6 of the Federal Deposit Insurance Act⁸ requires the FDIC to consider seven factors when reviewing an application for deposit insurance:

- (1) the financial history and condition of the depository institution,
- (2) the adequacy of the depository institution's capital structure,
- (3) the future earnings prospects of the depository institution,
- (4) the general character and fitness of its management,
- (5) the risk presented by such depository institution to the Deposit Insurance Fund,
- (6) the convenience and needs of the community to be served by the depository institution,
- (7) whether the depository institution's corporate powers are consistent with the purposes of the FDI Act.

The weaknesses which make the ability of the parent company to meet the financial source of strength requirement highly uncertain - lack of profitability, reliance on an originate to distribute business model, and the dependence of the proposed bank on the parent - also make it very challenging for this application to satisfy a number of the statutory factors the FDIC must consider in its review. This is particularly true in regard to the adequacy of the depository institution's capital structure, future earnings prospects, and risk presented to the Deposit Insurance Fund.

In order to mitigate these weaknesses, the proposed industrial bank, the parent, and the controlling shareholder of the parent would be required to execute a Capital and Liquidity Maintenance Agreement (CALMA) to ensure the proposed bank maintains sufficient capital and liquidity, as well as a Parent Company Agreement (PCA).

The Capital and Liquidity Maintenance Agreement would require that Square:

- Maintain the leverage ratio of the proposed bank at least 20 percent at all times.
- Maintain a third-party line of credit for the benefit of the proposed bank acceptable to the FDIC.
- Purchase any loan from the proposed bank at the greater of the cost basis or fair market value, if deemed necessary by the FDIC or the proposed bank.

- Establish and maintain a \$50 million reserve deposit at an unaffiliated, third-party insured depository institution that the proposed bank could draw upon in the event Square fails to provide sufficient funds as required under the provisions of the Agreement.
- Submit an annual business plan to the FDIC for review and approval.

These are extraordinary conditions reflective of the underlying weakness of the application.

The Parent Company Agreement would require that Square:

- Consent to the FDIC's examination of Square and its subsidiaries;
- Provide an annual listing of its subsidiaries and affiliates, as well as other reports the FDIC may request;
- Limit its representation on the proposed bank's board of directors to no more than 25 percent
- Adopt a contingency plan that describes actions Square would take if it were unable to serve as a source of financial strength, and set forth options for the orderly wind down of the proposed bank through liquidation, sale, or merger, without entering receivership.
- Engage a third party to review and provide periodic reports concerning the effectiveness of Square's complaint response system and if any material concerns are identified.

The final condition is also unusual, perhaps reflective of the fact that Square received an "F" rating from the Better Business Bureau.⁹

Conclusion

The deposit insurance application for Square Financial Services to be an industrial bank suffers from fundamental weaknesses that make it unqualified for approval.

The parent company, Square, Inc., has failed to demonstrate profitability over a ten-year life during a largely favorable economic environment. It relies on an originate-to-distribute business model that is highly vulnerable to an economic downturn. The proposed industrial bank would be entirely dependent on the parent.

The parent cannot meet the statutory financial source of strength requirement, nor several of the statutory factors the FDIC must consider in its review of the application. The extraordinary capital and liquidity conditions that would be imposed in order to mitigate the failure to satisfy the statutory factors are insufficient to compensate for an unproven business model that would be highly vulnerable to an economic downturn.

These conditions are the foundation of this Board case. It is important to note, however, the FDIC Board resolution to approve this case would delegate to staff authority to modify or dispose of the conditions without further review or approval by the Board. This is contrary to the resolution adopted by the FDIC Board in 2007, reserving to the Board approval of ILC applications, and is of particular concern in such a problematic case.

For these reasons I will vote against the approval of this deposit insurance application.

¹12 U.S.C. 1841(c)(2)(H).

²12 U.S.C. 1815(a).

³FDIC Board Resolution bearing Seal Number 085095 (Sept. 11, 2007).

⁴*See* Interagency Charter and Federal Deposit Insurance Application, Square Financial Services, Inc.; various public filings, such as 10-Ks, available https://s21.q4cdn.com/114365585/files/doc_financials/2018/Q4/Square-Q4Y18-Form-10K.pdf or at www.sec.gov; and Square Capital: Quick Business Loans for Square Merchants at <https://www.nerdwallet.com/blog/small-business/square-capital/#readmore>.

⁵12 U.S.C. 1831o-1(b).

⁶12 U.S.C. 1831o-1(e).

⁷*See, e.g.,* https://s21.q4cdn.com/114365585/files/doc_financials/2018/Q4/Square-Q4Y18-Form-10K.pdf at 45-49.

⁸12 U.S.C. 1816.

⁹<https://www.bbb.org/us/ca/san-francisco/profile/credit-card-merchant-services/square-inc-1116-370609>