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TESTIMONY

INNOVATION AND COMPETITION IN LENDING IMPROVES ACCESS TO CREDIT

Brian Knight
Director and Senior Research Fellow, Program on Innovation and Governance, Mercatus Center at George Mason University

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Good morning, Chairwoman Waters, Ranking Member McHenry, and members of the committee. Thank you for inviting me to testify.

My name is Brian Knight and I am the director of the Program on Innovation and Governance and a senior research fellow at the Mercatus Center at George Mason University. Much of my research focuses on the role of technological innovation in the provision of financial services. Any opinions I express today are my own and do not necessarily reflect the views of my employer.

First, let me congratulate Chairwoman Waters and Ranking Member McHenry. The topic of innovation in financial services is an important one and I applaud your interest and leadership in it. I also appreciate you soliciting input from a broad array of perspectives and look forward to a collegial and respectful discussion. It is an honor to testify.

The key point I want to leave you with is that innovation and competition in lending, of which the bank-partnership model is a key part, is helping to improve access to credit, especially for borrowers poorly served by the traditional market.

We are witnessing an important evolution in the credit markets, powered by innovative firms partnering with banks, frequently smaller banks. Fintech firms, many of which partnering with banks, now account for 38 percent of unsecured personal loan balances, up from only 5 percent five years ago.[1] There is evidence that these partnerships allow some borrowers to access credit on better terms then they would receive from a traditional lender.[2] There is also evidence that these partnerships allow for

1. TransUnion, "FinTechs Continue to Drive Personal Loan Growth," news release, February 21, 2019, https://newsroom.transunion.com/fintechs-continue-to-drive-personal-loans-to-record-levels/.
2. Julapa Jagtiani and Catharine Lemieux, "Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information" (Working Paper No. 17-17, Federal Reserve Bank of Philadelphia, Philadelphia, PA, July 6, 2017); Julapa Jagtiani and Catharine Lemieux, "The Roles of Alternative Data and Machine Learning in Fintech Lending: Evidence from the LendingClub Consumer Platform" (Working Paper No. 18-15, Federal Reserve Bank of Philadelphia, Philadelphia, PA, January 2019).

greater access to credit for borrowers in parts of the country that are underserved by traditional lenders and that innovative lending can be less racially discriminatory than traditional lending.[3]

These partnerships are mutually beneficial for both the fintech firm and the bank. The bank receives access to technology beyond what it could develop on its own; customers outside of a bank's immediate geographic area help the bank to diversify its business, improve management of its balance sheet, and enhance servicing capacity. Fintech firms receive assistance with regulatory compliance and they become able to do business nationwide under a consistent regulatory regime in conjunction with their bank partner.

It is important to keep in mind that these relationships are highly regulated. Fintech firms that partner with banks are frequently regulated under the Bank Services Company Act and are subject to examination by the bank's federal regulator for the services the fintech firm provides the bank.[4] Additionally, the fintech partner is frequently subject to examination by a state bank regulator if the partner bank is state chartered and is covered by consumer protection laws enforced by the Consumer Financial Protection Bureau and the Federal Trade Commission. Likewise, the bank is accountable for the actions of its fintech partner taken in furtherance of the partnership.[5] Bank regulators have shown themselves to be willing and able to police bank partnerships and hold both banks and their partners accountable for bad acts.[6]

While these partnerships between banks and innovative technology companies have displayed significant promise, they have been threatened by recent litigation that has disrupted long-settled expectations. In the case of *Madden v. Midland Funding, LLC*,[7] the US Court of Appeals for the Second Circuit held that New York law governed a loan that was originally validly issued by a bank under Delaware law and that it was therefore usurious when it was sold to a debt collector after default. In effect, the court held that the legality of a validly made loan could change depending on who held it after it was made, even if the terms of the loan did not change. This holding has been criticized as an incorrect interpretation of the law by the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Obama Administration's solicitor general.[8]

While this case does not directly deal with the type of bank partnership at the heart of innovative lending, it appears to have had a significant and negative impact on credit markets because it calls into question the ability of banks to sell their loans to fintech partners. One study found that, in the wake of

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3. Julapa Jagtiani and Catharine Lemieux, "Do Fintech Lenders Penetrate Areas That Are Underserved by Traditional Banks?" (Working Paper 18-13, Federal Reserve Bank of Philadelphia, Philadelphia, PA, March 2018); Usman Ahmed et al., "Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises," *Innovations* 10, no. 3-4 (2015): 35–48; Bartlett et al., "Consumer-Lending Discrimination in the FinTech Era" (NBER Working Paper No. 25943, National Bureau of Economic Research, Cambridge, MA, June 2019).
4. 12 U.S.C. § 1867(c).
5. Federal Deposit Insurance Corporation, "Guidance for Managing Third-Party Risk" (Financial Institution Letter No. FIL-08-044, Federal Deposit Insurance Corporation, Washington, DC, June 6, 2008). "[T]he FDIC evaluates activities conducted through third-party relationships as though the activities were performed by the institution itself. In that regard, it must be noted that while an institution may properly seek to mitigate the risks of third-party relationships through the use of indemnity agreements with third parties, such agreements do not insulate the institution from its ultimate responsibility to conduct banking and related activities in a safe and sound manner and in compliance with law."
6. Federal Deposit Insurance Corporation, *In the Matter of Bank of Lake Mills Lake Mills, Wisconsin, FDIC Order for Restitution and Order to Pay Civil Money Penalty*, 2017; Federal Deposit Insurance Corporation, *In the Matter of Freedom Stores, Inc., as an Institution-Affiliated Party of Bank of Lake Mills Lake Mills, Wisconsin, Order for Restitution and Order to Pay Civil Money Penalty*, 2017; Office of the Comptroller of the Currency, *In the Matter of Peoples National Bank, Paris, Texas, Consent Order*, 2003; Office of the Comptroller of the Currency, *In the Matter of Advance America, Cash Advance Centers, Inc. Agent and Bank Service Provider for: Peoples National Bank, Paris, Texas*, 2003.
7. 786 F.3d 246 (2015).
8. Brief for the United States as Amicus Curiae Supporting Saliha Madden, Midland Funding, LLC, et al. vs. Saliha Madden (2016) (No. 15-610).

the *Madden* decision, funding for marketplace loans aimed at borrowers with FICO credit scores under 700 decreased significantly in New York and Connecticut compared to outside the Second Circuit because of concerns that any loan made to those borrowers may become invalid if sold to a non-bank marketplace lender.[9] A subsequent study found a reduction in marketplace lending credit availability to New York and Connecticut residents,[10] especially to low-income residents, as well as an increase in personal bankruptcies, a phenomenon the authors link to the inability of low-income borrowers to access credit in order to refinance debt or address exigent circumstances such as medical bills.

These unfortunate results highlight the potential harm of impeding increased innovation and competition in credit markets. Consumer protection is essential, but denying consumers access to credit does not necessarily protect them because it does not remove the underlying issues motivating the need for credit. Rather, allowing more innovation and competition in credit markets, especially for those insufficiently served by traditional products, presents a better path to what everyone wants: a credit market that allows consumers to make informed choices that best serve their needs.

Thank you again for the opportunity to testify. I look forward to your questions.

9. Colleen Honigsberg, Robert J. Jackson Jr., and Richard Squire, "How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment," *Journal of Law and Economics* 60 (2017): 673.
10. Piotr Danisewicz and Ilaf Elard, "The Real Effects of Financial Technology: Marketplace Lending and Personal Bankruptcy" (working paper, 2019).