

FINTECH REGULATION NEEDS TO KEEP PACE WITH ECONOMIC AND TECHNOLOGICAL EVOLUTION

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License to Bank: Examining the Legal Framework Governing Who Can Lend and Process Payments in the Fintech Age

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Good day, Chairman Lynch, Ranking Member Emmer, and members of the Task Force on Financial Technology. Thank you for the opportunity to testify today.

My name is Brian Knight and I am the director of and a senior research fellow for the Program on Innovation and Governance at the Mercatus Center at George Mason University. Much of my research focuses on the interplay between technological innovation and regulation 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 Representatives Lynch, Emmer, and the other members of the task force for their leadership on the topic of fintech regulation. I also applaud your solicitation of the views of a wide range of knowledgeable people. I look forward to a collegial and productive discussion.

The goal of this hearing is to examine the rules governing which firms are allowed to lend and process payments in the age of fintech.¹ This issue that is both timely and relevant. The past few years have seen significant reform and controversy from state and federal regulators on that very topic, including litigation between state bank regulators and the OCC. However, contra *Macbeth*, this sound and fury signifies something very important—namely, that the technological and economic reality of how Americans access financial services has outpaced the law. And while both the states and the OCC deserve credit for recognizing this reality and trying to be responsive, an optimal and stable solution will likely require action by Congress.

I submit, for your consideration, four key points in my testimony:

1. Technological and economic progress has overtaken existing law, leading to an overly burdensome and unfair regulatory environment that impedes innovation and competition, to the detriment of Americans.

1. “Fintech” is a term susceptible to multiple definitions. For the purposes of my testimony I will use it to refer to nonbank lenders and money transmitters who use innovative technology as a significant part of their value proposition.

2. Both the OCC and the states have taken admirable steps to reform financial regulation, but under existing law, even their best efforts are not likely to establish an optimal policy framework.
3. Congress can and should reform the law to allow nondepository lenders and money transmitters, subject to appropriate requirements, to operate on a nationwide scale on the basis of a unified license or charter—and with powers similar to those enjoyed by national banks with regard to governing interest and access to the Federal Reserve payments system.
4. This does not mean that a federal license or charter should be the only option. Rather, the states should be able to serve as competitive laboratories of democracy within a “market-preserving federalism”² framework buttressed by federal law, similar to how state-chartered, FDIC-insured banks were granted parity with national banks when it comes to interest rate exportation.³

THE PROBLEM WITH THE STATUS QUO

Nonbank fintech firms have become a significant source of competition in a financial services market once thought to be resistant, if not immune, to significant disruption. American consumers seem to have embraced this newly emerged form of competition. For example, the share of loans involving nonbank fintech lenders exploded from around 5 percent in 2013 to 38 percent in 2018.⁴ Likewise, fintech payments firm have seen significant increases in usage over the past decade.⁵ For example, PayPal, one of the earliest nonbank fintech firms, has seen its global payment volume grow from approximately \$50 billion in the first quarter of 2014 to almost \$225 billion in the second quarter of 2020.⁶ Consumer adoption has been driven by various factors including cost, convenience, speed, and availability.⁷ There is also evidence that fintech lenders may be somewhat less discriminatory than traditional lenders.⁸

While these fintech firms may take advantage of cutting-edge technology, they are still subject to a regulatory system that did not contemplate the ability of nonbanks to serve customers nationwide instantly. Contrary to some assertions, fintech firms are not “unregulated” or even necessarily less

2. As described by Barry Weingast, “market-preserving federalism” reflects an environment where there is competition between governments (in his construction, subnational governments) to regulate within the context of a common market, such that consumers can choose which rules they wish to utilize. The exportation of laws governing interest for bank is to some degree an example of this in that credit customers can choose credit products crafted under different states’ laws as part of a national common market. Barry R. Weingast, “The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development,” *Journal of Law, Economics & Organization* 11, no. 1 (1995): 1–31. While the national banking system may be seen as a threat to market-preserving federalism, to the extent that state- and nationally chartered banks play by the same rules, this threat is to a degree at least mitigated.

3. 12 U.S.C. § 1831d (2018).

4. TransUnion, “FinTechs Continue to Drive Personal Loan Growth,” press release, February 21, 2019, <https://newsroom.transunion.com/fintechs-continue-to-drive-personal-loans-to-record-levels/>.

5. Caitlin Reilly, “Mobile Payments Up but Pace of Growth Slows,” *Roll Call*, June 18, 2019.

6. J. Clement, “PayPal’s Total Payment Volume from 1st Quarter 2014 to 2nd Quarter 2020” (dataset), Statista, August 13, 2020, <https://www.statista.com/statistics/277841/paypals-total-payment-volume/>.

7. 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. The authors find that PayPal Working Capital loans were disproportionately disbursed to areas with relatively high declines in the number of banks and to traditionally underserved populations. 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); Isil Erel and Jack Liebersohn, “Does FinTech Substitute for Banks? Evidence from the Paycheck Protection Program” (Working Paper No. 2020-16, Charles A. Dice Center for Financial Economics, Columbus, OH, September 16, 2020); Julapa Jagtiani and Catharine Lemieux, “Do Fintech Lenders Penetrate Areas That Are Underserved by Traditional Banks?” (Working Paper No. 18-13, Federal Reserve Bank of Philadelphia, Philadelphia, PA, March 2018).

8. Bartlett et al., “Consumer-Lending Discrimination in the FinTech Era” (NBER Working Paper No. 25943, National Bureau of Economic Research, Cambridge, MA, June 2019).

regulated than traditional banks on a line-of-business basis. Instead, these firms find themselves frequently subject to cumbersome state-by-state regulation that places them at a disadvantage compared to their chartered bank rivals.⁹

For example, while under federal law national and FDIC-insured state-chartered banks may lend nationwide on the basis of their home state's laws defining and governing interest, fintech firms must generally obtain lending licenses from and are subject to the laws of every state in which they offer credit.¹⁰ Likewise, national banks are not required to obtain a state money transmitter license to provide money transmission services.¹¹ State money transmitter law also generally exempts state-chartered banks.¹² Conversely, nonbank fintech money transmitters must obtain licenses in every state in which they offer services. Additionally, while banks can generally access the Federal Reserve's payments system to transmit payments, nonbank fintech firms cannot, unless they are acting as an agent of a bank.¹³

This cumbersome and uneven regulation is unjustified and can result in higher costs, reduced service, competitive inequality, and even political inequality.¹⁴

This unfair discrepancy in regulation frequently forces fintech firms to partner with banks and pay banks for access to government services, such as the payment system that they are excluded from, or play a lesser role in the transaction than they could have but for the regulation.¹⁵ Even this partnership is not fully stable, however, with litigation in some cases undermining the stability of the partnerships and resulting in diminished access to financial services,¹⁶ potentially to the significant detriment of the public.¹⁷

CURRENT REFORM EFFORTS ARE WELL MEANING BUT SUBOPTIMAL

Recognizing the mismatch between the regulatory environment and the economic and technological reality facing fintech firms, both federal and state regulators have shown an admirable willingness to innovate. Beginning in the Obama administration, the OCC announced a plan to offer special-purpose national bank charters to nondepository lenders and money transmitters.¹⁸

9. For a thorough discussion of this dynamic, please see Brian Knight, "Federalism and Federalization on the Fintech Frontier," *Vanderbilt Journal of Entertainment Technology & Law* 20, no. 1 (2017): 129-206.

10. Knight, "Federalism and Federalization," 141, 144-45.

11. 12 U.S.C. § 24 (Seventh) (2008); 12 C.F.R. § 5.20(e) (2017); Kevin V. Tu, "Regulating the New Cashless World," *Alabama Law Review* 65, no. 1 (2013): 1377.

12. Tu, "Regulating the New Cashless World," 89.

13. Brian Knight and Trace Mitchell, "Private Policies and Public Power: When Banks Act as Regulators within a Regime of Privilege," *New York University Journal of Law and Liberty* 13, no. 1 (2019): 93, citing George Selgin, *Re: Potential Federal Reserve Actions to Support Interbank Settlement of Faster Payments: Docket No. OP-1625* (Washington, DC: Cato Institute, December 14, 2018).

14. To the extent that firms are forced to conform the product they offer nationwide to the requirements of the largest states—even though citizens of other states have no representation in those decisions—the citizens of smaller states are in effect being regulated by other states. Knight, "Federalism and Federalization," 191-98.

15. It must be noted, however, that not every fintech-bank partnership is driven by regulation and that in many cases fintech firms and banks partner purely because it is mutually beneficial.

16. 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, no. 4 (2017): 673.

17. Piotr Danisewicz and Ilaf Elard, "The Real Effects of Financial Technology: Marketplace Lending and Personal Bankruptcy" (working paper, 2020); but see Marco Di Maggio and Vincent Yao, "Fintech Borrowers: Lax-Screening or Cream-Skimming?" (working paper, June 2020). The authors find that borrowers from fintech firms are more likely to default than borrowers from banks but also that fintech loans serve as a resource to recently unemployed borrowers.

18. Office of the Comptroller of the Currency, *Exploring Special Purpose National Bank Charters for Fintech Companies*, December 2016.

The response from the states was mixed. On the positive side, state bank regulators have announced a host of regulatory reforms aimed at lowering the burden of state regulation.¹⁹ On the negative side, however, states have sued the OCC, seeking to block the fintech charter, arguing that the OCC has exceeded its authority and, with some narrow exceptions, cannot charter nondepositories as banks. New York's efforts have succeeded at the trial-court level and this decision is currently being appealed by the OCC before the US Court of Appeals for the Second Circuit.

While the question of whether the OCC has exceeded its authority is interesting, with knowledgeable experts disagreeing, it is also arguably beside the point for this body. Congress is in the enviable position of being able to create, amend, or repeal law, subject to Constitutional limitations. This is good, because both the OCC and the states are forced to operate under suboptimal conditions under current law.

While the OCC's plan is by no means perfect, it does arguably represent the best regulatory option currently available. However, it is not at all clear that the burdens that come with being a national bank are needed or appropriate for nondepository entities. Additionally, critics have raised concerns that, under the interlocking body of law that applies to national banks, there may be unintended and potentially undesirable consequences to nondepository firms being able to obtain a bank charter.²⁰

Likewise, while states' resorting to litigation to stop the OCC charter is regrettable, it is also at least somewhat understandable. Under current law a state cannot offer a charter or license comparable to the OCC fintech charter to a nondepository fintech firm, even if it wanted to. For example, to obtain the ability to lend nationwide on the basis of its home state's law governing interest, a state bank is required to be an FDIC-insured depository institution.²¹ It is worth noting here that the ability of FDIC-insured state banks to lend nationwide is a product of Congress recognizing both that it was necessary to restore competitive parity between state-chartered and nationally chartered banks and that there was no justification in allowing one set of competitors to enjoy a regulatory advantage over similarly situated firms.²²

Additionally, while Congress has called for states to harmonize their money transmission laws,²³ and the states have recently made some strides in that direction,²⁴ the fact remains that absent federal enabling law that would prevent states from erecting barriers to out-of-state competition, there is no way to guarantee a state licensed money transmitter a comparable,²⁵ durable ability to operate in a national market without the risk that states will re-erect regulatory barriers.

WHAT CONGRESS SHOULD DO

All of this leaves policymakers in search of a better path forward. To find that better path, Congress should encourage competition and market-preserving federalism by aligning regulation with technological and economic reality. Nondepository institutions that offer credit or money transmission

19. CSBS, "State Regulators Roll Out One Company, One Exam for Nationwide Payments Firms," press release, September 15, 2020, <https://www.csbs.org/regulators-announce-one-company-one-exam-for-payments-companies>; CSBS, "CSBS Announces Vision 2020 for Fintech and Non-Bank Regulation," press release, May 10, 2017, <https://www.csbs.org/newsroom/csbs-announces-vision-2020-fintech-and-non-bank-regulation>.

20. Brief of Thirty-Three Banking Law Scholars as *Amici Curiae* in Support of Appellee, Submitted July 29, 2020, Laceywell v. Office of the Comptroller of the Currency, Joseph M. Otting, United States Court of Appeals for the Second Circuit. The scholars express concerns about, *inter alia*, the issue of the separation of banking and commerce posed by the OCC fintech charter.

21. 12 U.S.C. § 1831d (2018).

22. *Greenwood Tr. Co. v. Massachusetts*, 971 F.2d 818, 826 (1st Cir. 1992). The source quotes a statement by Senator Dale Bumpers.

23. Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, § 407(a)(1), 108 Stat. 2160, 2246-48 (1994) (codified as amended at 31 U.S.C. § 5311 (2012)).

24. CSBS, "State Regulators Roll Out."

25. It should be noted that while state money transmission law generally exempts banks chartered by other states, there is no constitutional requirement that this be done. Therefore, in theory, even state-chartered banks may find themselves requiring money transmission licenses to do business in other states.

services nationwide should be able to do so without being faced with an undue regulatory disadvantage compared to their traditional bank competitors, especially with regard to barriers to entry or operation when engaging in interstate commerce.

To this end, Congress should facilitate a means by which nondepositories that provide credit and payments services in interstate commerce be able to do so under a consistent rule set with minimal barriers to entry. This could take the form of making clear that both states and the federal government can authorize firms, whether through a special-purpose bank charter or a license, to lend or facilitate payments with comparable relevant authority to that currently enjoyed by nationally chartered depository banks. Critically, any requirements or limitations should be properly calibrated to the risks created by the actual products, services, and business models, rather than applied simply because they apply to depository institutions, who by their very nature have a significantly different business model and can pose different risks than nondepositories.

The exact contours of what these rules should look like remain to be determined. For example, should these firms be banks, even if they are special, given the regulatory legacy and regulator discretion that comes with a charter? Would nonbank licenses be more appropriate? And if so, should the federal government introduce a licensing system to go alongside those issued by the states? What risks do nonbank fintech lenders and money transmitters create? Which of those risks are the legitimate province of government regulation? And what should those regulations look like?

These are all important questions that should be answered, but first policymakers and researchers should acknowledge that the current regulatory regime is suboptimal and should be modernized. Both the OCC and the states are trying their best to keep up, but under existing law there are significant impediments. Congress should take advantage of its unique ability to modernize regulation and create an environment conducive to innovation and competition that benefits the American people.

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