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REPLY COMMENT

REGULATING FINTECH: CREATING A REGULATORY REGIME THAT ENABLES INNOVATION WHILE PROVIDING APPROPRIATE CONSUMER PROTECTION

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Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective
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Dear Comptroller Curry:

I appreciate the opportunity to respond to the Office of the Comptroller of the Currency's (OCC) request for feedback on its recent report, Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective.[1] The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and advancing knowledge about the effects of regulation on society. This comment, therefore, does not represent the views of any particular affected party or special interest group but is designed to assist the OCC as it considers how best to address the evolving landscape of technology-enabled financial services.

INTRODUCTION

The recent rise of "FinTech"—the use of technology to provide financial services in innovative ways—has the potential to significantly change how consumers access financial services.

1. Office of Comptroller of the Currency, Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective, March 2016.

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These changes are pressuring existing regulatory structures and norms, and they are creating concern that regulators will hamper needed modernization or fail to prevent a harmful destabilization of the financial system. I commend the OCC for acknowledging that its existing model for regulation could be improved to better match the needs of the current market and for providing an initial framework for how it plans to address innovation within its jurisdiction. I further applaud the OCC for inviting comment on its proposals. I respond to this invitation with a desire to see a regulatory environment that allows innovation to occur with minimal impediments and provides sufficient consumer protection. To that end, I suggest that the OCC should avoid undue regulations motivated by fear so as to avoid hampering innovation, and any regulations that are promulgated should be driven by the risk created, not the service provided. A centralized office representing the concerns of both consumers and innovators would be beneficial, as would increased coordination among regulators. Additionally, the OCC should consider whether the current regulatory structure for certain market actors who are currently primarily regulated at the state level has become obsolete.

GENERAL PRINCIPLES TO CONSIDER WHEN DEVELOPING THE OCC'S FRAMEWORK FOR INNOVATION

What follows are some general principles that the OCC should consider in developing its framework for innovation.

1. Curtailing innovation via undue regulation motivated by fear is unwarranted.

The OCC has stated that it aims to support "responsible innovation," which seeks to "balance" innovation with "effective risk management and corporate governance."[2] While it is important to be mindful of potential risks posed by innovations, it is also important to consider the risks posed by impeding innovations that are driven by market demand, especially at those innovations' early stages. As my colleague Adam Thierer points out, basing policy on the fear of hypothetical worst-case scenarios can impede innovation and prevent the full benefits of innovation from being achieved.[3] The OCC has acknowledged this risk in its report's discussion of steps the OCC can take to "support responsible innovation" and make the OCC's culture more welcoming to innovation.[4]

The current period of innovation, driven by the application of technology to financial services in new ways, has the potential to significantly improve financial access, inclusion, and quality for consumers. Undue regulatory burdens will discourage entrepreneurs and firms from devoting resources to providing new services and products or utilizing technology to try to expand services to underserved markets. While the OCC should monitor developments closely, it also should avoid impairing innovation. Any foregone beneficial innovation

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2. "Supporting Responsible Innovation," 5.
3. Adam Thierer, *Permissionless Innovation: The Continuing Case for Comprehensive Technological Freedom* (Arlington, VA: Mercatus Center at George Mason University, 2016), 2.
4. "Supporting Responsible Innovation," 5.

will extract a cost on consumers, especially those who are most poorly served by the current system. At the forefront of the OCC's considerations should be concern over the risk that consumers could be denied better, cheaper, more effective services than are currently available, simply because of unnecessary impediments to innovation.

Likewise, while the OCC should be vigilant, it should also remember that innovation alone is generally not sufficient to create widespread harm. In discussing the need for "responsible innovation," the OCC references the financial innovation linked to the financial crisis.[5] While it is true that financial innovation played a role in creating the conditions for the crisis, the crisis was more fundamentally attributable to failures of both public and private sector actors to appreciate the change in market conditions and incentives created by regulatory policies and to respond to resulting risks.[6] For example, the size of the US mortgage market at the end of 2007 was approximately $10 trillion,[7] with subprime mortgages accounting for approximately $1.2 trillion.[8] From 1998 to 2007, approximately $3.15 trillion worth of residential mortgage-backed securities (RMBS) were generated from prime and Alt-A mortgages, and approximately $2.44 trillion in RMBS were backed by subprime and junior lien mortgages,[9] along with approximately $640 billion in mortgage-backed collateralized debt obligations.[10] It is unlikely that the markets most impacted by financial innovation will pose a similar risk anytime soon.[11] In fact, the recent market pullback from purchasing loans originated by alternative lenders[12] may indicate that the market is attuned to risk and is operating in a disciplined manner, unlike the reckless activity leading up to the crisis. This is not to say that the OCC should not monitor market developments, or that no regulation is needed, but the risks presented by the current FinTech environment are not yet, and may never become, similar to those that caused the crisis.

Additionally, while technological innovation could contribute to increased risks, it might also help mitigate risk for consumers. To the extent that innovation increases competition and encourages entry into the market, it can result in consumers enjoying more choice and being more resilient against economic shocks. For example, the fixed costs faced by a lender have a significant impact on the rates they can charge borrowers.[13] Technology may permit lower

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5. Ibid.
6. For example, see Stephen Matteo Miller, "Long Live Risky Finance?," *US News & World Report*, June 23, 2014.
7. Scott Frame, Andreas Lehnert, and Ned Prescott, "A Snapshot of Mortgage Conditions with an Emphasis on Subprime Mortgage Performance" (Federal Reserve, Washington, DC, August 27, 2008), 4.
8. Ibid.
9. Larry Cordell, Yilin Huang, and Meredith Williams, "Collateral Damage: Sizing and Assessing the Subprime CDO Crisis (Working Paper No. 11-30/R, Federal Reserve Bank of Philadelphia, May 2012), 38.
10. Ibid. Figure includes CDO^2s.
11. For example, the entire US "online alternative finance market" is estimated to have generated about $36 billion in 2015. Robert Wardrop et al., "Breaking New Ground: The Americas Alternative Finance Benchmarking Report" (Cambridge Centre for Alternative Finance, University of Cambridge and Polsky Center for Entrepreneurship and Innovation, University of Chicago, April 2016), 25.
12. For example, see Peter Rudegeair, "OnDeck Losses Grow as Lender Sells Fewer Loans," *Wall Street Journal*, May 2, 2016; Peter Rudegeair, "Square Faces Questions on Lending Strategy as Shares Drop Nearly 20%," *Wall Street Journal*, May 6, 2016.
13. Thomas A. Durkin, Gregory Elliehausen, and Min Hwang, "Rate Ceilings and the Distribution of Small Dollar Loans from Consumer Finance Companies: Results of a New Survey of Small Dollar Cash Lenders" (working paper, December 2, 2014), 3–6, available through SSRN at http://ssrn.com/abstract=2533143.

overhead costs[14] that could allow for lower prices and better terms to customers.[15] Likewise, there is evidence that technology-enabled alternative lenders have helped fill the gap for small business credit in areas that have seen a comparatively high reduction in the number of banks.[16]

Innovation may also lower systemic risk by lowering market concentration, encouraging diversification, and improving transparency. As US Commodity Futures Trading Commission Commissioner J. Christopher Giancarlo recently said with regard to the potential benefits of distributed ledger technology (DLT) for regulators:

> If an accurate DLT record of all of Lehman's transactions had been available in 2008, then Lehman's prudential regulators could have used data mining tools, smart contracts and other analytical applications to recognize anomalies in trade activity, divergence in counterparty exposure (specifically those willing to trade with Lehman), widening credit spreads and disruptions in short term funding activity. Regulators could have reacted sooner to Lehman's deteriorating creditworthiness.[17]

Commissioner's Giancarlo's comments highlight that innovations may be able to mitigate existing risks, making markets safer. However, this will only happen if entrepreneurs are not discouraged from spending the resources necessary to pursue new ideas. Unduly onerous regulation, or a regulatory environment that is needlessly paranoid about new ideas, can serve as a major deterrent, depriving consumers, and the market, of the benefits of innovation.

Lastly, the OCC should consider the advantage that comes with waiting to regulate new technologies. If it exercises restraint to let new technologies develop it can always intervene later with appropriate regulation should risks emerge, but if it regulates excessively or prematurely it may hamper the development of beneficial innovation. Overregulation may raise the costs of entry into a market so high that new competitors cannot enter to compete with incumbents, or it may cause companies to distort otherwise effective business models to obtain technical compliance[18]—at the cost of decreased efficiency and increased complexity. As such, the OCC should exercise caution and forbearance when deciding whether and how to regulate new technological innovations to allow the market to develop, and intervene aggressively if, and only if, it is absolutely necessary.

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14. For example, there is some evidence that marketplace lenders can provide loans at lower rates to some borrowers, with similar loan performance. Miklos Dietz et al., "Cutting through the Noise around Financial Technology" (McKinsey & Company, February 2016).
15. Yuliya Demyanyk and Daniel Kolliner, "Peer-to-Peer Lending Is Poised to Grow" (Federal Reserve Bank of Cleveland, August 14, 2014).
16. Usman Ahmed et al., "Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises," *Innovations: Technology, Governance, Globalization* 10, no. 3-4 (2015), 35–48.
17. Commodity Futures Trading Commission, "Special Address of CFTC Commissioner J. Christopher Giancarlo before the Depository Trust & Clearing Corporation 2016 Blockchain Symposium," March 29, 2016.
18. Kevin Wack, "Lending Club Tweaks Business Model in Effort to Thwart Legal Challenges," *American Banker*, February 26, 2016.

2. Regulations should be driven by the risk created, not the service provided.

One of the most important effects of technological innovation is its ability to meet old needs in new ways. Generally speaking, financial service providers—both incumbents and insurgents—do not create completely new products. Instead, they use technology to meet the existing needs of clients more efficiently. As such, new methods compete with old, which inevitably prompts concerns about regulatory arbitrage. While these concerns deserve attention to the extent that bona fide risks that merit a regulatory response "fall through the cracks," when existing firms express these concerns, they may also be masking an effort to obtain a competitive advantage—or mitigate a competitive disadvantage—via regulation.[19]

Some have advocated imposing bank regulation on new innovators as a matter of both prudence and fairness.[20] There may be cases where, because traditional banks and innovative providers present risks that are sufficiently similar, applying the same rules make sense. However, there is also a risk that identical regulation will be unnecessarily burdensome or will fail to address unique issues posed by the different methods and models. Adopting existing regulations where doing so is not justified could result not only result in unnecessary burden but also in suboptimal consumer protection.

To avoid these mistakes when designing new regulations, the OCC should always consider the specific nature of the entity, market, and business model in question, rather than simply transposing existing regulations to new circumstances for which they may not be appropriate. For example, institutions that fund loans with federally insured deposits may present different risks than loans funded by invested risk capital, and regulation should reflect that difference. Likewise, financial institutions that provide a range of services may merit different regulation than institutions that offer more limited options because of their increased complexity, diversification, or structural significance.

While regulations should be fair, fairness does not necessarily mean that competitors should be treated the same. Different models and methods may create different risks and should be fairly regulated based on those risks. While regulation should not unduly advantage or disadvantage any market participants, to the extent that a method, model, or innovation lowers risk, there should be a concomitant reduction in regulatory burden. This difference in regulatory burden may result in some firms or methods having an advantage because their way of doing business necessitates a lower compliance burden, but so long as this is a result of fair and properly scaled regulation, the ultimate benefit will accrue to the consumer.

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19. For example, see Bruce Yandel, "Bootleggers and Baptists—The Education of a Regulatory Economist," *AEI Journal on Government and Society*, 1983, 13–14.
20. For example, see The Clearing House's white paper advocating for alternative payment providers to be regulated to the same standard as banks. "Ensuring Consistent Consumer Protection for Data Security: Major Banks vs. Alternative Payment Providers," (The Clearing House, New York, NY, August 18, 2015). See also Rob Nichols, "Bank or No Bank, Fintech Must Be Regulated" *American Banker*, February 18, 2016.

WHAT CAN THE OCC DO TO FOSTER POSITIVE INNOVATION?

Consistent with the general principles above, the OCC can take several steps—either by itself or in conjunction with market participants, other regulators, and Congress—to create an environment where innovation can thrive. While there is likely no "magic bullet," regulatory clarity, consistency, transparency, and predictability will help market participants best serve the needs of consumers. To this end, the OCC should consider the following.

1. The OCC should create a centralized office of innovation charged with internally representing the interests of innovators and consumers who benefit from innovation.

As part of its framework, the OCC proposed the creation of a centralized office of innovation to help meet the needs of regulated entities seeking to innovate.[21] Done properly, this would be a significant step in the right direction. Such an office could serve as an independent voice for innovators and the consumers who benefit from new products and services, and it could provide needed balance within the OCC. The OCC is charged with helping to protect the safety and soundness of the banking system. As such, it is expected that its culture, mindset, and assumptions would be risk-averse and conservative. An office of innovation would serve as an internal counterweight that could argue for the opportunities afforded by new technologies, methods, and competitors. Providing examiners with clear guidance would be a significant benefit to consumers, market participants, and the OCC.

While an office of innovation could be beneficial, it is important that, if established, it does not become a gatekeeper that innovative companies must receive approval from to participate in the market. Such a development would not only frustrate the OCC's salutary efforts to help encourage innovation and the increased quality and access to financial services that follow, but it could also make the environment for innovation worse than the status quo. Entry into the market should be as free and open as possible, and while an office that provides the OCC with internal expertise and advocacy for innovation would be an improvement, an office that stymies innovators with unnecessary bureaucracy would be a great loss to not only the OCC but also to the consumers it ultimately serves.

2. The OCC should lead efforts to bring more effective coordination among regulators.

The OCC lists as one of its guiding principles for innovation "collaborate with other regulators."[22] This is to be applauded—but to be effective there must be tangible changes to how regulators work with each other. As a recent Government Accountability Office report makes clear, the US financial regulatory landscape is highly fractured, with many agencies responsible for overlapping jurisdictions.[23] Given its openness to innovation and willingness to lead, the OCC can play a central role in creating structural changes to improve regulatory coordination and provide innovators with a more transparent and seamless regulatory environment.

21. "Supporting Responsible Innovation," 6.
22. Ibid., 5.
23. See Government Accountability Office, "Financial Regulation: Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness," February 2016.

One option the OCC should consider is spearheading a multiagency web-based tool that would help inform innovators about what laws and regulatory agencies their products implicate. The Federal Trade Commission, in conjunction with the Office of the National Coordinator for Health Information Technology and the Department of Health and Human Services Office for Civil Rights, has launched a similar tool for health care apps.[24] Innovators using the tool anonymously describe their application via a questionnaire and receive a list of laws that are likely applicable. The OCC, in conjunction with other financial regulators, could provide a similar tool that could at least provide entrepreneurs with a general idea of the legal issues they potentially face and the regulators that govern a particular product. While this will not replace competent legal counsel, it could help provide some clarity and transparency to innovators without significant cost, allowing them to better adapt their business models and expectations to reality.

Another admittedly more difficult possibility is to establish a uniform and consolidated process for companies seeking no-action relief from financial regulators. Numerous regulators offer companies the opportunity to request insight on a proposed course of action via some form of no-action letter or comparable process. While no-action programs can provide welcome transparency for regulators and certainty to market participants—including firms who are informed by relief granted to other firms—these programs are limited to the jurisdiction of the single regulator. For transactions that cut across jurisdictions, innovators still must deal with uncertainty about how all of the relevant regulators will react. The federal government could provide a common point of entry program, where companies submit requests that are reviewed by all of the federal regulators, with the relevant ones engaging and either granting or denying no-action relief. This program could dramatically simplify and clarify the process and allow companies to adapt their plans to better conform to the law.

3. The OCC should consider whether new charters for innovative companies that only offer a portion of traditional bank services are appropriate.

Technology is enabling specialized insurgent competitors to compete with full service banks on a nationwide basis. These new firms may compete with banks in one product line (e.g., payments or lending) without adopting the full suite of services or taking federally insured deposits. While these companies may provide a better fit for some consumers, they often operate under a different and more diffuse regulatory regime. For example, even though marketplace lenders offer loans to customers nationwide, they are regulated and licensed on a state-by-state basis or partner with banks to take advantage of banks' preemptive abilities.[25]

This two-tier system, where banks and nonbanks provide similar services but are regulated differently, has led to concerns of regulatory arbitrage from both sides. While the OCC expressed concern about the possibility of providing a federal license to firms that do not have "any of

24. Federal Trade Commission, "Mobile Health Apps Interactive Tool," April 2016.
25. It should be noted that marketplace lenders are generally subject to the same laws as banks with regard to fair lending, truth in lending, and unfair and deceptive trade practices.

the safeguards or responsibilities that apply to banks and thrifts,"[26] the appropriate question should not be "are the regulations the same as existing banks or thrifts?" but "are the regulations appropriate for the risks reasonably generated by this business model?"

Current and future innovations will allow new competitors and incumbent banks to satisfy consumer needs in ways that may create less systemic and consumer risk. The regulatory environment should reflect that, but it currently does not. As a result, companies that could provide improved services have to deal with complex, fractured, and inconsistent rules that discourage these companies' contributions. For example, Oportun,[27] a nonbank lender that specializes in small-dollar loans to the Hispanic community, commented to the Department of the Treasury:

> The lack of consistency [among state laws] creates a significant challenge to any online marketplace lender's ability to successfully scale its products and offer them to the full scope of traditionally underserved consumers that would benefit from having less expensive choices.[28]

A modernized and properly scaled regulatory regime that reflects the evolution of these specialized providers and gives them a fair and consistent set of rules will help them better serve the needs of their customers. Such a regime should not necessarily be mandatory since existing state rules may be appropriate for some providers who operate primarily within a small number of states. But an "opt-in" regime can provide a way for companies that operate or seek to operate on a national scale to have regulations that match the needs and risks of the market.

The OCC should consider whether the special purpose bank charter is the appropriate vehicle to enable innovative companies to conduct business in a manner that best benefits the public.[29] If so, the OCC should permit companies to obtain such charters, and it should structure regulations so they adequately protect the public without unnecessary hindrance to innovation or competition. To the extent the OCC believes that the special purpose banking charter is not an appropriate vehicle, it should identify and explain the reasons why so that the public and policymakers can understand the deficiencies and adopt an adequate solution.

CONCLUSION

The OCC should be commended for taking the lead on addressing the role of innovation in the provision of financial services. However, this leadership also entails a significant responsibility to set the appropriate tone, and adopt appropriate policies to avoid needlessly frustrating beneficial innovation. The truth is that at, ex ante, it will be difficult if not impossible to identify

26. Office of the Comptroller of the Currency, "Remarks by Thomas J. Curry Comptroller of the Currency Before the Harvard Kennedy School's New Directions in Regulation Seminar," March 31, 2016.
27. Oportun home page, accessed April 26, 2016, http://www.oportun.com/
28. "Comment from Mitria Wilson," Department of the Treasury Notice: Public Input on Expanding Access to Credit through Online Marketplace Lending, October 1, 2015, 12.
29. It has been reported that the OCC is considering this very option—this is encouraging and the OCC should be commended. Lalita Clozel, "OCC Weighs New Charter for Fintech Firms," *American Banker*, May 9, 2016.

any particular product or service as “good” or “bad.” As such, while the OCC should remain vigilant, it should focus on establishing internal and external facing policies and structures that encourage innovation, provide regulatory transparency and certainty, and allow for regulation that addresses risks created and allows for a fair playing field.

I thank you again for the opportunity to comment. If I can be of any further assistance as you consider these important issues, please do not hesitate to ask.

Respectfully,

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