CURRENT TECHNOLOGY ALLOWS NONBANK financial service providers to compete on a national scale with banks more effectively in areas including lending and money transmission. While these firms may be able to offer services at lower cost and lower risk while improving access to underserved customers, they also face challenges from the existing regulatory structure. If these challenges are not successfully addressed, they risk denying consumers the benefits of innovation and competition that financial technology (fintech) can provide.

The inadequacy of the existing regulatory structure is particularly evident in the allocation of regulatory responsibility between the states and the federal government. Banks frequently are subject, via federal law and state comity, to relatively uniform legal rules in important areas like licensing and the laws governing interest on a loan. Conversely, nonbank fintech firms providing lending or money transmission services are generally subject to inconsistent state-by-state regulation. Nonbank fintech providers thus operate at a disadvantage compared with banks, and the unequal treatment of banks and nonbank firms causes both inefficiency and inequity in the financial marketplace. Table 1 illustrates the differences in regulatory treatment for certain issues between national banks, state banks, and nonbank financial institutions.

PROBLEMS POSED BY INCONSISTENT STATE-BY-STATE REGULATION

The choice between federalization and state regulation is a continuum, not a binary decision, Banks, despite the uniformity owing to federal preemption that they enjoy in many areas, are still subject to significant state regulation in certain cases. The current regime of burdensome state regulation for nonbank
fintech firms creates three separate but interrelated problems: (1) it harms consumers by forcing fintech firms into an inefficient regulatory environment; (2) it damages competitive equity by differently regulating firms that offer similar services; and (3) it risks violating political equity among citizens of different states because some states de facto regulate the national market. Fortunately, there are ways to address these problems, which will be discussed below.

Inefficiency

Being forced to obtain licenses from each state in which a nonbank firm wishes to do business can be costly and time consuming. In addition to the cost and delay of obtaining licenses, different states impose different substantive requirements regarding licensing and what products or services licensed firms can provide. This inconsistency can also impose significant ongoing “search costs” on firms as they need to constantly monitor each state for changes in the law. This inefficiency can make it hard for firms to offer products, which has led many firms, especially in the lending space, to partner with banks to take advantage of the banks’ federally granted preemption. The bank-partnership model addresses the inefficiencies of state-by-state regulation, but it does so at a cost. The direct costs include the banks’ compensation for their participation and the added complexity required to structure the transaction. But there are also indirect costs, including uncertainty about enforceability, which has been exacerbated by recent litigation and state regulatory action.

These actions include the recent Madden v. Midland Funding, LLC decision, in which the United States Court of Appeals for the Second Circuit held that a loan originally valid when made by a bank could subsequently become usurious and invalid once sold to a nonbank. While this decision does not directly involve innovative nonbank lenders, it does strike at

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“Regulatory Institutions Deregulation Act of 1980 (12 U.S.C. § 1831d(a) (2015)) (granting the same power to state-chartered, federally insured banks); FDIC, General Counsel’s Opinion No. 10; Interest Charges under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 74 (1998) citing 12 C.F.R. § 7.4001(a) (1997) and 12 C.F.R. § 560.110(a)(1997) (allowing banks to use their home state’s definition of what constitutes interest nationwide); Greenwood Trust Co. v. Massachusetts, 971 F.2d 818, 827 (1st Cir. 1992) (“The historical record clearly requires a court to read the parallel provisions of DIDA and the Bank Act in pari materia. It is, after all, a general rule that when Congress borrows language from one statute and incorporates it into a second statute, the language of the two acts should be interpreted the same way.”).”


“US Department of the Treasury, Opportunities and Challenges in Online Marketplace Lending, May 10, 2016, 6; Douglas, “New Wine into Old Bottles,” 34.”

“Department of the Treasury, Opportunities and Challenges, 6; Douglas, “New Wine into Old Bottles,” 34.”


“Tu, “Regulating the New Cashless World,” 89; Bryan Cave LLP, “The Latest in Money Transmitter Licensing.”

“Tu, “Regulating the New Cashless World,” 86–89.”
While the problems posed by inapt state regulation of nonbank fintech firms are real, there are solutions. Federal regulators, the states themselves, and Congress all have options that can help.

the heart of the bank-partnership model, which relies on banks selling loans to nonbanks for servicing.

The *Madden* court’s reasoning has affected the nonbank lending market. Loan volume for borrowers with relatively low credit scores seeking to use innovative lenders has declined significantly in 2016 relative to 2015 in the areas covered by the Second Circuit, while it has increased outside the Second Circuit. Additionally, other parties have adopted the reasoning of *Madden* to directly attack the bank-partnership model, arguing that even if a loan is valid when made by a bank, it can become invalid when sold to a nonbank firm. For example, Colorado’s Uniform Consumer Credit Code administrator has sued two marketplace lenders alleging that the loans made by their bank partners were invalid, in part based on the claim that once the loans were sold to the nonbank lender, the loans lost the benefit of exporting the bank’s home state law.

In addition to the issue of loans that were valid when made, the issue of who is the true lender in a bank partnership—and whether it should matter—also calls the validity of the bank-partnership model into question. Some courts have held that the contractual relationship between the borrower and the bank controls because looking beyond the contract would intrude on the powers provided to banks by federal law. Other courts have held that the party with the “predominant economic interest” in the loan (i.e., the most to gain or lose based on the loan’s performance) is the true lender and that the laws that apply to that entity govern the loan. Concerns about true lender issues have caused firms and their bank partners to distort their contractual relationships in ways that seek to avoid invalidation of the loan but do not provide greater efficiency or benefit to customers.

**Competitive Equity**

Nonbank fintech firms turn to banks to avoid the inefficiencies of state-by-state regulation, indicating that banks enjoy a competitive advantage, despite the similarity of the products and services being offered. For example, the loans that Colorado is attacking would be unquestionably legal if made by a bank. The disparate treatment makes even less sense when one considers that nonbank lenders are governed by the same federal consumer protection laws as banks. Likewise, nonbank money transmitters are subject to federal consumer protection and anti-money-laundering law similarly to banks.

This disparate treatment of similar products runs contrary to “the principle that institutions offering similar products should be subject to similar rules.” Senator Dale Bumpers made this statement in the context of the debate about whether competitive fairness demanded that interest rate exportation be provided to state banks on the same terms as it was provided to federal banks. A similar dynamic exists today between banks and nonbank fintech firms, where the differences in regulation are not driven by differences in risks generated by the firms’ activity but by the charter or license status of the firms.

**Political Equity**

Competitive equity isn’t the only type of fairness imperiled by state-by-state regulation of fintech firms. There is also the risk that a state, especially a state that represents a large share of the market, will end up de facto regulating the national market. The New York Department of Financial Services (NYDFS) acknowledged as much in its complaint
against the Office of the Comptroller of the Currency (OCC) when NYDFS sought to stop the OCC’s fintech bank charter (discussed below). NYDFS’s statement that “New York is a global financial center and, as a result, [NY]DFS is effectively a global financial regulator” is not inaccurate, but it highlights the problem. While NYDFS may have global reach, it does not have global political accountability. The citizens of other states have no means of democratic redress against the NYDFS (or the regulators of other large and systemically important states).

This dynamic presents a problem for fintech firms because they will face significant economic and regulatory pressure to limit their national product offering to conform to state specific rules. For example, New York’s licensing regime for virtual currencies—the “BitLicense”—claims a sweeping jurisdiction, including any virtual currency transaction (as defined by the rule) that involves New York or a New York resident. Given New York’s importance to the financial system, it is questionable whether a firm seeking to establish a viable business could elect to avoid New York. Given the breadth of New York’s rules, firms would rightly be concerned that even if they intended to avoid New York, the NYDFS would consider them covered by New York law. Even if a firm were to successfully defend an enforcement action on the grounds that the NYDFS lacked jurisdiction, the diversion of resources away from competition to litigation could fatally cripple a company.

If firms must change their national products to comply with a specific state’s rules, then the residents of other states must also bear with their choices being limited by rules they have no control over. State regulators and legislators have an incentive to act in the best interests of their state (or the most powerful political factions therein), even if this means imposing costs on other states. Conversely, federal law and regulation is driven ultimately by the laws Congress passes, and Congress is accountable to the country as a whole.

WAYS TO ADDRESS THE PROBLEMS POSED BY INCONSISTENT STATE-BY-STATE REGULATION

While the problems posed by inapt state regulation of nonbank fintech firms are real, there are solutions. Federal regulators, the states themselves, and Congress all have options that can help modernize and streamline fintech regulation and make it more efficient and equitable.

Federal Regulators

Federal regulators—in particular the OCC, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve (Fed)—can address at least some of the problems facing fintech lenders and money transmitters.

- Address “valid when made” and “true lender” issues via regulation. The United States solicitor general and the OCC have correctly taken the position that the Second Circuit’s Madden decision is incorrect as a matter of existing law and that a national bank’s power to lend includes the power to sell the loan and have it remain valid. The Federal Deposit Insurance Act should be interpreted in parallel to convey the same power to state banks. Therefore, regulators could clarify via rulemaking that a bank may sell a loan without undermining the loan’s power to sell the loan and have it remain valid. The Federal Deposit Insurance Act should be interpreted in parallel to convey the same power to state banks. Therefore, regulators could clarify via rulemaking that a bank may sell a loan without undermining the loan’s validity. Additionally, bank regulators should clarify that the power of a bank to make a loan it plans to sell does not hinge on which party maintains the “predominant economic interest” in the loan.

- Provide a viable bank charter option for non-depository firms. The OCC has announced its intention to offer a special-purpose national bank charter for nondepository fintech firms. The OCC should continue to move this project forward and should structure the charter so that it is a viable option for smaller entities, omitting needlessly onerous
or restrictive requirements. The OCC should also vigorously defend its effort against the lawsuits brought by the NYDFS and the Conference of State Bank Supervisors. The Fed should support the inclusion of special-purpose national banks into the Federal Reserve system as needed.

Additionally, the FDIC should clarify that the definition of “deposit” for the purpose of federal law does not include money provided to fintech banks for the purposes of money transmission. The FDIC and the Fed should also support efforts by state banking regulators to pursue innovative charter structures comparable to the OCC’s effort, including supporting any necessary changes to federal law.

The States

The States could still play a major and productive role in improving fintech regulation. While they are making some efforts already, those efforts revolve around making it easier for firms to apply for multiple licenses and deal with multistate supervision. They do not address the core problems posed by the requirement for multiple licenses and the inconsistency of state law. Truly effective reform likely will require collaboration with the federal government.

- **Harmonization and reciprocity.** The states do not need the federal government’s help to make their laws more uniform and grant reciprocity for licensed entities. However, the history of state regulation in this space is not heartening. For example, Congress called on the states to harmonize their money transmission laws in 1994, but to date only seven states have adopted the Uniform Money Services Act established by the Uniform Law Commission for that purpose. The states could work with Congress to pass legislation that would allow for reciprocity for state-regulated nonbank financial services companies or for the exporting of certain legal provisions (for example, provisions governing interest), akin to the powers granted to state-chartered banks. States would remain the primary regulator, but it would be easier for state-licensed entities to compete on a national scale.

- **Innovative chartering and licensure.** Rather than opposing the OCC’s efforts at innovation, the states should emulate (and possibly surpass) those efforts by creating new chartering options for nondepository institutions. To the extent such efforts are inhibited by existing federal law, the states should work with Congress to remove those impediments to facilitate salutary competition between national banks and state-chartered or state-licensed financial institutions.

Congress

Given the interstate nature of the commerce in question, Congress has the broadest authority to address the issues posed by inapt state regulation of fintech. As discussed above, there are several areas where Congress may be needed to help state-licensed entities compete at the national level. Additionally, there are other areas of federal law that can be clarified or improved to help rationalize the regulation of fintech firms.

- **Codify “valid when made” and clarify “true lender.”** Congress could provide regulatory certainty by explicitly codifying the long-standing common-law rule of “valid when made” and making clear that a firm does not need to maintain a “predominant economic interest” in a loan to be considered the true lender. This clarification would assist in protecting existing powers held by national and state banks.

- **Change the law to help state-based innovation.** Congress could change federal law to allow state-licensed or -chartered entities to export key provisions of their home state’s law (for example, provisions governing interest) and
mandate reciprocity for certain licensed activities (for example, money transmission licensing). Congress also could amend the Federal Deposit Insurance Act and other laws to allow state-chartered nondepository banks to enjoy the relevant powers of a bank granted to insured depositories.

- **Modernize tools to resolve uninsured nondepository banks.** As Acting Comptroller Keith Noreika recently testified, the power of the OCC to place a noninsured bank in receivership relies on law going back to the passage of the National Bank Act and needs to be modernized. 42

Additionally, Congress could amend the bankruptcy code to expand its application beyond noninsured state banks that are members of the Federal Reserve system to include, at a minimum, nondepository national banks. 43 In cases where receivership is unlikely to be necessary to protect customers, failing firms should go through bankruptcy.

**CONCLUSION**

There are many virtues to the United States’ federal system, but as the Founders understood when they granted Congress the power to regulate interstate commerce, 44 there are times when the patchwork of inconsistent state regulations is counterproductive or even pernicious. The regulation of nonbank fintech lenders and money transmitters presents one such case, with inconsistent state regulation harming efficiency, competitive equity, and political equity. Both the federal government and the states themselves have options available to help address these problems and their underlying causes. They should consider exercising those options.

**NOTES**

3. “Ripple eliminates the risk that payments will not reach the targeted payee once the payer initiates the transaction... Either the entire transaction happens or none of the steps happen at all.” Marcel T. Rosner and Andrew Kang, “Understanding and Regulating Twenty-First Century Payment Systems: The Ripple Case Study,” *Michigan Law Review* 114 (2016): 661.
8. Obtaining licenses and maintaining compliance can cost over $1 million and take more than two years. Douglas, “New Wine into Old Bottles,” 46.
11. Tu, “Regulating the New Cashless World,” 112.
12. For example, Lending Club, Prosper, and PayPal all originate loans through WebBank, a state-chartered Utah industrial bank. Square partners with Celtic Bank, also a state-chartered Utah industrial bank,
and Intuit partners with Cross River Bank, a state-chartered New Jersey bank.

13. Madden v. Midland Funding, LLC, 786 F.3d 246 (2d Cir. 2015).
17. See, for example, Hudson at *16 (“[the plaintiff] invites the courts to draw boundaries between federal and state bank regulation depending on the subjective purpose of those engaged in the transaction and/or the precise extent of financial risk accepted by the national bank. The court sees no basis for drawing jurisdictional boundaries in such an uncertain and unpredictable way.”).
25. Ibid., ¶10.
30. “The historical record clearly requires a court to read the parallel provisions of DIDA and the Bank Act in pari materia. It is, after all, a general rule that when Congress borrows language from one statute and incorporates it into a second statute, the language of the two acts should be interpreted the same way.” Greenwood Trust Co. v. Massachusetts, 971 F.2d 818, 827 (1st Cir. 1992). See also FDIC, General Counsel’s Opinion No. 10; Interest Charges under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 74 (1998).
34. Lawrence D. Kaplan et al., “The OCC’s Proposed Fintech Charter: If It Walks Like a Bank and Quacks Like a Bank, It’s a Bank,” Paul Hastings LLP, December 13, 2016 (acknowledging that funds provided to a bank for money transmission purposes may potentially constitute deposits under the Federal Deposit Insurance Act (12 U.S.C. § 1813(i)).
36. Ibid.
42. Testimony of Keith A. Noreika, Acting Comptroller of the Currency, before the US Senate Committee on Banking, Housing, and Urban Affairs, June 22, 2017, 35–36.
44. 44 U.S. Const. art. I, § 8, cl. 3.
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