



FEDERALISM AND FEDERALIZATION ON THE FINTECH FRONTIER

Financial technology, or “fintech,” is the application of technology to the provision of financial services. Fintech allows new firms to compete with established entities like banks, something that was difficult to do profitably in the past. Industries that were relatively stable are now facing an influx of new competitors leveraging technology to provide more access, more efficiency, and better value than the status quo. However, unlike the established entities who enjoy more consistent rules through federal preemption, many of these new firms are regulated on a state-by-state basis, even though their transactions are interstate. This dynamic can harm efficiency, competitive equity, and political equity.

In “[Federalism and Federalization on the Fintech Frontier](#),” Mercatus Senior Research Fellow [Brian R. Knight](#) proposes criteria to be used by policymakers in deciding how to regulate fintech firms. Financial technology is changing how people access financial services and who provides them, and these new methods and market participants often do not easily fit in the existing regulatory boxes. These changes are straining existing regulatory assumptions, including the question of whether and how the states or the federal government should regulate. In cases where the reality of transactions has become more national in nature, policymakers should consider federalizing fintech regulation and displacing state-by-state rules to an appropriate degree. However, in cases where transactions are truly intrastate, the federal government should defer to the states.

CHARACTERISTICS OF FINTECH THAT MATTER FOR FEDERALISM

- *Borderless platforms.* Because the internet does not observe geographic boundaries or borders, previous assumptions by regulators about the geographic and political limits of a company’s market may no longer hold. The cross-border capability can make financial services more efficient by leveraging the economies of scale provided by a national market, but such capability also places service providers at risk of running afoul of state regulations.
- *Low barriers to entry.* Technology allows new companies to replace brick and mortar with bits and bytes, along with automating the staff. By leveraging technology both to lower

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overhead and to efficiently obtain capital, marketplace lenders using fintech can compete with banks without the need for deposits or ancillary lines of business found in universal banks. This use of fintech allows companies with dramatically different corporate profiles and regulatory regimes to compete for the same customers.

- *Disintermediation and entry.* Ease of access and the ability to offer products to a very broad audience very quickly have attracted new entrants to compete with traditional players. New methods, such as virtual currency, and new companies can quickly become significant from a regulatory perspective. Additionally, established players in other industries may now intentionally or inadvertently enter highly regulated financial markets.

This paper illustrates how the fintech frontier is regulated at both the state and federal level. Areas within the fintech frontier subject to regulation include consumer and small-business lending and interest rates, money transmission, virtual currency, and securities offerings.

WHO SHOULD REGULATE?

Congress can regulate and displace the states' regulation of fintech. But just because Congress *can* regulate doesn't necessarily mean it *should*. Congress should only intervene if it has a compelling reason such as to address efficiency, competitive equity among market participants, or political equity among the residents of various states.

- *Efficiency.* Whether efficiency is best served by federalism or federalization is a case-by-case question. However, state-by-state regulation contributes to regulatory uncertainty. Having to research and comply with multiple regulators or pay for multiple licenses, is inefficient, time consuming, and costly for companies, especially new firms with limited resources. The lack of consistent regulation may require more complex financial engineering to make products compliant. The result is greater complexity and higher costs, with the additional cost being passed on to borrowers and investors.
- *Competitive equity between market participants.* There is much wisdom to Senator Dale Bumper's reaffirmation of the principle that "institutions offering similar products should be subject to similar rules." In the realm of fintech, that is often not what happens. Instead, competing institutions offering similar products on a nationwide basis are often subject to different regulations depending on whether they are classified as a bank or not. Although the products that fintech firms offer are not identical to bank products, the differences do not justify the wildly different regulatory regimes.
- *Political equity between residents in different states.* In a national market, the effect of state regulation does not stop at the state border, but political representation does. Firms forced to comply with the laws of each state in which they sell products may decide not to offer a particular product anywhere in response to one state's ban, even if other states would welcome the product. States that offer particularly lucrative markets, like New York, set the regulatory tone for the rest of the country. Customers in other states not only bear the cost but are effectively being regulated across state lines.