

## LETTER OF COMMENT

### CONSIDERATION OF AUTHORIZING NATIONAL BANK CHARTERS FOR FINTECH COMPANIES

U.S. Office of Comptroller of the Currency

Submitted by Jo Ann S. Barefoot,

CEO, Barefoot Innovation Group LLC

Senior Fellow, Mossavar-Rahmani Center for Business & Government, Harvard University

January 17, 2017

Thank you for providing an opportunity to comment on the paper published by the Comptroller of the Currency (OCC) on December 2, 2016 regarding whether and how to authorize special purpose national bank charters for financial technology – or “fintech”-- companies.

My perspective on this matter is shaped by years of experience relating to financial regulation, with particular focus on fostering financial protection and inclusion for consumers and small businesses. I am a former Deputy Comptroller of the Currency, served on the staff of the United States Senate Committee on Banking, Housing and Urban Affairs, and served on the Consumer Advisory Board of the Consumer Financial Protection Bureau. For many years I have been a consultant to financial companies through my own company, as a managing Director at KPMG, and as co-chairman of Treliant Risk Advisors. I also serve on several nonprofit boards focused on these objectives. I am currently CEO of Barefoot Innovation Group, host the podcast show Barefoot Innovation, and am a Senior Fellow at the Mossavar-Rahmani Center for Business and Government in the John F. Kennedy School of Government at Harvard University. My Harvard work is focused on researching and writing a book on how best to regulate financial innovation. The views expressed in this letter are solely my own.

I also submitted comments on May 31, 2016, on the OCC’s previous paper regarding its broader innovation initiative. While the fintech charter concept is an important part of that effort, I view it as just one aspect of a far-reaching program to update regulatory strategy to address the enormous change that technology is bringing to finance.

I commend the OCC for exploring creation of a national bank fintech charter. I believe such a charter option could provide great benefits for the financial system and its customers. While the issue raises many important and complex challenges, these can be largely addressed through thoughtful design.

For the sake of brevity, I will largely frame my input in terms of consumer issues with the proviso that most of them affect small businesses in much the same way. I will also address certain issues specific to small businesses.

#### **Public Benefits of Fintech Innovation**

Before addressing the merits of a national bank charter for fintechs, it is important to be clear about why this issue matters. New technology is opening a historic opportunity to create a system of genuinely affordable and easily-managed financial services that can transform the financial health of customers in the United States and throughout the world. Using technology that has only recently emerged,

innovators are attacking virtually every factor that causes difficulties for financial customers. Online and especially mobile services are sharply reducing the cost of delivering services, in comparison to traditional branching systems. Blockchain and distributed ledger technologies (DLT) are similarly reducing the cost of producing financial products. “Big data,” combined with machine learning and artificial intelligence, is enabling advances in risk evaluation that can be simultaneously more inclusive and more accurate. Voice technologies and interactive “bots” are making it easier for consumers to select financial products wisely, manage money, set and keep to budgets, and get answers to questions. New high-tech helpers, leveraging insights from behavioral economics, are taking the initiative to remind consumers to save, or to do it for them automatically, and to reward and reinforce good choices.

Furthermore, new forms of digital identity are making it easier for financial companies to verify the identity of people who lack traditional credentials, thus enabling more customers to access mainstream services. New technologies also hold promise for improving consumer data security and privacy. In addition, blockchains and other breakthroughs are speeding up the payments system, reducing the problems faced by consumers who rely on high-cost cash services because they are tightly managing inflows and outflows of funds and must know precisely when a transaction clears.

These developments are the focus of my research on my book. While space here does not permit lengthy discussion, the OCC’s deliberations should be grounded in this recognition of what is at stake. New technology, products, delivery channels, business models, and market models are rapidly emerging and hold the promise of solving problems that have harmed consumers for centuries. At the same time, these shifts are raising new and increased dangers, including to privacy, customer data security, and fairness in product design and risk modeling.

In my experience, people in the financial ecosystem tend to underestimate the magnitude and velocity of these trends, because the forces driving them are developing largely outside their field of vision. Fintech is more “tech” than “fin,” in that its drivers are less about financial product development than about much larger shifts in universal technologies. Trends like mobile technology, big data, artificial intelligence, blockchains, and smart voice-based services are remaking not just finance, but nearly every aspect of modern life. Each technology shift is enormous, and importantly, they are also converging. Products that today leverage one or two new technologies will soon leverage more, creating sudden leaps in financial options.

In my view, whether these changes will capture their upside potential and contain their downside risk will depend mostly on how well they are regulated. Finance is the economy’s most pervasively regulated sector (with the possible exception of medicine) and is among those experiencing the most profound technology change. Regulators and other policymakers face the most difficult challenges in this ecosystem, and play the most important role, as they seek to permit desirable innovation and simultaneously to block new kinds of harm.

These issues are tremendously consequential not only for financial customers, but also financial providers, and especially banks. If innovative financial products do in fact enable financial products that are both more valuable to the customer and more efficient for the provider, then innovators will gain increasing market share. Speaking, again, as a former bank regulator myself, I think it is critical to assure that banks be able to participate fully in these trends. Today, banks are rarely the source of the most significant innovation.

## Financial Inclusion

In questions 3, 4 and 5, the OCC seeks public input on whether and how to shape a fintech charter option to promote financial inclusion.

A critical point, as noted above, is that the innovation emerging in fintech will, in and of itself, tend to drive the market toward easier access and affordability, and thus inclusion. Part of this is due to the fact that technology will make services more affordable – easier to provide profitably to far more people -- simply by reducing the costs of providing them (the Bank of England’s Andrew Haldane has noted that the cost of intermediating a U.S. financial transaction has remained the same for a century). Again, digital ledger technology shows promise of transforming the cost structure of operating complex financial companies, while mobile phones are making it profitable to bring financial services to people – hundreds of millions globally – for whom it would never have been cost-effective to build and staff a branch.

Inclusion is also being driven by new data and data analytics, which are enabling a fine-tuning of risk scoring for people with thin or no credit files or complex situations. These same factors are also enabling accurate identity authentication of people who lack traditional credentials, such as young people and new immigrants in the US and globally. This latter progress can reduce the harm done by anti-money laundering and anti-fraud “de-risking” requirements, which have unintentionally screened out numerous worthy consumers and small businesses because the commonly-used screening technologies cannot adequately distinguish between innocent people versus criminals and terrorists. While many of these trends are early and will need great refinement, they hold tremendous promise for building a financial structure in which everyone who is able to use a financial product appropriately will be able to qualify for and afford it.

Beyond this, a national fintech charter could raise other potential for building financial inclusion. The OCC is seeking input on the possibility of creating either a deposit-taking charter, and non-deposit-taking charter, or both. Fintechs that were authorized to accept consumer deposits would be subject to the Community Reinvestment Act (CRA) obligation to undertake affirmative efforts to meet the credit needs of low- and moderate-income customers. In my view, the CRA law and regulation are severely outdated, because they were written for a bygone era in which the banking system was built mainly around branches. It is beyond this scope of this letter to advocate for updating CRA, but creation of a fintech charter could lead to a healthy and overdue rethinking of how best to achieve its stated objectives. New approaches could simultaneously work better for banks and advance the policy goals that caused CRA to be enacted in the first place.

CRA has always been controversial and continues to be so today, with much debate centering on concerns that it has forced or incited banks to make “bad loans” to people who could not repay them, thus harming both the borrowers and the financial system. At the core of the problem has been the long-time difficulty of accurately assessing the risk presented by marginally-qualified customers, and of serving them profitably through expensive branches. It is worth noting that today’s technology has the potential to create a new win/win dynamic. It can lead to more lending to low and moderate income borrowers, soundly limited to those who truly can repay, and done profitably, and therefore at scale, without harm either to borrowers or the system. Such an opportunity can be realized only if emerging technology is wisely regulated.

The OCC is also exploring whether to make non-depository fintech national banks subject to an expectation of fostering financial inclusion, apart from the CRA mandates that attach to accepting deposits. I would not recommend imposing a CRA-like requirement on new classes of businesses unless and until CRA is updated. Nevertheless, there would be value in the OCC embracing a strategy of fostering innovation that offers high promise of promoting financial inclusion, on a sound basis.

Consumer advocacy groups have raised concerns that in creating a fintech charter, the OCC would have the power to preempt state laws intended to protect consumers. These include state usury laws and also laws barring unfair and deceptive acts and practices, or “UDAP.” In some states, UDAP protections are stronger than they are in the equivalent federal law, including that many states provide consumers with a private right of action. The OCC already defers to state-level UDAP protections. Possibly it could address some of these concerns by establishing limited exceptions to its federal preemptions, or by taking these concerns into account in evaluating individual fintech charter applications to satisfy itself that a new bank could not engage in “predatory” practices and pricing.

Question 3 asks what information an applicant should provide to the OCC to demonstrate its ability to promote financial inclusion. A good framework for this could be the financial health standards promoted by the Center for Financial Services Innovation (note that I serve on the Center’s board of directors). CFSI encourages financial companies to [evaluate impact on consumer financial health](#) with a focus on the four fundamental elements of spending, saving, borrowing, and planning. Charter applicants could be expected to address how their services would help consumers or small businesses enhance some or all of these components of financial health.

### **Protecting Small Business Borrowers**

Question 6 asks if the OCC should use its chartering authority to address the gap in regulatory protection afforded to consumers versus small businesses. Small businesses increasingly face the same kinds of issues that affect financial consumers, but have far fewer regulatory protections. As explored in a 2016 Harvard Business School [paper](#) by former SBA Administrator Karen Mills and Brayden McCarthy, there is currently little federal legal protection for small businesses, and there is no federal agency with responsibility for providing this kind of protection. This issue raises increasing concern in today’s “1099” or “gig” economy in which small businesses increasingly have profiles similar to those of consumers. It is well established that small businesses have trouble qualifying for bank credit and increasingly turn to online options, some of which are highly beneficial and some of which are harmful. Current federal law offers little assistance to small business regarding how to evaluate these online offerings or how to deal with difficulties when they arise.

In my view, the solution to this problem is *not* to extend current consumer protection regulation to small business. The current consumer rules impose very high costs on industry and are simply not achieving their intended benefits for consumers. They need to be revisited in light of new technology in both fintech and regtech. A new OCC charter process for fintechs focused on small business lending could help flesh out how best to approach this challenge.

### **Deepening Regulatory Sophistication on Technology**

One critical issue that is often overlooked is that a fintech charter would educate the federal regulators about financial innovation.

Broadly speaking, most of the important innovation underway today in finance is not happening at banks. It's happening at nonbanks. To some extent, this is a result of banks being more highly regulated – they find, or fear, that innovation will not receive regulatory approval. It also results indirectly from the fact that, as highly-regulated entities, banks tend to develop cultures that are more conservative than many industries. In addition, they have legacy products, structures, IT systems, costs, and other factors that make innovation difficult.

A little understood side-effect of this situation is that the regulatory agencies that generally dominate financial policy-making – the federal bank supervisors – have very little interaction with cutting-edge innovation. It's only a slight overstatement to say that they do not regulate innovators directly at all. They sometimes evaluate situations where banks want to partner with fintechs, in circumstances where the regulatory role is to assess the quality of the banks' third-party risk management. Field examiners, and sometimes national and regional officials, may see some of these situations. In addition the OCC, much to its credit, has established an office of innovation and named an acting Chief Innovation Officer, who has begun to set up a framework for meeting with fintechs. (The Consumer Financial Protection Bureau, too, has a similar program in its Project Catalyst).

These steps all have value, but there is a big difference between interacting with fintech firms versus actually regulating them. I have spoken with regulatory officials in other countries whose innovation initiatives are more advanced than those in the United States. Some describe having previously faced situations where innovative companies were emerging outside the scope of bank regulation. When these companies began to pose widespread potential for risks, bank supervisors found themselves caught in a reactive stance, ill-equipped to regulate companies they did not understand.

If the OCC creates a fintech national bank charter, it will develop deep institutional expertise in the technologies that are reshaping the financial industry. This will produce an array of benefits, including reducing the vulnerability of the financial system to emergence of risks outside the supervised banking system (a pattern that was a critical factor in the subprime mortgage crisis and subsequent financial crisis and Great Recession).

Over time, the term “fintech” may fade from usage because virtually all financial services will be technology products shaped by these innovation trends. Finance will increasingly be a technology industry. Its players may well include companies that we view today as “big tech” firms, like Amazon, Apple, Facebook and Google – all of which offer some form of consumer financial services even today. As this new world emerges, it will be important to have federal regulators steeped in understanding it.

The OCC charter would be a critical step in creating that capacity. It would enrich the federal policy dialogue with other regulators, legislators, incumbent banks, and others. This work would equip the OCC to begin to grapple with the enormous policy issues ahead. How will fintech impact community banks – and their communities? Which products and practices promote competition and which impede it? What trends help consumers and which may imperil them? Do federal laws need to change and if so, how? OCC supervision of fintechs would equip it to answer such questions with insight that is not available today to any federal regulator.

### **Supplementing State-by-State Licensing**

The United States enjoys great benefit from having a robust, multi-faceted regulatory structure that includes oversight of banks and nonbank financial companies at the state level. States charter and supervise banks and also license and oversee thousands of nonbank financial companies. While state laws vary, large numbers of them license most kinds of consumer lending and money transmission, which are two of the areas in which innovation is most active.

This state-based system is valuable and must be maintained, even as it is updated as discussed below. States are well-positioned to function as “learning laboratories” for government innovation and indeed have done so in many realms, including financial regulation. They enjoy an inherent advantage in this thanks to both tradition and to simply being smaller and more nimble than is the norm for the federal government. Today, many states are adapting their rules and procedures to address emerging innovation. The variation in their approaches offers a real-time experiment in what is working well.

State-based regulation of nonbank financial companies is also a practical necessity. They currently oversee tens of thousands of companies. The federal government generally, and the OCC specifically, is not designed to provide active oversight of so many firms, especially during rapid change.

The system also generally works well for small innovators seeking to operate in only one or a few states, which is the typical case for most early startups.

Despite these virtues of state regulation, the absence of a federal “licensing” option is causing significant challenges for many fintechs. The process of securing a new license in every state is extremely expensive and time-consuming. Fintechs report spending several years and millions of dollars to accomplish this goal. Even after licensing, moreover, state-regulated entities must invest very substantially in legal and compliance activities such as monitoring changing law and regulation and meeting continuous individual demands for information and reports.

State regulators and their organization, the Conference of State Bank Supervisors, are working to address many of these concerns, exploring ideas for streamlining, updating, and coordinating among the states. These efforts are invaluable and will undoubtedly lead to great improvements in state-licensing.

Nevertheless, creation of a fintech national bank charter would offer a valuable additional alternative. Even the most successful streamlining will not be as efficient as having a single national regulator. Qualified fintechs should have that option.

Many observers fear that creation of a national bank charter would somehow bring an end to state-based licensing or erode it to a dangerous degree. In my view, this concern is not realistic. After all, the United States has had a healthy “dual banking system” for many years. Banks have the option of being organized either as national banks by the OCC or as state-chartered banks created by and accountable to the states (with additional oversight from the FDIC), and thousands continue to elect state-based chartering. The same would undoubtedly be true for most fintechs, especially since gaining a national bank charter would involve a rigorous process and high standards on factors like capital, liquidity, and management, as well as far more intrusive oversight than is the norm for nonbank companies. The national charter would appeal only to a cadre of strong, highly-capitalized and well-managed fintechs, and only companies such as these would be able to secure it.

### **Specific Challenges of Fintech Charters**

Question 7 asks what potential challenges might be unique to a fintech banking charter. In my view, the most significant of these challenges would be the fact that many fintechs are startup enterprises engaged in efforts that, almost by definition, incur relatively high risk of failure. This risk appetite is part of what makes innovators able to innovate – they use “trial and error” to determine what will work, and the error side of the equation can bring failure. While willingness to risk failure is central to the innovative spirit, it generally should not be part of the banking system. The OCC should charter fintechs that have low risk of failure, as it does for traditional banks.

### **Competitive Advantages over Traditional Banks**

Question 8 asks if a new charter might create unfair advantages of fintechs over banks. The OCC should assure that fintechs receiving national bank charters meet the same rigorous standards that apply to banks. The charter option should be designed to level the playing field, not to tilt it against banks.

### **Health of the Banking System**

Question 9 asks if there are risks to traditional banks from fintech companies that do not have bank charters. The answer is that banks do face significant challenges from nonbank fintechs that will increasingly offer superior services, due to their ability to innovate.

Banks are at risk of losing market share to nonbanks, in part because complex and rigid regulation will increasingly tend to push innovation out of the legacy banking system. This pattern will cause the banking sector to suffer and therefore will undermine the health of the financial system – which continues to be bank-centric. The OCC and other prudential bank regulators are responsible for managing systemic risk to the financial system. They should avoid creating a situation in which growth is occurring disproportionately outside the scope of the institutions they oversee. Good innovation should be brought inside the mainstream financial system so that system can thrive, and “bad” innovation should evolve within the purview of regulators that can perceive and address it.

It seems likely that prudential, safety and soundness bank regulation will soon focus not on whether banks are adopting risky technology, but rather on whether they are putting themselves at risk by failing to embrace innovation.

### **Interagency Coordination and Testing of Innovation**

Question 11 asks how the OCC can enhance coordination and communication with other regulators.

This might be the most important issue raised in the OCC’s paper. The United States is at risk of losing its global leadership role in finance, due to the unique complexities of our regulatory system. The main source of this vulnerability is the fact that the United States has a fragmented regulatory system. Five federal agencies directly supervise financial institutions. Approximately twenty other federal agencies play roles in consumer financial regulation. In addition, every state has a regulatory role overseeing banks, and most regulate nonbank financial activities like lending and payments.

It is unlikely that we would design our system in this form if we were starting today, but changing it would be difficult. It is imperative, therefore, that the U.S. regulatory agencies work toward new models of voluntary collaboration that can forge uniform approaches to fintech change. Lack of uniformity leads to lack of regulatory certainty, and this uncertainty is cited as a major obstacle to innovation, both by incumbents and by investors in the sector.

It is also essential that financial regulators develop mechanisms that permit empirical testing of innovation to validate benefits and identify risks. Such experimentation is being rapidly embraced by financial regulators in other parts of the world. Last year the U.K.'s Financial Conduct Authority launched a regulatory "sandbox" that is actively testing fintech innovation, and approximately twenty other countries have similar initiatives underway or being evaluated. The OCC has communicated plans to conduct pilot programs of this nature as part of its innovation initiative (and the CFPB has a mature program pursuing similar aims through its Project Catalyst).

In my view, it is essential that the U.S. financial regulators pursue *both* interagency collaboration and a "reg-lab" type of experimentation. Testing is the best way to generate rapid learning and regulatory responsiveness to today's technological change, in order to assess potential consumer benefits and identify emerging risks. I encourage the OCC to pursue its pilot program concept and to invite its sister agencies to join in working with it. The work of such a "lab" effort would answer many of the questions that need to be resolved regarding when and how to permit national bank charters for fintechs.

### **Reg-Tech**

Finally, I encourage the OCC to develop and deploy "reg-tech" that can bring high-tech solutions to regulating not only fintech, but to all of finance. Reg-tech is rapidly evolving throughout the world today and here again, the U.S. is lagging due to our fragmented regulatory structure. The promise of reg-tech is that it can, in concept, improve public policy outcomes while simultaneously reducing costs for both industry and regulators, by leveraging technology that did not exist even a few years ago. It holds the potential to solve regulatory problems that have seemed heretofore unsolvable.

Again, I appreciate the opportunity to comment, and I commend the OCC for its leadership regarding financial innovation, including in the consideration of a fintech charter.