



May 31, 2016

Re: Comment on the OCC Perspective on Responsible Innovation

Dear OCC Staff:

The Comptroller's invitation to comment on the OCC Perspective on Responsible Innovation in the financial market place is a welcome initiative. The white paper and the upcoming forum should provide a catalyst for a constructive dialogue on how regulatory support for productive innovation in the banking sector can be pursued.

The paper frames the OCC perspective around a definition of responsible innovation that places its emphasis on novel or improved products, services or practices that productively respond to market demands consistent with sound risk management. This definition fits within the Schumpeterian paradigm of economic analysis that underscores the conversion of inventive opportunities into productive and effective end-uses successfully brought to market by the innovative entrepreneur. [Baumol 2010, p. 26]ⁱ

The pervasive impetus of innovation in the American free-market economy is naturally reflected in that economy's banking sector. As the Comptroller acknowledges, "innovative spirit has been especially evident in recent decades as national banks and federal savings associations have led the way in developing and adapting products, services and technology to meet the changing needs of their customers." This is in keeping with the academic recognition that "in key parts of the economy the prime weapon of competition is not price but innovation." [Baumol 2002, p. ix]ⁱⁱ There is no more key part of the economy than the banking sector and no more important factor in its evolution than the adoption of innovative means for competitively serving the sectors' customers and communities.

This comment offers input on the OCC Perspective by dividing the proposed principles into two categories: Principles 1-3, 7 and 8 constitute the regulatory infrastructure category. Principles 4-6 constitute the regulatory policy category and will be addressed first.

Regulatory policy supporting responsible innovation.

The OCC principles recited as four through six embrace important guideposts for regulatory policy supporting responsible innovation. Given the broad range of financial activity to be encompassed, these principles succeed at finding common ground for organizing policy responses to financial market innovation.

Principle 4 is fundamental to addressing the "responsible" qualifier to financial innovation in the banking sector. However, it warrants an important edit that replaces "consumers" with "communities." The scope of responsible innovation must be coincident with the scope of



the federal and state institutions that are obligated to address the convenience and needs of the communities they are chartered to serve.

As the Comptroller notes elsewhere, the impact of financial innovation has a broad footprint and is not limited to consumers, but also covers businesses and public entities across international, national, regional, local, and rural communities alike. While there may be varying degrees of vulnerability among the full range of banking customers, delivering “responsible innovation” is a concept applicable to all banking activities.

Responsible Providers of Innovation

In the broader literature on the economics of innovation, the Schumpeterian model considered innovation as a virtually unalloyed benefit in the capitalist free market. This has been re-assessed in subsequent analysis that acknowledges that free market innovation, albeit predominately productive under capitalism, can also spur rent-seeking, and in an important concession to realistic analysis, even criminal activity. [Baumol 2002, p. 5, p. 62] Accordingly, there is a legitimate role for market regulation in achieving responsible innovation.

It is worthwhile remembering that productive innovation is not an instantaneous output of technological advance. Instead, it is the product of a competitive spirit to benefit oneself (individual or organization) by delivering products or services more responsively to market than one’s rivals. As Baumol has observed (building on Adam Smith’s insights), the importance of such a entrepreneurial spirit “is not whether the motivation force in question is to be viewed approvingly as ‘responsible pursuit of the profit motive’ or is more appropriately classed among the seven deadly sins.” [Baumol 2002, p.14] As Baumol has subsequently noted, monetary profit is not the only valued recompense for innovative entrepreneurs. Psychic rewards such as the “*prospects of glory, wealth and fame...and even the pleasure of puzzle-solving*” can incentivize and compensate the innovator. [Baumol 2010 p.52] The important thing is that however motivated an entrepreneurial spirit is a very real driver of innovation in competitive response to changing market demands.

Not surprisingly, the economic analysis of the entrepreneurial incentives to innovate parallels the recent regulatory focus on holding banks (and where reachable nonbanks) accountable for managing the risk of harm their incentives generate. On both the domestic and international plane, supervisory agencies are probing the ability of regulatory policy to demarcate the line between productive innovation and harmful risk taking. See, [Interagency Proposal on Incentive-based Compensation Arrangements](#) (April 26, 2016) and [FinCoNet Report on Sales Incentives and Responsible Lending](#) (January 2016). Both of these regulatory initiatives deserve much more penetrating analysis than this comment can muster. Yet, both should be addressed within each proposal’s forum by policy agencies and financial firms in a manner mindful of the implications of each for productive financial innovation.



There is often a fine line between productive and harmful innovation especially at the early stages of a product's introduction to the market. Often the difference is one discernible only with hindsight. This invites supervisory second-guessing and a chilling effect on innovation. Whenever enforcement theories of liability blaze trails of liability not previously articulated in notice and comment rule-making or established precedent, responsible risk management and compliance are impaired and the reliability of supervisory expectations is undermined. There can be no functional clarity to regulatory guidance on responsible innovation without reliable consistency in its application by supervisory agencies and law enforcement.

Responsible Users of Innovation

Furthermore, the responsibility of producers of innovative financial products and services is only half of the equation necessary for attaining a sustainable market for responsible innovation. There must also be responsible conduct on the part of those that demand and use those innovations to address their wants and objectives. Such personal or organizational responsibility for appropriate use of innovation should be no less true in the financial market than it is in the rest of the economy. Yet the discussion of responsible innovation reflected in the white paper is bereft of this side of the equation.

No more apt example of this duality of responsible conduct is more readily available than that of the personal smart phone. As a talisman of empowering innovation, the cell phone/smart phone has few equals. It has revolutionized communication and already has delivered financial innovation in business and consumer markets. But the legitimacy of imposing standards of responsible conduct on consumer use of their mobile devices is unassailable—as numerous state and local laws restrict the personal use of mobile phones for voice, text or app activity that contribute to distracted driving.

If the FCC had imposed on the phone manufacturers the production of failsafe capabilities on the first cell phones imagine the delay in the introduction of this technology. Responsible use was an accepted predicate to mobile communication innovation. As technology and individual preferences continue to evolve, fault tolerant features can be introduced, but there will always be a line drawn that assigns personal responsibility to the user of innovation.

Similarly, customer use of financial innovation entails the insistence on responsible conduct by the user. Whether it is the safeguarding of debit card PIN numbers or the simple balancing of one's check book, consumers must be responsible for the consequences of their handling of reasonably safe and sound financial products. There is nothing revolutionary about this requirement. Indeed, if anything it has become even more imperative with the evolution of information technology. Accordingly, the principle of provider responsibility must be accompanied by a parallel principle of consumer responsibility if the OCC's Perspectives are to be an effective foundation for regulatory policy on supporting responsible innovation. Hopefully this will get more attention during the upcoming forum.



Safe and Sound Innovation

OCC Principles five and six combined are an expected reminder that innovative banking must remain safe and sound banking. The principles expressly encompass core risk management and governance disciplines and incorporate existing fundamental guidance. Too often, such guidance puts the emphasis on limiting the downside risk of banking operations with little recognition of the upside potential of delivering innovative products or employing innovative means of conducting operations. This is a function of the predominantly risk averse nature of the banking regulatory framework and supervisory culture. It is worth keeping in mind that “safe and sound” is not a standard compelling minimum risk, but rather is a guard against “abnormal risk.” The gains of innovation in the naturally dynamic banking sector can only be realized with a willingness to accept the adverse impact of occasional failure.

A safety and soundness regime that discourages the entrepreneurship necessary to champion competitive innovation will disadvantage the banking sector in comparison to its less-regulated and unsupervised nonbank competitors. As the economic literature recognizes entrepreneurial skill will naturally be attracted to those sectors of the financial market where “the relative profit prospects” are greater. [Baumol 2002 p. 60] If the OCC and its colleagues wish to redress the trend toward unregulated fintech innovation, the agencies must review their approach to existing safety and soundness policy and more explicitly approve the entrepreneurial risk-taking that drives responsible innovation. This begins with a rewrite of existing guidance publications so that they convey more than the conservative expectations of enterprise stability; but rather nurture the dynamic growth of entrepreneurial initiative. It is time to recast ERM as an engine of innovation by placing the acronym’s emphasis on entrepreneurial risk and reward management.

Disseminating Innovation

From a sector-wide policy standpoint promoting strategic innovation is not limited to encouraging novel products and practices to be developed independently by every firm. For regulators the goal is also achieving banking sector adoption and adaptation of innovative activity pioneered elsewhere or by others. As Thomas Edison recommended, “Keep on the lookout for novel and interesting ideas that others have used successfully. Your idea has to be original *only in its adaptation to the problem you’re currently working on.*”

As Baumol’s concept of innovative entrepreneurship illustrates, the emphasis is on the “business person who recognizes the value of an invention, *determines how to adapt it to the preferences of prospective users*, and then brings the invention to market and promotes its utilization.” (Emphasis added.) [Baumol 2010, p.26] This puts community bankers very much in the game for adapting someone else’s novel or interesting ideas to align with the preferences of the prospective users in his institution’s local community market.

What has already succeeded in one context may afford competitive advantages as an innovation in the market context faced by another bank in another community. This reality



places many successful community bankers in “a substantial class of entrepreneurs who ... specialize in recognizing new markets or new uses for an innovation.” [Baumol 2010, p.101-102] As Baumol goes on to explain, there are two reasons why this can be considered an innovative activity: “First, the very recognition of an appropriate and promising new market is an act of discovery. Second, very often in the process of transfer, intellectual property is adapted to local conditions and needs, and even materially improved.”

Creating a regulatory environment that encourages dissemination of innovative products and practices and their ready adoption and adaptation by entrepreneurial followers is vitally important. Since such dissemination is a free-market phenomenon [Baumol 2002, p. 73 et seq.], it is the responsibility of regulatory policy not to impair such market impulses, but rather to enable them wherever responsible innovation can occur. Three examples of supportive regulatory policy come to mind.

The Comptroller’s efforts to encourage community banks to work collaboratively opens one avenue for banks to share experience with innovative practices or products and to facilitate more effective ways of incorporating those innovations in their respective operations. Second, third-party risk management guidance should be revised to legitimize the more rapid spread of recently proven innovation. This can be further supported by regulators signaling confidence in service providers who have demonstrated responsible product development and have passed supervisory muster.

A third means of encouraging banking innovation, particularly where it is applied to responding to underserved customers and communities, is leveraging the Community Reinvestment Act (CRA) public evaluation process. Since 1995, the CRA rules have incorporated recognition for banking innovation across the spectrum of banking products and practices. The application of these rules has made positive use of the notion of contextual innovation by bestowing positive consideration on bank performance that is new in its community even though it may be established in other geographic markets. Yet, despite 20 years of data on creditworthy innovation, the agencies have done little to analyze the data. This is an opportunity whose value for encouraging the dissemination of innovation has been woefully delayed. Identifying replicable innovative activity from bank CRA evaluations would go far in disseminating productive innovation within the banking industry and across America’s communities.

These examples of supportive regulatory policy for banking industry innovation unsurprisingly leverage the more economically conservative forms of incremental improvements that in aggregate account for significant sector-wide innovation penetrating diverse markets across the country. Baumol describes this type of innovation as “devoted primarily to improving products—by enhancing their reliability and user-friendliness—and finding new uses for these products” yielding a conservative approach “applicable within markets that are relatively unspeculative.” [Baumol 2010, p.32] Without pigeon-holing all banks into that category, the designation is probably apt for the vast majority of institutions in the sector.



Regulatory infrastructure supporting responsible innovation.

Government regulation of financial innovation, particularly in the banking sector, necessarily requires interagency collaboration and coordination. Principle 8 of the OCC's litany recognizes this but does so largely within the established structure of interagency coordination where each separate agency establishes its own capacity and then strives to accommodate their respective policy and jurisdictional differences.

Of course, it would be presumptuous of OCC to articulate a regulatory strategy for the entire banking sector, let alone the entire financial market, despite its jurisdiction over the substantial majority of bank assets. Nevertheless progress by the OCC on its first three regulatory infrastructure principles will fall short of sector-wide success without an interagency consensus on supervisory clarity, a common supporting oversight culture and a shared knowledge base. As welcome as the Comptroller's leadership is, especially for national banks and federal savings associations, the scope of the market in which those charters compete demands a broader regulatory framework than any one agency can provide.

Many will point out that this agency-by-agency framework is the result of the peculiarly American model of banking and financial regulation that has resisted past (even recent past) efforts at reform. On the other hand broader regulatory reform will never occur without its own form of innovation or regulatory disruption. To that end, the good ideas proposed by the OCC's regulatory infrastructure principles should be pursued under a joint agency venture. This venture would have:

- 1) Its own Executive Director and a dedicated staff commensurate with the resources necessary for success;
- 2) An equitable joint agency funding mechanism;
- 3) A culture of growing and sharing a knowledge base on economic, financial, technological and regulatory policy innovation;
- 4) Input from a formal academic research council that can function as a source for leading analytical thought and debate, a peer review panel for government initiated policy research, and an extension service for pursuing quality academic research on policy options; and
- 5) A robust process for disseminating innovative practices through government sponsored outreach.

In this joint venture more resources could be mobilized than any one agency could bring to bear with less redundancy. In addition, accepting a degree of detailed personnel as part of the venture's "dedicated" staff could promote more efficient sharing of the joint knowledge base and encourage consensus on the analytical predicate of responsible innovation policy.



While this joint venture may strike some as needing an empowering legislative action, the necessary authority to build such a venture already exists in the form of the FFIEC whose recently revised membership encompasses the core agencies and an adequately flexible statutory mission. Despite the FFIEC's history of labored interagency coordination, the only obstacle to using it as the platform for a joint agency venture on innovation is a lack of will and leadership. This is a deficiency the Comptroller's initiative demonstrates is not insurmountable. It simply requires some of the innovative spirit that the OCC and its brethren see in the market around them and within their regulated constituency.

Conclusion

The OCC's initiative and forum sponsorship are welcome signs of an agency commitment to fostering a market environment that enables banks of all sizes and strategies to benefit from the entrepreneurial pursuit of financial innovation through the creative development of products and processes and the adaptation of technology to financial applications. As the OCC and its colleagues proceed, they should be vigilant about protecting a competitive market that affords the necessary incentives to expand financial innovation among banks of all charters and sizes. After all, the lessons of economic analysis and banking experience demonstrate that productive and responsible innovation is driven by market forces, not by regulatory command.

Respectfully submitted,

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ⁱ Baumol, William J., *The Microtheory of Innovative Entrepreneurship*, Princeton University Press, 2010.

ⁱⁱ Baumol, William J., *The Free-Market Innovation Machine*, Princeton University Press, 2002