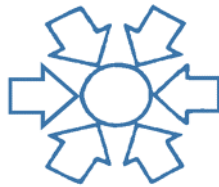


**The Road to Intermediation is Paved with Ruins:  
Equifax and the End of Banking as We Know It**



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- Asymmetric regulation and warp-speed innovation combine to disintegrate traditional financial intermediation, the basic activity that defines U.S. banking.
- Equifax is the disintermediation canary – its business model relegated banks to pass-through lenders, not underwriters or portfolio lenders that meet unique credit needs in local communities even though banks take the risk when credit-bureau models are wrong or fall into criminal hands.
- If regulation serves no stability or policy purpose, then only shareholders would suffer if financial intermediation and critical infrastructure abandon regulated banks. However, the 2008 crisis showed the critical importance of resilient finance and effective backstops. The next crisis could well come as non-bank customers and counterparties under stress search desperately for safe havens. By then, banks may well be unable or unwilling to provide this traditional, stabilizing function.
- U.S. bank charters of all sizes are at a pivotal strategic decision point that forces focus to shift from continuing compliance and comment on the Dodd-Frank framework to a new business and policy agenda.

It is a pleasure again to open this meeting of counsel from across the largest U.S. and foreign banks. Ursula reminded me that last year I provided you all with an in-depth, inside view of what would happen to financial policy under President Clinton. Onward, as we say. This morning, I'll turn not to what may lie ahead for the Trump Administration. Instead, I'll focus on an increasingly urgent set of decisions that cannot await certainty – by the time we know what the final shape of all the post-crisis rules looks like, the banking industry could well be in the grip of a new crisis. This one could well come from the combined power of asymmetric regulation and warp-speed innovation to disintermediate banking into component, mostly unregulated parts. This will prove profitable at least for some, productive in terms of innovation, and even beneficial for financial inclusion. But asymmetric regulation means not only freedom to innovate, but also systemic risk under stress when customers and counterparties recall what they liked about banks and flood back to banks no longer able or willing to serve this critical function.

Is this alarmist? A look at just one historic staple of traditional banking – mortgage finance – shows how inexorable the transition to disintermediation has become. In just a few short years, non-banks have gone from a sliver of the origination and servicing markets to dominant players. In 2016, non-banks controlled 53 percent of U.S. mortgage origination<sup>1</sup> with no sign of slowing until the business is predominantly one shared by non-banks and the U.S. Government. For an array of reasons, mortgage finance is a business where both asymmetric rules and technology play particularly pivotal roles, but many other sectors show similar transformation. Equifax is one we don't often think about because it isn't a lender, but it nonetheless gradually and thoroughly took over one of the most critical aspects of lending – knowing your customer. The role of non-banks in mortgage finance is not a coincidence to the growth of credit bureaus as the arbiters of American credit. Disintermediation comes not just from direct challenge to the ability of banks to take deposits, make loans, and clear, settle, or pay transactions. It also occurs when core functions related to these intermediation activities go beyond banking to specialized providers that, while often expert, nonetheless may well present the type of resolution and structural risks that Equifax epitomizes. It's little wonder, but still stunning, that IMF Managing Director Lagarde on Friday said that the fractional-banking model that has defined the industry for centuries is disintegrating before our eyes.<sup>2</sup>

## What Banking is Becoming

Earlier this week, I spoke to the OCC's National Risk Committee.<sup>3</sup> I focused then on what this tectonic change means to bank supervisors; now, I'll present the same strategic landscape with an eye on what it means to you. I'll conclude with a suggested approach to gap analysis reflecting your expertise in the U.S. and global policy arena.

The Basel Committee's new consultation on fintech<sup>4</sup> is a great starting point. Although the consultation is sadly scant on specific policy recommendations, its analysis of the rapid transformation of traditional banking is stunning. Basel lays out five scenarios for banking based on a comprehensive landscape of retail and wholesale fintech and resulting disintermediation.

In very short, these scenarios lead to:

- **"Better Banks:"** Here, regulated institutions become more innovative but nonetheless face heightened risk due to greater competition, more outsourcing (think Equifax), and continuing reliance on obsolete, legacy systems prone to operational risk. Perhaps what's most striking about Basel's consultation is its pessimism about the ability of banks to be better or of supervisors to understand them if they are.
- **"Challenger Banks:"** These are regulated institutions that gradually displace incumbents. The OCC's special-purpose national bank charter is an example of the challenger-bank construct as are the ILCs that SoFi and Square now seek from the FDIC. As with incumbent banks, these "neo-banks" own the entire customer relationship. Most of these banks rely on fee income, not intermediation, meaning that current rules would be far less onerous. Basel notes that none so far has gained traction, in part due to high customer-acquisition costs and aggressive pricing combined with limited product/revenue streams.
- **"Distributed Banks:"** Think Equifax. In this model, financial services break into modules for retail, wholesale, or payment-system products and core infrastructure. Incumbent banks grab enough of these to sustain a profitable business model, likely using a "plug-and-play" approach in which the incumbent interfaces with fintech and other entities. Banks and other firms compete to own the customer, working with niche players and conceding profits as required. Financial-infrastructure services such as innovative payment-system products also come under the distributed-bank model, redefining financial-system critical infrastructure in ways we are only beginning to contemplate.
- **"Relegated Bank:"** If you didn't like any of the options above, you surely won't care for this moniker. Here, customer relationships are owned by new intermediaries, relegating banks to the bits and pieces for which their commoditized model remains suitable (e.g., securitization), with or without retaining any balance-sheet risk. Data aggregators are an example of a new approach that relegates banks regardless of the degree to which some now agree to partner with them. Wholesale-market developments have also relegated banks – see for example the valuation or other services provided to asset managers.
- **"Disintermediated Bank:"** The last option is of course the most extreme, but it is as readily apparent as the "relegated bank." When customers simply bypass a bank, a bank's value as a

trusted partner or the resilience of its balance sheet ceases to offer sufficient economic return for the out-competed bank. Examples already abound in both retail and wholesale finance: mortgages, of course, and also P2P, aspects of DLT, and leveraged loans from private-equity firms coming immediately to mind along with the full panoply of asset-management products in which investors directly buy pieces of loans generated by the asset manager or another non-bank.

In my view, these five options are not mutually exclusive; they should be considered a spectrum that lays out end-points that confront banks and their regulators once finance passes the critical fork in the road past which regulated banks can no longer profitably intermediate the range of deposit, lending, and infrastructure services on which credit availability, deposit safe-keeping, payment integrity, and monetary-policy transmission still depend. Past the fork in the road, markets will move on regardless of what becomes of these core macroeconomic functions – quite simply, as investors grow tired of hoping for better than a ten percent ROE from regulated banks, money will move, bank market capitalization will crumble, and we'll have a whole new banking system poised for a frightening new crisis.

## **What to Do?**

First, I urge the industry not to try simply to block competition on grounds that new entrants are, well, new. To be sure, banks forestalled non-bank charters after Walmart tried to charter a “challenger bank” before 2008. This rear-guard action bought time, but not change. One recent study estimates that between ten and forty percent of bank revenue and twenty to sixty percent of retail-banking profits are at risk over the next decade due to fintech, not counting all the less techy non-bank competition.<sup>5</sup> Wanting banking back the way it was won't make it so.

When I spoke earlier this week to the OCC, I urged it to undertake gap analysis to identify the differences between critical intermediation business lines and activities housed in or outside regulated U.S. banks. Using comparative analytical tools, it quickly comes clear why banks are exiting core services. We've done this analytical work for several large banks and their rapid exit from businesses that once defined their franchise is testament to what it shows.

For regulators and policy-makers, this comparative-analytical framework is a rigorous way to see what new policies do to the market. If the new policies create a new market with perverse consumer protection, economic equality, credit availability, illiquidity, or monetary-policy problems, this analysis spots them. As a result, regulators can realign policy or recommend to Congress that this be done.

What should bankers do? First, I suggest making it a top priority to do your own comparative analytics as dispassionately as possible and make policy-makers keenly aware of how markets are changing and what risks may lie ahead. If your key message then is that policy-makers should secure shareholder value, you will find most policy-makers unsympathetic given memories of the 2008 crisis. If, though, these analyses show how asymmetric regulation creates new prudential, equality, and macroeconomic risks, then you will have a formidable argument for structural realignment that preserves regulated financial intermediation in a new, fintech-driven financial future.

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<sup>1</sup> Neil Bhutta, Steven Laufer, and Daniel R. Ringo, “Residential Mortgage Lending in 2016: Evidence from the Home Mortgage Disclosure Act Data,” Federal Reserve Bulletin, October, 2017 at [https://www.federalreserve.gov/publications/files/2016\\_HMDA.pdf](https://www.federalreserve.gov/publications/files/2016_HMDA.pdf).

<sup>2</sup> IMF Managing Director Christine Lagarde, *Speech at the Bank of England Conference, London, EN: Central Banking and Fintech – A Brave New World?* (September 29, 2017), available at <http://www.imf.org/en/news/articles/2017/09/28/sp092917-central-banking-and-fintech-a-brave-new-world>.

<sup>3</sup> Karen Shaw Petrou, *Speech at the Office of the Comptroller of the Currency National Risk Committee, Washington, DC: The Day the Banks Stood Still: Financial-Stability Risks from Beyond* (October 3, 2017), available at [http://www.fedfin.com/images/stories/press\\_center/speeches/Karen%20Petrou%20Remarks%20Prepared%20for%20National%20Risk%20Committee%20Office%20of%20the%20Comptroller%20of%20the%20Currency.pdf](http://www.fedfin.com/images/stories/press_center/speeches/Karen%20Petrou%20Remarks%20Prepared%20for%20National%20Risk%20Committee%20Office%20of%20the%20Comptroller%20of%20the%20Currency.pdf).

<sup>4</sup> Basel Committee on Banking Supervision, *Consultative Document: Sound Practices: Implications of fintech developments for banks and bank supervisors*, (August, 2017), available at <http://www.bis.org/bcbs/publ/d415.pdf>.

<sup>5</sup> McKinsey & Co., *Global Banking Annual Review*, (2015), available at <https://www.mckinsey.com/industries/financial-services/our-insights/the-fight-for-the-customer-mckinsey-global-banking-annual-review-2015>.