Rip, Release, Regret?
The Potential and Perils of Financial Innovation

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- Tech-finance within the boundaries of current U.S. law and rule will likely safeguard consumer protection and stability within the confines of the regulated bank. However, major risks lie outside this porous perimeter.
- Global agencies have identified numerous structural risks arising from tech finance, many of them particularly pressing in the U.S. given the limited reach of bank regulators and the FRB.
- Tech-finance innovations pose equality risks due to conflicts and contagion related to ungoverned interaction between banking and commerce, changing terms and conditions, unknown servicing capacity, and consumer expectations of bank-like safeguards.
- Solutions to advance innovation without systemic or equality risk readily at hand under current law include narrow-bank charters, enforceable best-practices commitments, SROs, and/or activity-and-practice standards or FMU designation.

It is an honor to join a panel featuring both tech-finance leaders and legal experts. Each of you has detailed how your emerging ventures comply with current U.S. law and what that law in fact requires. I agree completely that these innovative ventures are launched with the very best of intentions not just for profit, but also economic equality and financial stability. And, I don't disagree with the presentations that described the law that now governs innovative charters and the compliance safeguards fintech and tech-platform companies must ensure. However, I worry that current law reaches only old risks, even as tech finance presents many new ones both to the structural soundness of the financial system and its ability to deliver equitable services.

Successful technology innovation, including that in the fintech arena, is distinguished by the "rip and release" corporate ethos epitomized in Facebook's "move fast and break things" motto. More charitably, this is called agile development. There's no question that it leads to great new products on which we each rely every day. However, as many of us have also come to fear, rip and release may tear up core personal values such as privacy and security. If rip and release in tech finance leads not just to innovation, but also to conflicts of interest, poor internal controls, and balance-sheet risk, we'll live to regret it – maybe very, very ruefully after an all-too costly learning experience. Tech innovation and safe, equitable finance are not incompatible -- had the first automobiles had seat belts or roads then were bordered by guardrails – well within technology's reach at the time – then thousands would have been protected from injury and death over the decades even though cars traveled just as fast.

Emerging Tech-Finance Risk

In our practice, my firm spends a lot of time surveying global and U.S. policy developments, advising both firms and government policy-makers about emerging risks and what might be done to address them. I will confine my comments today to publicly-available information from the global policy arena; comments about next steps reflect solely my own views.

That's not to say that I don't hear a lot of worries. Global standard-setting bodies such as the Financial Stability Board and Bank for International Settlements watched over the past five years as technology became increasingly intertwined with banking, pressing banks to innovate while watching warily as tech companies began to run rings around the regulatory perimeter. Reluctant at first to do more than write updates lest this dampen innovation, global regulators in 2019 dramatically ramped up both their worry and proposals to address them. The U.S. Financial Stability Oversight Council (FSOC) has also done the same.[1] Some of the most consequential recent statements highlight:[2]

- the ability of Big Tech firms to use network effects powered by data to cross-subsidize, target, and package commercial and financial services without capital buffers or operational safeguards;
- cyber, misconduct, and operational risk due to "adversarial" business models and inter-operability dislocations in the payment system;
- procyclicality due to untested business models or short-term market changes;
- concentration risk that could lead to "natural oligopolies" in areas such as payment services;
- tech-finance resolution and recovery risk;
- contagion and single-point-of failure risks when financial companies rely on Big Tech for core infrastructure (e.g., cloud services); and
- the transformation of finance into a "decentralized" framework in which regulated financial intermediaries are sidelined or even eliminated.

This may seem hyperbolic, and perhaps it is, but it is unquestionably correct to note that the very nature of Big Tech allows it to target particular services to particular customers, eliminating the construct of portfolio risk-taking managed by a single entity. Financial regulators fear that this will reduce economic growth as tech firms cherry-pick the most profitable customer segments and broader, regulated financial intermediation withers or even dies. I would add that it also blocks the various "transmission channels" on which monetary policy has long relied.

One might say that few, if any, of these worries apply to fintech partnerships or, less charitably, "rent-a-bank" arrangements with regulated banks. But, even if Citibank's CEO isn't worried about becoming a "dumb utility" for fintech, [3] regulators fear massive disintermediation as banks increasingly become core infrastructure, low-return providers of deposit services, or little more than conduits to the payment system.[4]

Inequality Issues

Last February, my firm issued a detailed analysis of fintech and Big Tech considerations related to U.S. economic inequality.[5] Several of the issues we addressed – e.g., the risk of AI-driven disparate impact – have since become far more widely discussed. Others are integrated with the structural construct I've just outlined, focusing on the radical change in consumer-financial product design resulting from the huge amounts of personal information that tech companies possess not only about transactions involving money, but also likes and predilections far afield from finance with strong bearing on the ways households save, borrow, and use the payment system.

The term "surveillance capitalism" was aptly used in an influential book describing the extent to which personal data are now the coin of the capitalist realm.[6] Indeed, digital information may well be the most important capital asset of the 21st century.[7] This gives technology companies tremendous economic power, raising important questions about whether it will indeed be equitably deployed.

Some of the structural concerns I've just outlined have inequality impact in addition to macro effects. For example, it seems likely that network effects combined with big data will lead tech finance to target the consumers most profitable to them likely also to be either the wealthiest or most vulnerable. Low-cost, low-risk, low-return services are equality essential, but they are also a very complex profitability conundrum. To prevent banks from using their market power to succumb to profit temptation, U.S. bank holding companies are not only placed under the Community Reinvestment Act and other standards, but also barred from "tying" traditional banking products sought by a customer (e.g., a loan) with a requirement or price incentive for the purchase also of an additional product (e.g., an insurance policy). As a result, even if a bank knows a lot about a customer these rules make it difficult to win market advantage or force households to buy a high-cost product in order to get an essential service. No such restraints apply to tech-finance companies unless they become known to the market and, even then, only if the Federal Trade Commission is willing or able to consider them unfair or deceptive acts or practices.

Further, due to the banking/commerce firewall, a bank cannot alter the cost or selection of goods a consumer purchases with a payment instrument based on what it knows about the balance in a savings account for remaining debt capacity. Tech companies on both sides of a financial and commercial transaction have tremendous power to do so, with significant potential risk not just to our privacy, but also market integrity and the cost of being a low-or-moderate income household. After all, profit margins on low-cost goods are thin – might it not be tempting to up financing costs or add a payment "service fee" to make up a bit of the difference?

Another equality risk derives from the difficulty of telling traditional and innovative services apart when it comes to longstanding legal protections. For example, consumers are now completely accustomed to bearing little data-breach risk due to the longstanding body of law governing credit cards along with a binding voluntary agreement by banks on debit cards. It is at best unclear if these same $50 ceilings for all but negligent losses apply to emerging technology payment products. If the product is directly offered by a bank, then current protections apply, but the bank may be at unanticipated risk unless the nonbank's systems are secure, its fraud and cyber protections are robust, and its operational-risk buffers are sufficient no matter the lack of capital or liquidity requirements. The current third-party vendor regulatory regime captures some of these risks, but others remain untouched and none has yet been stress-tested.

Even if tech finance is resilient enough to survive a severely-adverse downturn, it's not clear if the same will be true for their customers. Vulnerable households by definition have scant financial resources, with almost forty percent of U.S. households unable to handle even an unexpected $400 auto repair without stress.[8] Even middle-class families with seemingly more resilience live pay check to pay check – one quarter of the middle class now skips medical treatment because it's unaffordable.[9] As a result, a payment that goes awry can expose many Americans to severe financial stress even if the loss is seemingly minor. Failure to handle more significant disputes over mortgages or auto payments can have devastating consequences as we saw all too painfully in the aftermath of the great financial crisis. Banks have been forced to create servicing capacity and maintain the capital and liquidity to ensure it. Changing service agreements at short notice or burying consumer liability in them may protect the tech provider from legal risk, but the consumer may still be in the crosshairs.

Ensuring Inclusive, Resilient Innovation

Let me close by making it very, very clear that I do not think the risks I've outlined mean that U.S. finance should remain the exclusive preserve of regulated banks. What I am recommending is that U.S. financial regulation be reconfigured to ensure that firms advance by virtue of sound strategy, not regulatory arbitrage. Let me outline three policy options that could permit tech finance to redesign the U.S. system without adding new risks or exacerbating inequality.

First is a "narrow bank" structure, which I think has significant advantages over the OCC's special-purpose fintech charter or some industrial loan companies from a policy perspective and often also for bottom-line purposes. Narrow banks are simply those that take deposits or house funds used for financial activities only in no- or low-risk assets. The IMF has posited this as the way to let tech-platform companies directly enter the payment system without the risks that would result due to tech firm complexity, leverage, and many of the other vulnerabilities described above.[10] The Fed is very, very wary of narrow-bank charters, but this is because it fears their impact on monetary-policy transmission,[11] but this isn't their necessary result. Narrow banks prohibited from taking consumer deposits, limited to payment activities, firewalled from the parent, and covered by an enforceable source-of-strength commitment are an option worthy of serious consideration that could advance quickly under current law without the need to reverse-engineer the framework of bank capital, liquidity, resolution, operational, and consumer-protection standards for tech-finance companies. Narrow banks might not solve for data-privacy or -integrity risk, but conflict-of-interest safeguards might.

Another option is best practices, although I am unpersuaded by their value in the absence of an enforcement mechanism. Still, it's worth noting a recent U.K. trade association report proposing best practices to safeguard consumer, market, and policy interests.[12] The idea here is to govern AI and ML fintech use through public statements and standards. New protocols could, this paper suggests, apply to privacy, conduct, cyber-resilience, and self-building or predictive-analytical models that may be ill-understood even by the companies that deploy them. In the U.K., these codes can be more easily enforced by the Bank of England and other regulators; in the U.S., it would take self-regulatory organizations or similar bodies to do so. These have worked well – if not always flawlessly – for years in the retail-brokerage arena. They are worth a hard look for tech finance.

What of other financial products offered by just one firm, aimed at businesses, or providing core infrastructure? Here, there are clear remedies readily at hand in U.S. law. First is the activity-and-practice framework FSOC has now adopted to short-circuit risk to financial stability and, to a lesser degree, those putting vulnerable households at risk.[13] FSOC also has formidable power to designate companies in the payment, settlement, and clearing arena as "financial market utilities" (FMUs), stating recently that nothing in its general reluctance to designate nonbanks applies to FMUs. Both activity-and-practice and FMU-designation create tools with which to ensure that like-kind activities and practices come under like-kind rules. While cumbersome and complex, they nonetheless also provide opportunity under current law to encourage innovation without at the same time enabling risk-taking.

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Let me conclude by reiterating that protecting banks from innovative competitors is no more warranted than protecting banks from broader market forces – banks must adapt and rules should help them do so. However, rules should also ensure that all providers of bank-like products abide by bank-like rules, rules revised as needed to ensure safe, equitable, and stable financial innovation. The current patchwork of regulatory standards and all its wide-open spaces enable financial institution design for maximum regulatory-arbitrage advantage, not for best-possible innovation and safe, competitive, and equitable product offerings.

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[1] Financial Stability Oversight Council (FSOC), 2019 Annual Report, December 4, 2019, available at https://home.treasury.gov/system/files/261/FSOC2019AnnualReport.pdf.

[2] See for example Financial Stability Board, BigTech in finance market developments and potential financial stability implications (December 9, 2019), available at https://www.fsb.org/wp-content/uploads/P091219-1.pdf; FSB, Third-party dependencies in cloud services considerations on financial stability implications (December 9, 2019), available at https://www.fsb.org/wp-content/uploads/P091219-2.pdf; Bank for International Settlements (BIS), Big tech in finance: opportunities and risks, BIS Annual Report Economic Report, (June 30, 2019), available at https://www.bis.org/publ/arpdf/ar2019e3.pdf; FSB, Decentralized financial technologies report on financial stability, regulatory and governance implications (June 6, 2019), available at https://www.fsb.org/wp-content/uploads/P060619.pdf; FSB, FinTech and market structure in financial services: Market developments and potential financial stability implications (February 14, 2019), available at https://www.fsb.org/wp-content/uploads/P140219.pdf; and FSB Artificial intelligence and machine learning in

financial services market developments and financial stability implications (November 1, 2017), available at https://www.fsb.org/wp-content/uploads/P011117.pdf.

[3] Brendan Pedersen, "Citi's Corbat warns banks: Don't become 'the dumb utility,'" *American Banker*, November 20, 2019, available at https://www.americanbanker.com/news/citigroups-corbat-warns-banks-dont-become-the-dumb-utility.

[4] Basel Committee on Banking Supervision, Implications of Fintech Developments for Banks and Bank Supervisors (February 19, 2018), available at https://www.bis.org/bcbs/publ/d431.pdf.

[5] Karen Petrou, Making "Responsible Innovation" a Reality: Big Tech, Small Money, and U.S. Economic Equality (February 4, 2019), available at http://www.fedfin.com/info-services/issues-in-focus?task=weblink.go&id=486.

[6] Shoshana Zuboff, *The Age of Surveillance Capitalism: The Fight for a Human Future at the New Frontier of Power*, (New York: PublicAffairs, 2019).

[7] Tom Wheeler, "Who makes the rules in the new Gilded Age?," *Brookings Institution*, December 12, 2018, available at https://www.brookings.edu/research/who-makes-the-rules-in-the-new-gilded-age/.

[8] FRB, *Report on the Economic Well-Being of U.S. Households in 2018*, 2 (May 23, 2019), available at https://www.federalreserve.gov/publications/files/2018-report-economic-well-being-us-households-201905.pdf.

[9] *Ibid* at 23.

[10] Tobias Adrian and Tommaso Mancini Griffoli, The Rise of Digital Money, *IMF FinTech Notes No. 19/001* (July 15, 2019), available at https://www.imf.org/en/Publications/fintech-notes/Issues/2019/07/12/The-Rise-of-Digital-Money-47097.

[11] Federal Reserve Board (FRB), Regulation D: Reserve Requirements of Depository Institutions, Advance notice of proposed rulemaking, Fed. Reg. Vol. 84, No. 48, 8829, available at https://www.govinfo.gov/content/pkg/FR-2019-03-12/pdf/2019-04348.pdf.

[12] UK Finance, Sustainable Financial Services in the Digital Age (May, 2018), available at https://www.ukfinance.org.uk/system/files/Financial-Services-in-the-Digital-Age-FINAL.pdf.

[13] FSOC, Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 12 C.F.R § 1310 (2019), available at https://www.govinfo.gov/content/pkg/FR-2019-12-30/pdf/2019-27108.pdf.