FedFin Client Report

Thursday, December 3, 2020

FedFin Forecast: 2021, the Year Digital Becomes Financial

Client Report: **DIGITAL6**

Executive Summary

Even though 2020 was of course preoccupied by the pandemic, there was no scarcity of the oft-repeated nostrum that law and rule must define the future of digital finance. True enough, but there was little substantive policy change even as Amazon became still more imperial, Libra turned itself into Diem despite demands that global stablecoins stand still (see FSM Report **CRYPTO14**), one U.S. regulator – the OCC – tried to do digital finance on its own (see FSM Report **CRYPTO15**), another U.S. regulator decried the ability of banks to ensure inclusive digital finance, and the Fed took ever-cautious steps to instant payments (see FSM Report **PAYMENT20**) and CBDC (see Client Report **CBDC3**).

Despite these halting moves, the pandemic accelerated the digital transformation of both retail and wholesale finance. As a result, 2021 will be an inflection point. Either adroit, powerful, and seemingly-insatiable firms will define digital finance around, through, and with regulated companies or antitrust authorities, legislators, and regulators will move quickly and preemptively to define key terms of engagement. Given macroeconomic stress, financial-market risks, and continuing political dysfunction, FedFin forecasts a framework in which regulatory arbitrage will define comparative advantage leading to eventual policy change largely ratifying a new tech-finance landscape in concert with retrofitting some safety-and-soundness, privacy, and consumer-protection standards. This report goes in depth on these trends and the strategic decisions that will prove critical to shaping them early in the new year.

Analysis

One forecasting caveat: in addition to the uncertainties created by the U.S. political transition and global pandemic, there is another unknowable dictating the future of digital finance and most other financial-policy outcomes: crisis or scandal. If a major fintech company is found to have harmed consumers, a cyber-incident scrambles transactions, another crypto miner shuts down, or any other large-scale debacles occur, policy will be quickly reprioritized to address those challenges, letting long-term, structural realignment proceed without intervention. Another over-arching consideration – the extent to which Congress and/or the Biden Administration alters antitrust law to censure BigTech – also affects the future of digital finance, but only indirectly unless or until considerations turn from merchant access, competing apps, and press-freedom to finance. To be sure, any near-term express tech-platform acquisition allowing direct financial-sector entry will come under stringent antitrust review under existing DOJ/FTC policy and pending guidelines for finance (see Client Report **MERGER5**) will be quickly tightened to reach into tech. With this in mind, we believe that key 2021 decision points include:

- Who Owns Consumer Financial Data: This is perhaps the most important threshold question of all of those dictating the future of digital finance given that data is increasingly at least as powerful a source of capital as money. The U.S. would need a significant statutory rewrite to construct the open-banking system now required in the EU, but the CFPB has recently restarted a long-stalled inquiry (see FSM Report **DATA**) that could still alter the balance of power between legacy financial companies, the platforms/fintechs, and consumers. Given the highly-preliminary nature of the request, the lengthy transition to a new CFPB director, and many other pressing challenges, consumer-data ownership will be decided more by who has the data than by who wants it.
- New Charters: Companies ranging from GM to SoFi are racing to obtain industrial-bank or even national-bank charters from the FDIC (see FSM Report **ILC14**) and OCC, with the FRB even very occasionally lending a hand by allowing new fintech owners to operate within the folds of a bank holding company. We expect this to continue into 2021 for carefully-constructed transactions, but we think applications from tech-platform companies (e.g., Google, Rakuten) will face added scrutiny on financial-policy and antitrust grounds. As chartering options develop and the role of national bank "partnerships" evolves (see below), tech firms seeking access to retail customers without the need also for low-cost funds will work with banks willing to allow them "top-of-wallet" rights. The size of the banks amenable to these alliances, the ability of legacy banks on their own to control the top of the wallet, the success of evolving arrangements, and the ability of tech-platform and fintech firms to access the payment system (see below) will determine the extent to which new charters are needed by new-entry financial companies or those seeking to add finance to their platforms.
- Partnerships: The OCC has made it clear not only that federal charters provide preemptive protection (see FSM Report **PREEMPT35**), but also that federally-chartered banks will be held liable for the consumer-protection standards and prudence of those with which they partner. We expect this standard to remain under a Biden appointee, but the bank-accountability requirements may well be codified into an express rule or even statutory requirement. Control of the Senate will determine the prospects for a national usury ceiling that would alter the appeal of many current arrangements.
- Payment Systems: The plumbing of the national and global financial system is being redesigned and the extent to which nonbanks gain access to it will have profound strategic impact in 2021 and thereafter. Global regulators are open to nonbank access to cross border payments (see FSM Report **PAYMENT21**), but this is

because most central banks have direct authority over nonbank financial companies. This is not the case in the U.S., leading the Fed so far to restrict its systems to regulated banks (see FSM Report **PAYMENT17**). We do not think this will last in the U.S., with the Fed over time likely to open its systems to tech-platform and fintech firms if sufficient sterile reserves are posted against payment exposures. What these reserves are, how sterile they must be, and the standards governing interchange fees will have far-reaching strategic impact on legacy banks, as will the extent to which national banks use new OCC authority (see FSM Report **CHARTER27**) to become members of non-traditional payment systems. Core processors are the most likely near-term providers of new payment portals, but numerous fintechs and even tech-platform entries are possible. U.S. CBDC remains years off, but new postal-banking options and "FedAccount" constructs (see *Client Report* **CBDC2**) are likely from the Biden Administration (see forthcoming FedFin report).

- Crypto-assets: Reflecting longstanding Fed concern – not to mention downright Democratic opposition to stablecoins – a Yellen Treasury Department will take a very, very cautious stand on crypto-assets deferring to the Fed but strongly resisting Facebook's Diem and other stablecoin or crypto options without significant statutory change giving the U.S. central bank and financial regulators considerably more influence over such offerings. The AML/CFT risks on which stablecoin providers have generally focused are in some ways the least of U.S. concerns, which range over questions such as the extent to which monetary policy could be transmitted, challenges to financial stability, and risks to vulnerable consumers increasingly taking center stage. Congress will ultimately determine the U.S. crypto construct, leading to incremental offerings, small transactions, occasional partnerships with regulated banks, and other ventures that – while potentially very profitable to providers – have minimal structural impact.
- DLT: While nominally crypto-assets, DLT money transactions do not necessarily face the obstacles of pure crypto-assets if they are used in permission, wholesale, or other contexts under a federal financial regulator. We expect significant progress in "smart-contract" custody services and agency work on embedded supervisory and regulatory tools that expand the ability of this technology to power and speed financial transactions.

NOTE: This report is a brief summary of critical developments and FedFin forecasts. Clients are reminded to call or note via email any additional matters on which they have questions or seek assistance.

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