**Monday, November 21, 2022**

# Treasury Plumbs the Depth of Nonbank Finance, Seeks New Merger Policy, Rules

**Client Report: FINTECH31**

## Executive Summary

As promised, this report provides an in-depth analysis of Treasury's report and resulting recommendations to the President's Competition Council on the impact of new nonbank consumer-finance entrants from a competition, consumer-protection, and financial-stability perspective. Although the report calls for reconsideration of bank-merger policy with an eye to the growing role of fintechs and bigtechs, its overall view of market power fails in our view to capture the actual landscape in which these important new entrants compete with banks. For example, its focus on deposit-market concentration compares banks principally to neobanks, failing to consider deposit-like products such as prime MMFs and in many cases also credit-union deposits. As a result, erroneous conclusions are drawn about market power that exists when all competitors – not just bigtechs or fintechs – are considered. Similar methodological challenges appear with regard to lending markets, where banks are assessed versus new entrants without much regard to competitors such as nonbank mortgage firms (conflated with fintechs in some statistics) and payday or subprime auto lenders. Combining new fintechs with incumbent nonbanks also leads to confusion over the extent to which Treasury's recommendations are intended to apply to all nonbanks, but in many cases this is likely given the focus also on regulatory arbitrage. That said, this report provides an exhaustive analysis based on 460 footnotes of markets, regulation, and policy considerations across an array of consumer-finance products with competitive and policy implications for firms in each sector. Its clearest recommendations reinforce ongoing CFPB rulemakings in areas such as data rights and put pressure on the banking agencies to update and in some cases toughen standards for mergers, alternative approaches to credit underwriting, third-party fintech relationships, small-dollar lending, and data use.

## Analysis

New entrants assess include:

- bigtechs;
- fintechs; and

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- retail firms (all others). Despite this statement, firms that are neither fintechs nor bigtechs are rarely taken into account in specific markets or product segments.

Incumbent firms – apparently defined as those which entered consumer finance before 2010 – are not included in the analyses below although in several cases – e.g., data on nonbank fintechs in the mortgage sector – incumbent and fintech data may be conflated.

Competition-related conclusions include:

- Banks and the nonbanks noted above compete and collaborate, making competitive implications complex, especially in the absence of official data on the nonbank sector.
- Banking concentration (which may be a poor measure of market competition) has grown but is the result of consolidation at all bank size levels, not only the growth of large banks. The reduction in the number of bank branches may reflect consolidation, but also that of lingering effects of the 2008 crisis, technology adoption, and other factors. However, branch closures are most acute in majority-minority and rural communities and thus require consideration in merger policy.
- Banking is generally both vertically and horizontally integrated, while nonbank entrants unbundle financial intermediation and infrastructure and consumer data in ways not amenable to current bank-merger analytics. The report includes an extensive discussion of unbundling and re-bundling at various points in consumer interactions, in bank/nonbank relationships, and across the value chain.
- Because concentration is dubbed a problematic measure of market competition, the paper also looks at bank-income growth as a proxy for uncompetitive mark-ups. It finds limited evidence that may be explained in some or most part by externalities, also using net interest margin as the income proxy even though we would note the critical importance of fee income in recent years.
- Competition via new bank charters is limited, but nonbank entrants have proliferated. Increasing control to the point of entry for consumer financial services, especially for payment and lending.
- Bigtech firms are particularly problematic in terms of market power.
- Bank control over the payment system is waning along with increasing concentration of core-service providers. Competition impacts are uncertain, but an array of risks is growing.

Consumer-protection and inclusion conclusions include:

- Although fintechs may enhance inclusion, consumer-protection concerns are significant and judging this balance thus requires additional study.
- An array of risks is detailed in terms indicating Treasury has concluded that inclusion benefits are outweighed by risk and regulatory-arbitrage opportunity; new rules "must" thus be quickly imposed.

### *Risks and Opportunities*

This section of the report details the regulatory framework for insured depositories and BHCs and then contrasts it for entrant and, by inference, incumbent nonbanks. It is largely a review of existing standards or the absence thereof for individual charters and product lines. This section also includes an extensive discussion of consumer-data use and risks, often echoing the CFPB's pending inquiry (see FSM Report **DATA3**).

Recommendations include:

- The banking agencies and Department of Justice need to revamp bank-merger policy. How best to do so nor is the long-pending request for comment (see FSM Report **MERGER10**) discussed other than by reference to it having been issued.
- Credit underwriting should be reformed to enhance the availability of debt that enhances wealth equality and preserves income. Alternative scores could enhance competition as well as increase sustainable credit availability, but more data, especially through the cycle, are needed to demonstrate this. Algorithmic lending exacerbates the risks of traditional underwriting and should be reformed, but at the same time also encouraged to increase consumer welfare and competition.
- Due to the prevalence of bank/nonbank partnerships, Federal banking agencies can set new standards that may govern the industry more generally. The banking agencies are also urged to work with banks and develop standards to develop new underwriting techniques and model-validation to advance these under appropriate consumer-protection standards.
- The banking agencies are also urged to govern bank/nonbank fintech relationships with more clarity and thoroughness by finalizing long-pending standards for third-party relationships (see FSM Report **VENDOR9**) with tighter contractual requirements, thus holding banks responsible for fintech partners in order to extend the reach of federal standards.
- New rules should restrict high-cost small-dollar lending products often offered through bank/fintech partnerships and encourage responsible short-term, small-dollar products via new supervisory guidance.
- Supervision should increase for fintech alternative lending (i.e., with non-traditional cores). The CFPB is urged to continue its work supervising and enforcing consumer protections regarding small-dollar loans, to issue guidance in this area, and to expand its supervision to the largest nonbank lenders.
- The CFPB is also urged to act on the data-rights proposal noted above, as well as considering the use of its authority to govern data aggregators. The banking agencies are also encouraged to review current standards for third-party data aggregators and data users along with related cyber-security standards, reaching coverage to "fourth users."

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