FTA
FINANCIAL TECHNOLOGY ASSOCIATION

Fintech Regulation, Explained

Modernizing Financial Policy to Drive Inclusion and Innovation

Executive Summary

Financial technology ("fintech") has gone mainstream, with nearly nine in ten Americans using some form of fintech in the last year.[1] From lending and payments to investing, fintech fills the gaps left by traditional financial services with safe, transparent, and consumer-centric products that lower costs and foster inclusion.

The rise of fintech adoption has sparked discussions around appropriate regulations to govern these new technologies. Today, federal and state regulators apply essential consumer protection laws and regulations to fintech providers. Yet, in many instances, modernized financial regulatory policies can help ensure that consumers, small businesses, and the broader economy reap the benefits of responsible fintech.

This white paper from the Financial Technology Association (FTA) outlines the current state of fintech regulation. It provides suggestions for improvements to further promote safe and consumer-centric innovation in financial markets and services.

Key Findings Include:

- ➔ Fintechs play a crucial and wide-ranging role in modern financial services, improve technological capabilities, and enhance financial choice and outcomes for consumers, small businesses, and market participants.
- ➔ Fintechs are subject to robust oversight by state and federal financial regulators. They must comply with a range of laws designed to protect consumers and ensure the safe and sound operations of financial institutions.
- ➔ Policymakers should prioritize forward-leaning, modern regulatory frameworks that continue to spur innovation while safeguarding consumers, including:
    - ◆ Supporting public-private standards-setting organizations and certification mechanisms, as well as enhancing third-party risk management guidance to foster further technology adoption and safeguard our financial system.
    - ◆ Supporting and encouraging fintech-bank partnerships to provide consumers and small businesses with improved access to capital and financial services.
    - ◆ Harmonizing the payments regulatory framework through streamlined state-level regulation and related oversight and examination processes for fintech firms.
    - ◆ Recognizing broad federal regulator chartering authority and fostering viable paths for fintech applicants to advance innovation and competition in financial services.

[1] Plaid, *The Fintech Effect: Fintech's Mass Adoption Moment* (Oct. 12, 2021), available at https://plaid.com/blog/report-the-fintech-effect-2021.

Introduction

Technology-driven innovation is transforming financial services and markets across the United States. By using internet and mobile platforms, machine learning, automation, and other modern technologies to deliver financial products and services, financial technology ("fintech") companies are filling gaps in the financial system by improving efficiency and transparency, broadening equity, access, and inclusion, reducing costs, and increasing financial choice and opportunities. For consumers of financial services, fintech innovations mean the difference between promptly receiving wages or having to pay a costly overdraft fee, receiving a small business loan in the face of an unexpected cost or temporarily ceasing operations, and building financial wealth or facing constant economic insecurity.

The benefits of fintech innovation and competition are clear, yet many fail to understand the regulatory landscape underpinning fintech's advances.[2] Far from being an unregulated "Wild West," fintech companies – similar to traditional banks in many respects – are subject to licensing, supervision, and enforcement by state, local, and federal regulators, depending on their activity.

The following white paper outlines the current state of fintech regulation. It further offers lawmakers and regulators suggestions for modernizing existing regulatory frameworks to protect consumers best, responsibly advance innovation, and encourage competition for financial services.

Fintechs play a crucial and wide-ranging role in modern financial services, improving technological capabilities and enhancing financial choice and outcomes for consumers, small businesses, and market participants.

Despite the broad use of the term "fintech," innovative technology-centered financial services firms are not homogenous in their structure, offerings, or regulatory designations -- they support the financial system and consumers in several different ways, including in the following capacities:

1. **Vendors & Technology Solutions.** As technology vendors or providers supporting financial services firms and consumers: for example, AI/ML credit underwriting software and anti-money-laundering compliance tools;
2. **Bank Partners.** As customer-facing technology platforms that partner with banks or other financial institutions to provide financial services to consumers and businesses: for example, a consumer-facing platform that partners with a bank to offer consumer loans; and

[2] Ibid.

3. **Direct Providers.** As federal- or state-chartered or licensed financial institutions: for example, a state-licensed lending platform, a payments provider, a digital bank, or a robo-advisor.

As detailed in the following section, regardless of the business model chosen by a particular fintech, a broad range of federal and state laws and regulations govern critical activity, safeguard consumers and small businesses, and promote competition.

Fintechs are subject to oversight by state and federal financial regulators and must comply with a range of laws designed to protect consumers and ensure the safe and sound operations of financial institutions.

While FTA strongly supports further modernization of existing financial regulations that can advance a technology-driven and consumer-centric future of finance,[3] the existing landscape for the fintech industry is far from a "Wild West." On the contrary, **fintechs are subject to the same activities-based and entity-based regulatory frameworks that govern the entire U.S. financial services industry and have done so for many decades.** As such - whether serving as a vendor, partner, or direct provider - fintech companies must comply with a range of financial laws and regulations set and enforced by federal, state, and local governments.

Fintech Vendors and Technology Solutions

To the extent that a fintech serves as a vendor or technology provider to a chartered bank or financial institution, the fintech is subject to consumer protection laws (as detailed in the partnership section below) and banking regulation through third-party risk management requirements. For example, fintechs that provide AI/ML underwriting solutions to lenders are subject to CFPB oversight of fair lending requirements under the Equal Credit Opportunity Act (ECOA) and its implementing regulation ("Reg B").

Additionally, federal banking regulators issue guidance and impose requirements on their chartered entities that incorporate or partner with fintech solutions. Subject to these requirements and federal oversight, banks are ultimately responsible for ensuring the safety and soundness of their operations and the fair treatment of customers. The banks, however, impose the same compliance requirements on the vendors. Further, federal third-party risk management guidelines

[3] For example, the FTA supports codifying a consumer's right to his or her financial data pursuant to Dodd Frank Section 1071 and argues in favor of enhancing international payments pricing transparency through revision of the Remittance Rule.

provide banking regulators with discretion to "examine the functions or operations performed by a third party on the banking organization's behalf."[4]

Moreover, fintech infrastructure layer firms who provide services to fintechs, like aggregators, are subject to consumer laws and have asked for supervision in an anticipated Dodd-Frank 1033 rulemaking on consumer financial data sharing. Notably, fintech companies are generally amongst the most vocal proponents of empowering consumers by unlocking their personal financial data.

Key Policy Takeaways:

➔ Financial institutions have procured or incorporated new technologies and related vendor solutions for decades -- it is what has helped keep the financial services industry in the United States the most innovative and dynamic in the world. Regulators have a proper framework to foster further technology adoption and safeguard our financial system and should continue to advance principles-based compliance frameworks.

Recommendation:

➔ By further clarifying third-party risk management guidance and encouraging public-private standards-setting organizations (SSOs) and certification mechanisms, regulators can encourage technology adoption, especially by community banks, and ensure the safety and soundness of the financial system.[5]

Fintech Partnerships

In other instances, fintechs play a more prominent customer-facing role than traditional vendor relationships. These relationships may involve lending activity or payments services facilitated through a fintech and bank partnership. By partnering with a fintech, community and midsize banks or credit unions can expand their reach and more effectively compete with the largest banks.

These partnerships (as with other third-party technology solutions noted above) are subject to a broad range of federal and state laws and regulations, including around anti-money laundering, fair lending, unfair and deceptive trade practices, credit reporting, debt collection, privacy, fair treatment of customers, and electronic fund transfers. Put simply, consumer protection laws apply.

Additionally, as with fintech vendors, fintech-bank partnerships are subject to robust regulatory oversight and guidance. For example, the FDIC has issued prior guidance to help banks and

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[4] *See* Fed, FDIC, and OCC, *Proposed Interagency Guidance on Third-Party Relationships: Risk Management* (July 19, 2021), available at https://www.federalregister.gov/documents/2021/07/19/2021-15308/proposed-interagency-guidance-on-third-party-relationships-risk-management.

[5] *See* FTA, *Response to Request for Comment on Proposed Interagency Guidance on Third-Party Relationships: Risk Management* (Oct. 18, 2021), available at https://www.ftassociation.org/wp-content/uploads/2021/10/FTA_Response-to-Third-Party-Risk-1.pdf.

fintechs navigate lending partnerships,[6] and the FDIC and OCC have direct visibility into lending and payments partnerships through the chartered banking entity.[7]

Key Policy Takeaways:

➔ Policymakers and regulators should support and encourage fintech-bank partnerships that provide consumers and small businesses with improved access to capital and financial services and expand the reach and competitiveness of smaller financial institutions.[8] While the existing regulatory framework ensures rigorous oversight of lending partnerships and enforcement of consumer protection laws, ongoing legal challenges have created degrees of confusion and instability for such relationships.

Recommendation:

➔ To create a stable environment for partnerships, state and federal policymakers should act decisively and craft a forward-leaning consensus on standards for responsible lending partnerships.
    - A recent settlement in Colorado between the State Attorney General and bank-fintech partners, which created an effective safe harbor for such partnerships, might serve as a baseline for harmonizing a consistent, national approach that includes consumer protections.[9]

Fintech Licensure & Chartering

Some fintechs engage in specific activities that require licensure -- typically at the state level -- or seek banking charters to avail themselves of privileges associated with banking, including streamlined oversight, access to the federal payments system, and/or the ability to offer federally-insured deposit accounts. State-based licensure and bank chartering frameworks generally impose

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[6] FDIC, *Supervisory Insights: Winter 2015*, available at https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin15/si_winter2015.pdf; FDIC, *Conducting Business with Banks: A Guide for Fintechs and Third Parties* (Feb. 2020), available at https://www.fdic.gov/fditech/guide.pdf.

[7] Carl White, *Regulating Fintech: One Size Does Not Fit All*, Federal Reserve Bank of St. Louis (Feb. 24, 2021), available at (https://www.stlouisfed.org/on-the-economy/2021/february/regulating-fintech-one-size-does-not-fit-all (noting that "[f]intech firms that partner with banks need to meet the required licensing requirements and submit to supervision from state regulatory authorities; their bank partners are still supervised by federal and state banking agencies, depending on charter type.").

[8] *See* Fed, FDIC, OCC, and NCUA, *Interagency Lending Principles for Offering Responsible Small-Dollar Loans* (May 2020), available at https://www.fdic.gov/news/press-releases/2020/pr20061a.pdf (noting that banks "could include effectively managed deployment of innovative technology or processes for customers who may not meet a financial institution's traditional underwriting standards. Such programs can be implemented in-house or through effectively managed third-party relationships.").

[9] Jeremy T. Rosenblum, Alan S. Kaplinsky, Mindy Harris & John L. Culhane, Jr., *Colorado Settlement Provides a Possible Path Forward for Certain Bank-Fintech Online Lending Partnerships* (Aug. 24, 2020), available at https://www.consumerfinancemonitor.com/2020/08/24/colorado-settlement-provides-a-possible-path-forward-for-certain-bank-fintech-online-lending-partnerships/.

requirements proportionate to the risks posed by the entity. For example, an entity that takes insured deposits poses a higher degree of prudential risk than a non-depository lender.

State-Based Licensure

Fintechs that directly provide certain financial services to consumers and small businesses must secure state-based licenses. For example, fintechs engaged in lending, money transmission, and cryptocurrency exchange activity must obtain a license to engage in such activity in each state in which they operate (sometimes all 50). State regulators conduct examinations, impose capital and liquidity requirements, define permissible investments, and enforce consumer protection laws.[10] These licensed non-bank fintech firms are also subject to the same consumer protection laws identified in the section above as banks.

Key Policy Takeaways:

➔ Importantly, state-based licensing frameworks do not connote a lack of regulation; to the contrary, they rely on tailoring laws and regulations to the risks posed by particular financial activities. They can further allow for business model innovation and optionality. However, navigating 50 different state licensing and oversight regimes can be onerous for fintechs.

Recommendations:

➔ FTA strongly supports the Conference of State Bank Supervisors' (CSBS) ongoing efforts to streamline state-level regulation and related oversight and examination processes for fintech firms.

➔ FTA further supports the CSBS-sponsored uniform money transmission law and believes that state adoption can advance a more unified and efficient payments regulatory framework at the state level.

Fintech Bank Chartering & Federal Licensure

Some fintechs have or are seeking to become chartered or federally licensed financial institutions in return for associated privileges. Securing a banking charter or federal license to serve as a financial markets intermediary (e.g., a securities broker-dealer or investment advisor) subjects the entity to enhanced regulatory oversight, which many fintechs welcome, especially if it comes with a harmonized regulatory framework. The decision, therefore, to charter or license involves trade-

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[10] The Conference of State Banking Supervisors (CSBS) works to support state regulators to achieve coordination and consistency. CSBS has recently announced a 'Networked Supervision' approach to support collaboration between states and has continued to promote consistency and efficiency in applying state-level oversight. The multistate money services business licensing agreement, for example, is designed to streamline the money transmitter licensing process.

offs with respect to the privileges such a path offers, as well as the involved costs and potential limitations on activities.

Choice in terms of business models and associated regulation is not new. It is what has permitted economic dynamism, financial innovation, and competition in the U.S. -- all to the benefit of consumers, small businesses, and market participants.

It has long been the case that federal financial regulators have the authority and expertise to charter or license a broad range of financial services activities and entities. This is necessary as the business of banking and finance is constantly evolving.

It has also long been the case that federal regulators can tailor requirements to match the involved business models so that they can mitigate identifiable risks and not unnecessarily constrain innovation. It would be improper, for example, to subject a credit card bank to an identical set of requirements as would be imposed on a full-service depository institution -- this would fail to mitigate identifiable risks, limit business model innovation, and reduce consumer choice. Accordingly, it is prudent to take a risk-based approach to tailored oversight to permit business model competition and innovation.

Key Policy Takeaways:

- ➔ A sound regulatory approach to chartering leverages existing paths for new entrants, including fintechs, seeking the advantages and benefits a charter may confer, especially when this results in heightened regulatory oversight and greater financial services competition.

Recommendations:

- ➔ The FDIC should accordingly continue issuing ILC charters to fintechs predominantly engaged in financial services; the FDIC has emphasized its focus on safety and soundness by imposing capital and other requirements on recent ILC applicants that exceed those typically imposed on traditional de novo banks and ensured that the parent company of the ILC would serve as a "source of financial strength" for the ILC.
- ➔ The OCC should use its broad chartering authority to include fintechs and uninsured depositories whose parent is not subject to the Bank Holding Company Act (BHCA) because it has authority to impose restrictions and requirements on both the bank and its parent company, including significant capital and liquidity commitments intended to ensure that the parent company will serve as a source of strength.
- ➔ Policymakers should additionally explore additional new charter frameworks that properly capture the nature of financial services innovation and tailor requirements to mitigate identifiable risks; special-purpose charters are worthy of implementation, as is an exploration of a new fintech charter focused on digital-only companies that are

predominantly engaged in financial services and whose parent company is supervised by the Fed.

Conclusion

Fintech innovation comes in many different shapes and sizes. The U.S. financial regulatory system has the tools and capacity to keep pace with this innovation, whether fintech firms serve as vendors, partners, or direct providers. Key to the ongoing dynamism of financial services in America is regulatory adherence to common-sense principles of tailoring requirements to mitigate identifiable risks and imposing such conditions in a proportionate way to those risks. By focusing on the application of existing consumer protection laws to financial services activities, while simultaneously fostering diversity and competition amongst financial services providers, regulators can best serve consumers, small businesses, and the broader economy.

About Us

The Financial Technology Association (FTA) is a non-profit trade organization that champions the transformative role of financial technology for American consumers, businesses, and the economy. Representing some of the leading fintech companies, FTA educates consumers, regulators, policymakers, and industry stakeholders on the value of technology-centered financial services and advocates for the modernization of financial regulation to support inclusion and innovation.

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