Regulating Financial Institutions: Different for FinTechs

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To manage their money, a majority of Americans use some form of digital banking (Strohm, 2022). Just over a decade ago, the share was zero. Thereafter thousands of Financial Technology (FinTech) companies transformed the financial services industry by offering services previously unavailable to most Americans. FinTech has been profitable, but it has also been much less regulated than the financial institutions that predate them. Any consequent risks matter. FinTech companies control billions of dollars of customers' money; investors have put hundreds of billions more in them. Americans depend on the security of FinTech whether they use the new services or not (Crunchbase qtd. in Wilhelm, 2022).

In more recent years, industry groups representing FinTechs, traditional banks, and advocacies for consumer protections have competed to influence the regulatory regime to which FinTech companies are subject. The FinTech companies stress the opportunities that the relatively unrestrictive regulations currently permit. Customers and regulators, however, have warned of the risk of catastrophe in the event of mismanagement or financial crisis. Traditional financial institutions contend that the stricter regulations they face prevent them from competing with FinTechs. Subjecting FinTechs to regulation like those that govern banks would risk stifling the innovation and customer benefits these new companies bring to finance.

Review of Research

Due to the novelty and fluid nature of FinTech regulation in America, limited analysis has been published on the subject. Recent research by the World bank on FinTechs primarily "identifies a range of consumer risks posed by fintech," and then "discusses consumer protection regulatory approaches emerging internationally for policy makers to consider when developing

regulatory policy" (World Bank, 2019). In this research, the World Bank does not consider how the role of traditional banks could evolve in the space and how the regulatory approaches to these older firms could be adjusted to allow them to better serve consumers and compete with FinTech. The World Bank's suggestions are also not specific to the United States, rather for a broader international stage, which does not consider how domestic industry groups compete to influence the political and subsequent regulatory agenda around FinTechs. The World Bank has also conducted research on improving regulation on different parts of finance. In the late 1990s, the World Bank investigated pension fund regulations, specifically to "examine whether there is scope for improvements in pension regulation, particularly in light of regulatory and supervisory developments in the banking industry" (Rocha, 1999). While the contentions made in this research do not contain direct parallels to regulation of FinTech firms, the analysis used to evaluate policy and arrive at solutions are very relevant. The "developments" that the research mentions are also not as significant or digital as the recent developments in FinTech, but the claims the research makes are still useful.

Prior research also includes when Busch (2001) examined regulation of banks in six European countries during the turn of the century. At that time the financial services industry was experiencing innovation in the form of digitalization similar to what consumer banking has seen recently (Busch, 2001). Unlike FinTechs however, adoption of the provided services was not as rampant, the innovation not as dramatic and unregulated, and the regulatory environment itself was not the same as in the United States. Around the same time, the United States Securities and Exchange Commission conducted research on payment for order flow (SEC, 2000). Payment for order flow is a popular technique employed by certain FinTech companies, especially exchanges and trading platforms. As options became more popular in public markets, the SEC (2000)

became concerned about information asymmetry with consumers, quality of service, and the integrity of the markets. Despite originating decades before FinTechs, payment for order flow is still utilized in certain applications and many still have similar concerns about the practice. More recently, the Congressional Research Service conducted a study on the state of regulation on payment for order flow (Shorter, 2023). The report includes examples of implementation of the technique, proposed regulations, along with analysis of praise and criticism for each of the regulations (Shorter, 2023). While this research is inherently related to regulating FinTech, it is much too specific to be relevant to the entire industry. Payment for order flow is only used by certain trading platforms and exchanges while FinTech covers a broader scope of applications.

Like payment for order flow, specific research about regulating cryptocurrency has also been completed. The International Monetary Fund examined cryptocurrency as it gained a more public and popular presence (Narain, 2022). Their research focuses on striking a balance to allow for innovation, regulators worldwide need to catch up, and several international regulatory approaches (Narain, 2022). This research does not go into great detail about any of these aspects, does not apply specifically to the United States, and the approaches to regulation are also not relevant for a wide variety of FinTech applications. Research from William and Mary however gives specific advice for how to regulate intermediaries in the 'secondary market' of cryptocurrencies (Johnson, 2021). These are in effect the same trading platforms as the IMF describes but Johnson (2021) focuses away from the initial offerings of crypto that other researchers advocate intervening at and instead emphasizes regulating secondary markets to address concerns about misconduct, fraud, or theft. Since cryptocurrency is new and not well understood, there is no consensus view on how to best regulate the space. Another space that is potentially facing changed regulations and is also not well understood is social media. As data

use continues to be scrutinized and privacy and security valued by regulators, new regulation is constantly mentioned for social media platforms similar to that of FinTech applications. The Brookings Institution argues for transparency being at the center of regulating social media applications (MacCarthy, 2022). Transparency to end users, regulators, and researchers allows for the companies to face scrutiny from any or all of these parties in the public eye, something the research posits is an asset to keeping the platforms in line (MacCarthy, 2022). While this strategy may not be as effective with consumer money and FinTech, transparency based regulation is a possible solution to the lack of regulation and at times transparency with FinTechs.

FinTechs: The Great (Financial) Equalizer

FinTech companies focus on the financial opportunities they enable and the positive aspects of their products when describing current regulations. They do so in hopes of making any restrictions on how they conduct business seem unnecessary, oppressive, and actively against financial equality.

The Financial Technology Association (2023) claims that it “represents industry leaders shaping the future of finance” on its website. The site contains headlines such as “Transforming Financial Services” and self-written content explaining how “FinTech Supports Small Businesses” in an effort to convey strictly positive aspects of its members’ products and services (FTA, 2023). While their tone continues in describing FinTech policy, the underlying message differs. The trade association claims to “advocate for the modernization of financial regulation” that will “support inclusion and responsible innovation” in the United States financial system (FTA, 2023). On their “Sound Policy” page, after detailing ways financial innovations have

enabled a “equitable financial system for all,” the FTA (2023) posits that “Washington must enable this transformation, not slow it down” to convey regulators as detrimental to the adoption of new technologies, and thus opposing fairness and inclusion. The group omits that most enacted policies would serve as consumer protections for FinTech products, ultimately benefiting these consumers instead of hurting them. However, such regulations do not serve the best interests of FinTechs, causing a shift in focus to policies that are more like “rules of the road” or that provide “clear guidance” in their regulation (FTA, 2022).

Plaid, a FinTech company and FTA member, furthers this concept. On a webpage that appears as a news article, the company details fintech to those who may not be aware (Trificana, 2022). The “article” by Trificana (2022) includes positive language with each mention or description of fintech, from pointing out how “it’s beginning to reshape our financial world” to fintech serving as “a means to help consumers address financial challenges” and how they can “make progress toward financial goals”. The author continues by stating that “consumers report numerous benefits of using fintech including economic and time savings and reduced stress” upon citing a study conducted by Plaid itself (Trificana, 2022). Trificana (2022) repeats this throughout, insofar as describing specific benefits of Plaid services such as “Auth” and “Identity,” linking to them and other fintech services like “Dave, Brigit, and Astra” after explaining problems they solve. In what appears to the untrained eye as a news article, the fintech company misleads readers by running advertisements to its products by speaking specifically to their benefits. The page never describes downsides, drawbacks, compromises, or regulations with respect to FinTech.

FTX was a cryptocurrency exchange and a FinTech company until it went bankrupt in November of 2022. The downfall and subsequent bankruptcy of the firm was in part due to lack

of regulation. Since it was both an online securities and cryptocurrency exchange, much of its activity was unrestricted. FTX did face large amounts of regulatory scrutiny common for fintechs before its insolvency. In January of 2022, the company's then CEO, Sam Bankman Fried, gave an interview about regulation and the FinTech space and claimed "it's been a pretty tough struggle back and forth … for a while" despite his company not facing many of the same regulations as traditional exchanges (Revell, 2022). The CEO also believed in "some straightforward policy proposals that could solve for what regulators want" while also "allowing cryptocurrencies to really grow a lot as an asset class," reiterating that FinTech firms believe regulation should focus on facilitating their business and nothing more (Revell, 2022). Addressing "what regulators want" is akin to achieving transparency, proper data use, and consumer protections, while the "struggle" for FinTech companies is improving their public image, growth, and ultimately profits.

Opportunity's Cost: Concerns About Consumers, Security, and FinTech

Users, regulators, and competitors of FinTech firms all express concerns about the security of the sector's innovative services under current regulations. Consumer advocates and banks focus on data use transparency and funds management while regulators worry about risks posed to consumers and the American financial system in the event of an economic downturn. While the financial firms are ultimately advocating for their own profits, consumers and regulators hope to insure the safety of Americans and the money that these new firms control.

The National Consumer Law Center works "for consumer justice and economic security for low-income and other disadvantaged people" in the United States and expresses concerns on behalf of FinTech customers (Saunder, 2019). In a report detailing consumer protection and

fintechs, Saunders (2019) mentions that "innovation and fintech approaches are not invariably positive" and continues by explaining how "products may have hidden or unintended negative consequences" in addition to "risks that are not obvious at first" for consumers. The report later discusses specific concerns and potential problems like "Old wine in new bottles" for past consumer issues, "Disparate impacts and the perils of big data, privacy, and security" in terms of data use, and "Avoidance of consumer protection laws" to convey what that group considers disregard of consumer safety and FinTech firms focusing on profits over protecting their users (Saunders, 2019). While the advocates understand consumers' attraction to these innovative products and services, they remain skeptical of unregulated firms handling vast amounts of customer assets.

The National Association of Consumer Advocates, another group specializing in consumer protection, shares many of the same beliefs about FinTech impacts on consumer finance. While the National Consumer Law Center emphasizes inherent risks due to the nature of FinTech firms, the NACA describes "recognizable business practice[s]" of the new companies that they claim have "long haunted customers" of financial products since before finance and technology were intertwined (Myers, 2018). Myers (2018) describes such practices as including "forced arbitration clauses" that "deprive customers of the public court system and send them into secretive, private arbitration proceedings" and often "bar consumers from banding together in class actions" to fight against perceived financial malpractice. By including strategies that "appear to rely on providing innovative, accessible, user-friendly products that aim to simplify their customers' financial lives" while claiming consumers are deprived of many their rights and protections using fine print, FinTech companies are perpetuating predatory financial practices that have numerous consumer advocates concerned (Myer, 2018).

Financial regulators in the U.S. share sentiments on both the popularity of new payment methods and concerns about the control they have over their consumers. Chairman of the Federal Reserve Jerome Powell (2017) acknowledged that “technology is transforming the retail banking sector” and that “companies need not be bound by physical infrastructure” in the modern era. However, he also noted that “balance that needs to be achieved in this innovative environment” of financial services and the new, more convenient payment method must not “undermine the safety, security, and reliability” of preexisting financial services (Powell, 2017). This statement implies the current state of Fintech regulatory policy is not in balance and that adjustments in the form of increased regulation are needed to move towards balance. Chairman Powell (2017) also voiced concerns about interactions between traditional banks and FinTechs, citing an example of “screen scraping” or otherwise “finding ways to use banks’ data, in some cases without entering into an explicit partnership with the bank”. These practices are not only unauthorized use of customer and bank’s data, but also pose security risks to multiple parts of the financial system (Powell, 2017).

Leveling the Banking Field: Good for Everyone?

Traditional banks advocate for changes not only for how new financial service providers are regulated, but also for firms that have occupied the space since before the past decade. They argue FinTechs have an unfair advantage to innovate in the financial services industry by suggesting that traditional banks can not catch up under current legislation. These banks also claim that deregulation enables both greater fairness in banking and better services for customers, an action that would also enable new business opportunities.

The American Bankers Association, an industry group that represents traditional banks in the U.S., published an article on consumer views and preferences of traditional versus digital banks. They cite a study that claims "most consumers do not view digital banks as a "true alternative" to traditional banks" with the statistic of "39% of respondents said digital banks could be an alternative to traditional banks" as support (Williams, 2022). While Williams (2022) concedes that "the survey found that two-thirds of respondents were using digital banking services of some kind," the purpose of the article is seemingly to detract from the popularity of FinTechs given the headline "Most consumers stick to traditional banking over digital alternatives". The industry group emphasizes a small aspect of the survey results for the headline in addition to discussing supposed "concern for the overall security of their money and information" and states a fraction of those polled "did not trust digital banks' reliability or longevity" before mentioning the perceived usefulness of digital banking (Williams, 2022). By echoing concerns about digital banking, the banking group hopes FinTechs will face regulations that curtail their perceived benefits in order to address the worries and place the digital and traditional firms on the same playing field.

In his 2020 annual report to investors, Jamie Dimon, CEO of JPMorgan Chase & Co, a traditional bank, cited FinTech or evolving technologies in finance as 4 of the top 5 threats facing his bank at that time (Dimon, 2021). Dimon (2021) believes "AI, the cloud and digital are transforming how we do business," emphasizing the relevance of concepts at the core of FinTech business and that they are opportunities for traditional banks. Additionally, Dimon (2021) claims that "Fintech and Big Tech are here … big time!" to qualify the presence of the new firms in the market, and explicitly states "growth in shadow and fintech banking calls for level playing field regulation" when discussing policy. He later elaborates on how in the evolving financial sector,

"our government and regulators need to understand that maintaining the vibrancy, safety and soundness of this system is critical" including "maintaining a relatively fair and balanced playing field" to further the "open competition" he claims to support (Dimon, 2021). The traditional bank that Dimon leads is more heavily regulated than most FinTechs or digital banks, meaning that a "balanced playing field" could come in the form of either increased scrutiny on the new competition, or more relaxed legislation on institutions similar to his own.

Other traditional banks are less outspoken about their competition, but feel the same way. A survey conducted by PwC claims that "the majority of financial sector executives (73%) perceive consumer banking" as likely to be "disrupted by FinTech" in some way (Yazdani, 2016). The survey also asserts that the majority of bank senior executives believe the "rise of Fintech" will result in "loss of market share, pressure on margins, and customer churn" compared to before (Yazdani, 2016). While this demonstrates the concern of bank executives with regards to being competitive, their worries about consumers and data privacy can be seen in the more than 60% of respondents that believe an "information security/privacy threat" is imminent with the rise of FinTechs (Yazdani, 2016).

Conclusion

Whether through advocating for their own group or against opposing groups, each participant in the landscape of regulating FinTechs in the United States is fending for themselves. Each group values the money they have made, currently make, or hope to make through profiting as a company, taking advantage of financial products, or being elected to another term of office. Instead of adversarial interactions, the possibility of collaborative efforts exists between any combination of FinTechs, traditional banks, consumers, and regulators. Since this vein of

regulation is in its infancy, a number of developments could take place, changing the landscape of financial services just as FinTechs have already. In the current landscape, however, each of the groups relevant to FinTech regulation in the U.S. act in their own self interests.

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