Fintech 2022 Policy Outlook

Underappreciated risks and opportunities the industry will face this year

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CAPSTONE

Regulators Play Catchup with Fintechs

Fintech companies, which have sped their pace of innovation amid the COVID-19 pandemic, will face an accelerated pace of regulation in 2022 as President Biden's team begins addressing its priorities.

- Key regulators will push forward two key rulemakings on consumer financial data ownership and small business lending data collection.
- The CFPB will ramp up efforts to monitor payments innovations and scrutinize the buy now, pay later (BNPL) industry and large tech payment platforms.
- Regulators will further define what kinds of fintech-banking relationships are appropriate and clarify the scope for fintech bank chartering opportunities.

Major Themes

CFPB and Prudential Regulators to Expand Rulemaking

Winners	Open Banking: Intuit Inc. (INTU), Robinhood Markets Inc. (HOOD), Block Inc. (SQ), PayPal Holdings Inc. (PYPL)
Losers	Small business demographic data: Enova International Inc. (ENVA), Live Oak Bancshares Inc. Inc. (LOB) Funding Circle Holdings Plc (FCH on the London exchange)

The Biden administration took office with a narrow Democratic legislative majority, which—combined with President Biden's preference for nominating partisan regulators—meant the administration faced prolonged battles to win appointee confirmations. The delay in the confirmation for a new director at the CFPB slowed rulemaking processes that have significant implications for the fintech industry.

With Director Rohit Chopra now installed at the CFPB and reasserting the bureau's expansive authority, Capstone expects progress on multiple key rulemakings in 2022.

Commercial Lending Demographic Disclosure Targets Discrimination

Section 1071 of the Dodd-Frank Act mandates that the CFPB collect and report on small business lending demographic data to facilitate the enforcement of fair lending laws. However, rulemaking under Section 1071 has languished for nearly a decade until a legal settlement forced the bureau to accelerate the process. This led to a notice of proposed rulemaking (NPRM) in September to require all financial institutions that originated at least 25 credit transactions for small businesses in the preceding two years to collect demographic data on prospective borrowers that submit written or oral requests for credit.

This rulemaking is important for creditors, as demographic data collection is likely to reveal discrimination in small business lending. We believe such findings are likely to trigger fair lending enforcement actions under Regulation B of the Equal Credit Opportunity Act (ECOA), which prohibits discrimination in credit decisioning. There is ample academic evidence to suggest that minority- and women-owned businesses have a harder time getting credit than comparably situated white business owners.

Capstone expects that the finalized rule will be released by the end of Q3 2022 and will go into effect in early 2024.

Slower Progress with Open-Banking Regulation

In July 2021, President Biden issued an executive order focused on competition policy in which he encouraged the CFPB to accelerate its rulemaking process related to Section 1033 of Dodd-Frank. Under Section 1033, financial institutions are required to make consumer financial data more readily available and portable. Biden's comments were interpreted as an endorsement of an "open banking" system that would give customers greater control over their financial data and increase competition among financial institutions.

Despite the White House's push, the pace of CFPB rulemaking appears to be anything but urgent. The bureau's 2021 Fall Agenda indicated any 1033 regulation was still in a "prerule" stage and the next update will come in April 2022. Capstone expects that an NPRM will likely be delayed beyond then given the bureau's acknowledgment that a small business review panel will have to assess potential impacts—a step required for large rulemakings that may delay the process.

The eventual impact of open banking reform will be significant, with consumers gaining autonomy over their financial data, increasing competition for financial services companies.

We believe the UK's experience implementing its open banking directive can help us predict impacts in the US. In the UK, the open banking application programming interface (API) was slow to materialize but has rapidly accelerated in the past year. UK data show beneficiaries include institutions that provide financial advice and investment opportunities. If those patterns persist in the US, as Capstone expects, then open banking regulation would benefit Mint and Credit Karma, both units of Intuit Inc. (INTU), as well as fintechs Chime, Goin, Simpli.fi, and others that design financial planning tools for consumers.

Data portability will make it easier for customers interested in retail investing to move money from traditional checking accounts to platforms such as Acorn, Robinhood Markets Inc. (HOOD), Block Inc. (SQ), and PayPal Holdings Inc. (PYPL) that offer or plan to offer stock-trading opportunities.

We also believe firms such as the data transfer company Plaid, which recently announced a foray into payments processing, stand to benefit significantly from open banking reforms. With greater data portability and consumer financial data ownership, Plaid can expand connectivity and data sharing networks between financial institutions and help support and expansion of direct account-to-account and business-to-business payments.

Mastercard Inc. (MC) and Visa Inc. (V)—which tried to acquire Plaid but was blocked by the US Department of Justice—have sought to rapidly expand their API capabilities to better support open banking payments.

Payments Company Innovations Spur Rulemaking and Enforcement

Winners	A2A payments facilitators and partners: Plaid, MX, PayPal, Block Unaffiliated card networks, Star Network, Accel
Losers	PayPal, Affirm Holdings Inc. (AFRM), Block, Meta Platforms Inc. (MVRS), Alphabet Inc. (GOOGL), Apple Inc. (AAPL), Amazon.com Inc. (AMZN)

COVID-19 rapidly accelerated the transition to online and digital payments, a trend we expect to continue throughout 2022. Bloomberg forecasts that digital wallets' share of consumer payments could grow to 20% in 2022 and digital payment methods will be used for more in-person purchases. Regulators have taken note of this shift and are monitoring e-commerce payment methods more closely.

In June 2021, the Federal Reserve (Fed) proposed changes to the Durbin Amendment's Regulation II, which would require debit card issuers to enable two unaffiliated networks for card-not-present transactions. That regulatory "clarification," as the Fed termed it, would allow merchants to route online transactions across payment networks offering less expensive interchange rates than the dominant card networks, Visa and MasterCard. While merchants welcome the change, they still argue that interchange fees are too high and have encouraged the Fed to reduce the interchange limits for exempt and nonexempt banks.

The most relevant example of merchant frustration comes from Amazon.com Inc. (AMZN), which said it will stop accepting Visa cards in the UK because of fee hikes. While we expect Visa and Amazon will resolve their differences, the dispute speaks to merchant frustration with card-based fees even as the Fed tries to alleviate that strain.

Capstone expects that retailers will continue pushing regulators to amend Durbin even as Regulation II changes are finalized in early 2022. Additionally, as merchants continue to chafe at the cost of interchange, we expect more will try establishing direct account-to-account (A2A) payment options.

Direct account-to-account payments already took off in 2021 under the guise of buy now, pay later offerings. BNPL exploded in the US in 2021 amid a frenzy of deal-making, product rollouts, and news coverage. The CFPB took note, with initial consumer guidance this summer followed recently by letters to major BNPL companies inquiring about their business model. Affirm Holdings Inc. (AFRM), Afterpay Ltd. (APT on the Australian exchange), Klarna (KLAR on the Swedish exchange), Zip, and PayPal all received requests for information.

The CFPB inquiry highlights the bureau's concerns with the industry's underwriting, data collection, compliance, and customer protections. Capstone expects that the CFPB will initiate enforcement actions or potential rulemaking activity for BNPL firms in late March 2022, following the inquiry response deadline.

Finally, the CFPB recently sent letters of inquiry to six large tech companies and payment platforms, Block Inc. (SQ), Alphabet Inc. (GOOGL), Meta Platforms Inc. (FB), Apple Inc. (AAPL), Amazon, and PayPal inquiring about their financial products, payment offerings, and consumer protections. CFPB Director Chopra has expressed concern about consolidation in the payments sector, use of customer data, consumer protections under the Electronic Funds Transfer Act, and the Gramm-Leach-Bliley Act. We expect the CFPB to use this fact-finding mission as a basis for potential future enforcement action or larger participant rulemakings.

Banking Regulatory Perimeter Redefined

Winners	Fintechs with bank charters: LendingClub Corp. (LC), Nelnet (NNI), SoFi Technologies Inc. (SOFI), Varo Bank, Block
Losers	Large fintechs considering banking charters: Chime, Revolut, Brex

In comments to the American Fintech Council in November 2021, acting Comptroller of the Currency Michael Hsu said the "cornerstones of banking" are being reassembled "outside of the bank regulatory perimeter." Hsu noted two specific concerns about fintechs operating outside this envisioned regulatory perimeter: the potential for consumer harm from regulatory arbitrage and run risk.

Despite the concerns about fintechs' operation outside the banking regulatory perimeter, we believe the Federal Deposit Insurance Corp. (FDIC) and the Office of the Comptroller of the Currency (OCC) are reluctant to give fintechs non-traditional bank charters that could be perceived as having less burdensome compliance requirements than traditional bank charters. Additionally, we believe the FDIC, the OCC, and the Fed will finalize interagency guidance governing fintech relationships with banks. This move would force banks to carefully scrutinize partners and improve the compliance and consumer protection capabilities of fintechs.

The OCC is likely to withdraw the bank charter as an avenue for gaining bank status.

The OCC announced in July 2018 that it would accept applications for a special purpose national banking charter that would allow fintechs to become chartered banks without accepting deposits (thereby avoiding direct FDIC supervision). This special charter has been at the center of legal disputes since its formulation, facing challenges brought by the Conference of State Bank Supervisors (CSBS). Capstone believes the OCC, after agreeing to pause litigation to review the charter, is likely to withdraw the fintech charter as an avenue for gaining bank status.

In his remarks, Hsu focused on the three key functions of banks: taking deposits, making loans, and facilitating payments. The idea behind the fintech charter was to allow an entity to become a bank without fulfilling a bank's traditional deposit-taking responsibilities. Industry leaders remain concerned that even if the OCC moves forward, the CSBS would continue to challenge such charters with the goal of having them invalidated in court.

Fintechs and other commercial firms have also shown a renewed interest in pursuing an industrial loan company (ILC) banking charter. In 2020, after more than 10 years without an ILC approval, the FDIC approved charters for both Square (now Block) and Nelnet Inc. (NNI). With the recently announced resignation of FDIC Chair Jelena McWilliams, we believe that the FDIC board is unlikely to grant further ILC charters in the near term. Board member Martin Gruenberg voted against Square's ILC charter, and we believe other Democrat-appointed board members, most notably Rohit Chopra, are likely to share Gruenberg's outlook.

While ILCs or special charters are relatively unlikely to be granted to fintechs, we still see a path for fintechs to become chartered banks through acquisition. By purchasing existing state- and OCC-chartered and regulated institutions, fintechs can absorb, rather than develop, the more robust compliance capabilities of their targets and allay the concerns of some critics. LendingClub Corp. (LC) successfully pursued this strategy through its acquisition of Radius Bank, and we believe the OCC will approve SoFi Technologies Inc.'s (SOFI) acquisition of Golden Pacific Bank.

Finally, we expect that the FDIC, OCC, and Federal Reserve will finalize their interagency guidance on third-party relationships in 2022. The proposed guidance encourages banks to vet the financial condition, compliance capabilities, information security, and risk management procedures of fintechs fully before formally entering a partnership. Although it does not provide a path to bank status, the guidance will reduce regulatory concerns about banking-as-a-service (BaaS) relationships by forcing fintechs to improve internal compliance and security controls before engaging in partnerships.

Fintech Opportunities

Support for Portability Bolsters Digital Wallet Share and Payments Providers

Winners	PayPal, Block, Apple, Meta, Alphabet, Amazon
Losers	Traditional banks (facing disintermediation), data aggregators that rely on screen scraping

The pace of open banking rulemaking is progressing slowly. While we believe an NPRM is unlikely until at least Q3 2022 and a small business review panel for any rulemaking may be necessary, the CFPB is likely preparing to guarantee greater portability and consumer ownership over financial data.

In a moment of bipartisan agreement, Congress expressed similar interest in increasing portability and consumer control over financial data. In a September 2021 House Financial Services hearing, Democratic and Republican representatives called for tighter privacy regulation of consumer data sharing between big tech and financial firms and encouraged safer sharing of data to allow consumers to shop for financial products more effectively. Committee members also emphasized the need for strong APIs to securely share permissioned consumer data.

> The emphasis on data sharing and portability represents an opportunity for firms that are adding financial services to their platforms.

Capstone believes this emphasis on data sharing and portability represents an opportunity for firms such as Block and PayPal that are adding financial services to their platforms with the goal of building so-called super apps that centralize all consumer financial activity on a single platform. Both companies offer digital wallets (including their traditional A2A payments capabilities), have built or recently acquired BNPL products, and are assembling retail stock trading capability and crypto exchanges. As consumer financial data becomes more easily portable, apps such as Square and PayPal could displace traditional banking relationships and potentially let consumers handle all their financial services through a single integrated platform.

Major tech companies including Amazon, Apple, Meta, and Google also are poised to benefit. As consumer financial data becomes more portable, the companies can build financial platforms that allow consumers to unify their 'financial lives' under a single umbrella.

While the CFPB is monitoring these major industry actors, we expect that the trend toward financial data portability to present an opportunity for established financial apps to consolidate services and develop a full suite of integrated financial offerings.

Earned Wage Access Poised to Grow; Direct-to-Employer Providers Best Positioned

Winners	DailyPay, PayActiv, other direct-to-employer EWA providers
Losers	Earnin, Dave, payday lenders

We believe companies that facilitate earned wage access (EWA) cash advances using the direct-to-employer model are well-positioned relative to direct-to-consumer EWA providers in the coming year.

Consumer advocates have taken the position that finance charges that EWA companies assess are too high. Were the fees represented as annual percentage rates, they would far exceed the 36% interest rate cap in the Military Lending Act, which many consumer advocates would like to see extended to the broader consumer population. While advocates have recently encouraged the CFPB to look into the industry, we believe regulators are drawing a sharp distinction between direct-to-employer and direct-to-consumer business models.

We believe the direct-to-employer business model, which the CFPB defended in narrow industry guidance issued in 2020, is unlikely to be subject to regulatory scrutiny in the near term thanks to product features that limit the potential for consumer harm. Direct-to-employer EWA providers recoup advanced wages through payroll deductions and advertise their services as "nonrecourse," or without the ability to recover outstanding obligations directly from consumers. By self-limiting their collections capabilities, direct-to-employer EWA providers bill themselves as a consumer-friendly employee benefit.

Conversely, the direct-to-consumer EWA model, which does not involve an employer intermediary, is likely to be viewed less favorably by regulators. The direct-to-employer EWA providers link to consumer bank accounts and recover advances through direct debits. Another difference is many direct-to-consumer EWA providers utilize voluntary payments, using "tipping," to generate revenue. These EWA providers ask consumers to contribute a "tip" to the company after successfully utilizing their cash advance services. Consumer advocates note that tipping features are difficult to opt out of, and average tip sizes, when calculated as APRs, can exceed 100%.

While both models will face the risk that their product is reclassified as credit, subjecting them to a host of federal and state lending laws, we believe the direct-to-employer model is better suited to weather regulatory scrutiny. As the CFPB continues to limit payday lending while still providing opportunities for other providers of short-term financing, we believe PayActiv and DailyPay, direct-to-employer EWA providers with large retailer relationships, are particularly likely to benefit.

Conversely, Earnin and Dave (which plans to go public soon via a special purpose acquisition company, or SPAC), follow the more controversial direct-to-consumer business model, including tipping, and are more likely to be the targets of regulatory scrutiny as EWA gains traction.

Fintech Risks

Certain Bank Partnerships Under Fire; Exporting Interest Rates and Third-Party Guidance

Winners	Community banks, bank-chartered fintechs, LendingClub, Green Dot Corp. (GDOT)
Losers	Major Paycheck Protection Program fintech lenders, OppFi Inc. (OPFI), other fintechs that export interest rates

Following an attorney general's (AG) recent settlement in Washington, DC, and the repeal of the OCC's True Lender Rule, we expect that state AGs will be emboldened to bring additional lawsuits against fintechs that partner with banks to provide credit products with finance charges that exceed local lending caps. We also expect interagency guidance on third-party relationships to be finalized, with the potential to create compliance and partnership hurdles moving forward.

On November 30, 2021, DC AG Karl Racine announced that OppFi Inc. (OPFI) agreed to a nearly $2.4 million settlement to resolve allegations that it violated Washington, DC's usury laws by offering loan products with fees that exceeded the district's 24% interest rate cap. This fight is not new. Several lawsuits have challenged the legality of partnerships (or simply a relationship with a debt buyer, in the case of *Madden v. Midland*) that rely on state interest rate preemption to offer credit products that exceed local interest rate caps. The issue appeared settled by the OCC when its True Lender Rule took effect in late 2020. However, Congress rescinded the rule in 2021, meaning ambiguity about acceptable lending relationships between banks and fintechs remains. Given AG Racine's recent success and renewed calls from consumer advocates to aggressively pursue litigation, Capstone expects there will be additional challenges to certain fintech-bank lending partnerships.

In addition to the continued ambiguity about their ability to work with banks to offer higher-cost lending products, fintechs will have to deal with new guidance for bank partnerships coming from the OCC, FDIC, and Federal Reserve. Their joint guidance on third-party relationships will help banks address risks associated with fintech partnerships, and we expect it will encourage a more aggressive review of partnerships arrangements, with a particular focus on fintech compliance capabilities, information security, and financial stability. The guidance is meant to improve the strength, security, and resilience of partnerships between banks and fintech companies and is likely considering evidence that Paycheck Protection Program (PPP) loans facilitated via fintechs were far more likely to be fraudulent than those issued directly through banks.

The Select Subcommittee on the Coronavirus Crisis launched inquiries into the PPP lending activities of Kabbage Inc. and BlueVine, and more recently expanded that probe to include Blue Acorn and Womply. While the stringency of the guidance is yet to be determined, Capstone believes it again highlights regulators' interest in bank relationships with third parties, including fintechs.

Growth in BNPL, Size of New Players Likely to Attract Enforcement Actions

Winners	Credit card networks including Visa Inc. (V), Mastercard Inc. (MA), American Express Co. (AXP), Discover Financial Services (DFS)
Losers	Affirm, PayPal, Klarna, Afterpay (and Square), Zip, Sezzle Inc.

Consumer use and retailer interest in BNPL exploded in the past year, with media coverage and acquisition activity surging over the summer and early fall. Since June 2021, Affirm and Amazon partnered; Square agreed to acquire Afterpay; PayPal purchased Paidy; and Goldman Sachs Group Inc. (GS) announced a BNPL partnership with Apple and its acquisition of GreenSky Inc. (GSKY), a fintech lender targeting the home improvement market. Other banks and card companies announced that they were developing their own BNPL offerings and APIs. While deal activity and customer use grew, the CFPB kept mum on the topic outside of a single bulletin intended to educate consumers about BNPL products. However, that changed on December 16th, when the CFPB sent letters to Affirm, Klarna, PayPal, Afterpay, and Zip, asking for information on their policies and business practices, including underwriting, fees, loan performance, and consumer protections. Capstone believes this inquiry sets the stage for enforcement action in the short term and possible rulemaking in the long term.

BNPL companies bill their product as a consumer-friendly credit alternative to other point-of-sale and credit card financing options. Yet, recent consumer data on rising delinquency rates among BNPL users and negative credit impacts has increased interest in tighter industry regulation. Based on the CFPB's announcement and letters, we believe the bureau is focused on the following: 1) BNPL disclosures related to missed payments and impacts on credit scores; 2) assessment of late fees and their interaction with overdraft charges; 3) underwriting policies and rates of delinquency; and 4) fair lending compliance. The CFPB set a March 1, 2022, deadline for responses, leading us to expect further CFPB action in the BNPL space, particularly potential enforcement following that submission deadline.

In addition to bringing enforcement action to address any of the above, Capstone believes that the CFPB may utilize the inquiry as part of a future rule-making or larger participant rulemaking to bring BNPL under the CFPB's supervisory authority. While both of those potential oversight activities are long-term initiatives, Capstone believes that the current inquiry will lead to more immediate enforcement action in the coming year to try and curtail any practices which the bureau views as significantly harmful to consumers.

Major Questions

Will Bank Regulators Jointly Overhaul the Community Reinvestment Act in 2022?

In late July, the Fed, FDIC, and OCC issued a statement committing to modernize and update the Community Reinvestment Act (CRA). Then, throughout the fall, the OCC took steps to formally rescind the agency's 2020 update to CRA—a move that consumer advocates widely applauded. While the federal banking agencies have promised to work together to overhaul the CRA, the timeline and specifics of their reform effort are unclear.

Broadly, the CRA was developed when digital banking was nonexistent and the current CRA evaluative framework does not consider the impact of online banking. Industry critics of the current CRA also suggest that bank scores are not sufficiently differentiated to give insight into CRA performance, and they would like to see a more quantitative and objective evaluation framework developed. Additionally, some consumer advocates would like to see CRA evaluations applied to non-bank lenders, a reform we believe is unlikely.

Reaching an interagency agreement on CRA modernization, however, will be challenging, as evidenced by the OCC and Fed's decision to pursue unilateral CRA updates during the past several years. Acting Comptroller Hsu observed that updated rulemaking will likely be time-consuming because modernization issues are "complex." One potential hurdle to CRA overhaul, ideological disagreement over the purposes of CRA reform, is likely removed following the announced resignation of Jelena McWilliams, a Trump appointee and current FDIC chair. We viewed her leadership at the FDIC as a possible barrier to interagency agreement on reform and expect that her departure will make it easier for the FDIC, OCC, and Fed to come to agreement on a new CRA framework.

While the exact nature of the reform efforts is unclear, Capstone expects that a CRA overhaul will present opportunities for fintechs that facilitate bank lending. Any overhaul effort is likely to emphasize both the dollar volume and quantity of loans issued to low- and middle-income (LMI) individuals and communities. As banks increasingly close branches, partnerships with fintech firms may be critical to banks remain in compliance with the CRA and are trying to reach LMI populations.

How will regulators assess artificial intelligence and machine learning in underwriting?

The CFPB and banking regulators are carefully weighing the benefits of artificial intelligence (AI), machine learning (ML), and alternative data as a means for expanding credit access against the potential for these tools to reinforce systemic biases. Last spring, the CFPB, Fed, National Credit Union Administration, FDIC, and OCC put forth a request for information to gather industry and community perspectives on the use of AI/ML by financial institutions.

Many lenders see benefits from using AI and alternative data to increase credit access and improve racial equity within the financial system. Fannie Mae (FNMA in over-the-counter trading) recently announced that it would begin using a form of alternative credit data, evaluating the rental histories of homebuyers as part of its assessment of their creditworthiness. The Biden administration, however, has promised to increase enforcement of fair lending statutes to root out racial inequality in the financial system. Lenders and credit agencies that incorporate artificial intelligence may be exposed to enforcement efforts from the CFPB if their underwriting systems result in predictably differentiated outcomes for protected minority groups.

We believe consumer and banking agencies can take multiple steps to alleviate regulatory ambiguity that financial institutions face as they expand their use of AI/ML and alternative data. Banking regulators could update the Model Risk Management Guidance to provide explicit AI/ML considerations. Additionally, the agencies could expand the use of no-action letters and regulatory sandboxes to explore the impact of new underwriting technologies and inform future rulemaking, though progressives have traditionally opposed such measures. Similarly, regulators could provide sample data to help financial institutions build and test models that limit the potential for discrimination or provide guidance to lenders to evaluate third-party underwriting tools.

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