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Financial Institutions

Treasury's fintech report aims to align regulation with innovation

On 31 July, the US Department of the Treasury published a report on recommended changes to Core Principles of Financial Regulation pertaining to non-bank financial institutions, financial technology (fintech) and financial innovation.[1] On the same day, the Office of the Comptroller of the Currency (OCC) announced that it will begin accepting applications for national bank charters from fintech companies.

Roughly 30% of the 81 recommendations in the Treasury report require federal or state legislation, or both. Given the difficulty in passing legislation with bipartisan agreement, in this report we focus on the potential positive and negative credit implications of the Treasury's and OCC's key recommendations that US financial regulators could implement without legislation.

Treasury's proposals to support innovation, increase competition and modernize regulation have mixed credit implications for incumbent banks. Increased innovation, particularly with respect to lending and risk management, will be credit positive only if done prudently with adequate safeguards and testing. Increased competition will help boost economic activity, but poses risks to incumbents unable to keep up. Improved regulatory clarity is credit positive for financial institutions because it reduces liability and risk of exposure from noncompliance. However, a relaxation of regulatory oversight would be credit negative for financial institutions.

The OCC's fintech charter paves the way for new entrants, a credit negative for incumbent banks and credit positive for fintechs awarded a charter. Non-bank applicants would become special-purpose national banks with a single primary federal regulator versus the current situation of multiple state-based licensors and regulators, or having to partner with a bank. Competition from new entrants as well as their introduction of new and innovative delivery channels and product pricing are potentially disruptive to incumbents. The scale of the threat to incumbents will ultimately depend on how many companies apply and are approved for charters, the business lines they enter, and their success in attracting customers away from incumbents. We believe the OCC's charter standards are challenging and will likely dissuade applicants. The OCC charter will be credit positive for fintechs that obtain it as well as their sponsored securitizations.

Treasury supports a more modern, efficient payments system, a credit negative for incumbent providers if it increases disruption. We believe the incumbent providers will remain at the center of the complex US payments ecosystem. Fintech companies have been providing easy-to-use applications and wallets for clients to initiate and receive payments, but these innovative platforms so far still rely on existing core payment systems.

Treasury also supports streamlined regulation for financial advisors, a credit positive. While technology and demographics are driving a shift to digital financial advice, regulation has remained fragmented.

Greater innovation in lending will be credit positive only if new technology does not underestimate risk. The most comprehensive set of recommendations on lending applied to the residential mortgage market: the Treasury is encouraging the faster adoption of eNotes, which would improve credit quality because of improved data quality and would increase the liquidity of newly originated loans, a credit positive for mortgage originators as well as RMBS. In addition, the Treasury recommended that the Federal Housing Administration (FHA) and US Department of Housing and Urban Development (HUD) address issues that have driven banks' retreat from the FHA-insured mortgage market, which would be credit negative for non-bank mortgage companies owing to the potential for renewed competition from banks.

Treasury's proposals to support innovation, increase competition and promote regulatory modernization present both credit positives and negatives for incumbent banks

To stimulate innovation, increase competition and increase regulatory clarity around technological advances in financial services, Treasury recommended a number of initiatives including establishing regulatory sandboxes, modernizing consumer communication rules, encouraging open banking, relaxing vendor oversight, clarifying when a fintech would be subject to Bank Holding Company (BHC) regulations and facilitating the adoption of emerging technologies.

Increased innovation, particularly with respect to lending and risk management, will be credit positive only if done prudently with adequate safeguards and adequate testing. Increased competition is helpful with respect to supporting economic growth, but poses risks to incumbents unable to keep up.

We expect incumbent banks that aggressively pursue agile digital strategies to defend their core franchises, broaden their customer bases and improve efficiency, supporting their creditworthiness. Laggards will face increased customer attrition, reduced pricing power and uncompetitive cost structures. Increased regulatory clarity is credit positive for financial institutions as it reduces liability and risk of exposure due to noncompliance. However, a relaxation of regulatory oversight would be credit negative for financial institutions.

In a global context, a number of Treasury's recommendations are in line with some of the rules adopted in other developed economies. For example, the United Kingdom's open banking initiative and the European Union's Revised Payment Services Directive (PSD2) require banks to share customer data, at the customer's request, with other service providers. Both initiatives have specified standards for data sharing through application programming interfaces (APIs). PSD2 also looks to encourage additional competition in the European payments market by encouraging new entrants. A number of other jurisdictions, including the United Kingdom, Mexico, Thailand and Malaysia, have also been encouraging innovation and stimulating competition through creating or proposing regulatory sandboxes.

The establishment of regulatory sandboxes would be credit positive for financial services companies because it would allow them to innovate under a regulatory umbrella. Treasury recommended that financial regulators increase their efforts to bridge the gap between regulation and new technology. This could be done by forming "regulatory sandboxes" to permit and promote substantive experimentation with innovative products. Of note, the Treasury recommended that the sandboxes provide equal access to companies in various stages of the business life cycle (e.g., startups and incumbents). However, regulatory sandboxes may embolden fintechs and accelerate competition with incumbents.

Given the number of US financial regulators with overlapping jurisdictions, obtaining agreement to create sandboxes will be challenging, especially between federal and state regulators who often have differing agendas. If sandboxes are formed by federal regulators, banks and other federally chartered financial institutions who are pre-empted from certain state rules and regulation may be at an advantage.

Revisiting customer communication and disclosure rules would be credit positive for loan servicers and debt collectors. Treasury is recommending that the Federal Communications Commission (FCC) provide some leeway regarding calls being made to reassigned numbers, allowing callers a sufficient opportunity to learn that a client's number has been reassigned. Treasury also recommended that the Consumer Financial Protection Bureau (CFPB) codify that reasonable digital communications are appropriate for use in debt collection. These recommendations are credit positive for loan servicers and debt collectors because they would limit the liability and risk of exposure to penalties because of noncompliance and would also clarify what constitutes a digital communication. Treasury also recommended that Congress consider statutory changes to the Telephone Consumer Protection Act (TCPA), which would allow customers to avoid unwanted calls and provide for a revocation standard similar to the one under the Fair Debt Collection Practices Act (FDCPA).

Encouraging open banking would increase competition, a credit negative for incumbents. Treasury noted the consumer benefits of the United Kingdom's open banking initiative and the European Union's Revised Payment Services Directive (PSD2), which requires banks to share customer data, at the customer's request, with other service providers.

In addition, Treasury highlighted the importance of improving data collection methods, such as through APIs, the standardization of data, fair and proportional allocation of liability, and accountability in the event of a data breach. This would both be beneficial for consumers as well as reduce banks' compliance risk, a credit positive. Increased competition is helpful with respect to supporting economic growth, but poses risks to incumbents unable to keep up.

Easing of vendor oversight poses risks to banks, a credit negative. Treasury recommended that US banking regulators provide greater clarity around their guidance on vendor oversight requirements and look for areas to reduce "unnecessary" requirements. Treasury also highlighted the importance of data migration to the cloud and the benefits it provides in effectively managing a firm's IT and computing resources. Banks' migration of core activities to the cloud has been slow because of the sensitivity of such functions and the difficulty in transitioning away from legacy IT systems. As security breaches have increased, regulators significantly raised banks' requirements for vendor oversight, which we believe has been credit positive for the banks.

Though relaxing oversight could stimulate innovation and potentially increase partnerships between banks and fintechs, a credit positive, outsourcing tasks to vendors can pose significant risks to banks.

Facilitating the adoption of emerging technologies such as artificial intelligence and machine learning is credit positive only if done prudently with adequate safeguards and testing. Treasury recommended that financial regulators interact with other agencies on the topic of artificial intelligence (AI). The focus of such strategic efforts would be to emphasize use cases and applications in the financial services industry, including removing regulatory barriers to deployment of AI-powered technologies. However, Treasury highlights the importance of human primacy in decision-making for higher value use cases relative to lower-value use cases and the accountability of humans. Increased clarity around the testing and deployment of technologies such as artificial intelligence and machine learning would reduce banks' compliance risks, a credit positive. However, there are significant credit risks for financial institutions from mismanaging new technology, particularly "black box" models.

Clarifying when a fintech would be subject to Bank Holding Company (BHC) regulations would stimulate banks' investments in fintechs, a credit positive for fintechs. Banks will benefit from gaining access to technologies that foster innovation in their core operations provided such investments do not add material risk to the BHC and in turn the bank. Treasury recognized that investments in fintechs by BHCs may be impeded by the fintech's desire to avoid being considered a BHC affiliate or deemed to control the BHC, which would subject them to BHC-related regulations. Treasury recommended banking regulators harmonize their interpretations of a banking organization's permitted scope of activities as well as that the Federal Reserve reassess the definition of BHC control so that firms have a transparent standard to facilitate investments in innovation-related investments.

OCC fintech charter could pave the way for new entrants, increasing competition for incumbents

Following the Treasury's report and recommendation, the OCC announced that it will begin accepting applications from fintech companies for special purpose national bank charters. The OCC's initiative is credit negative for incumbent banks because of the potential for disruption and increased competition by new entrants. However, charters are not cost-free for fintech companies, which will have to comply with OCC's regulatory requirements .

The main motivating factor driving a fintech company to apply for the OCC's national bank charter would be pre-emption from state laws as well as fewer layers of regulation. In addition, companies that obtain a charter would have a single primary regulator, the OCC. The charter would provide a more efficient and standardized regime than the current state-based regime under which fintech companies operate. Companies that we expect would be interested in applying for the charter include marketplace lenders and payments companies, which current rules require to gain licenses in each state they operate in or service. The OCC's initiative is credit positive for marketplace lenders that obtain the charter, because it mitigates the risk that state regulators and borrowers will challenge them over violations of usury laws, licensing requirements or other regulations enforced at the state level. Reduced legal risk would also bolster the credit quality of their new originations and related securitizations.

The regulatory requirements include capital, liquidity and financial inclusion commitments. Companies will also be expected to submit an acceptable contingency plan to address significant financial stress. In addition, the OCC requirements include having strong management and directors, with background and expertise in regulated industries. Lastly, fintechs will be required to have an established business record, a clearly defined bank risk management framework as well as a risk assessment of third-party service providers, cybersecurity, Bank Secrecy Act, anti-money laundering requirements, Office of Foreign Assets Control economic sanction obligations, consumer protection and fair lending.

Since companies obtaining the special purpose national bank charter would not be deposit-taking, they would continue to have a weaker funding profile than traditional banks.

Treasury supports a more modern, efficient payments system

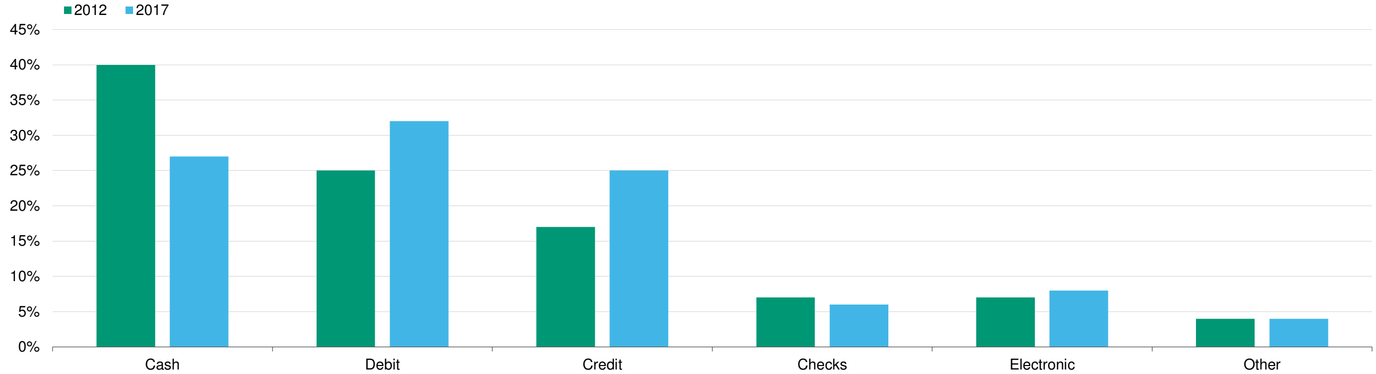
Payments: focus on fast and secure payments to drive efficiencies

Treasury's support of developing a faster, more efficient payments system presents the risk of disrupting the incumbent US providers, a credit negative, though for the foreseeable future we believe incumbents will remain at the center of the complex payments ecosystem. Fintech companies have been providing easy to use applications and wallets for clients to initiate and receive payments, but these innovative platforms still rely on the existing core payment systems infrastructure.

Treasury highlighted the importance of modernizing the payments system as well as industry efforts to raise efficiencies. Of note are the Faster Payments Task Force and the Secure Payments Task Force, both assembled by the Federal Reserve. Treasury's recommendation to the Federal Reserve is to help facilitate a faster retail payment channel, such as real-time settlement. The security of payments was also highlighted, with Treasury proposing that the Federal Reserve engage with stakeholders to assess the resiliency of new payment systems as they come online. If implemented, faster and more secure payment channels are generally credit positive because of the efficiencies they would bring to consumers, businesses and financial institutions as well as the protection from fraud.

Payment system efficiencies are increasingly important as the US shifts from cash to electronic payments. Treasury indicated that the payments landscape has been evolving, with an increasing number of US consumers drifting away from cash and leveraging the use of electronic payments such as debt and credit card payments (Exhibit 1).

Exhibit 1
Use of cash is still significant at 27% in 2017 but has been declining
Transactions by each payment instrument (in percent)



Source: Treasury report

Treasury also supports streamlined regulation for financial advisors, a credit positive

Treasury recommended harmonizing the regulation of financial planners, a credit positive for small new entrants because it would allow them to expand their digital product offerings within the same regulatory framework. The threat to incumbents remains moderate because they too have been investing in digital advice and have well-established platforms that allow for an efficient customer acquisition or transition to a digital or hybrid advice model. More efficient oversight of small financial planners by an appropriate existing regulator would reduce uncertainty around the regulation of specific investment products as well as bring consistent oversight to the financial planning arena. Currently, financial planners can be regulated by multiple agencies at the federal and state level, with different regulators addressing different tasks depending on the services offered by the financial planner.

An additional overall benefit from harmonizing the regulation of financial planning could be to further encourage the development of digital financial planning services. In its report, Treasury indicated that assets managed by digital advisors are projected to reach $385 billion by 2021, from $100 billion in 2017. We expect digital financial planning to continue gaining traction among tech-savvy customers who will increase their reliance on software applications such as robo-advisors.[2]

Innovation in lending will be credit positive only if mindful of past cases in which new technology underestimated risk

Treasury recommended that federal and state financial regulators further enable the testing of new credit models and data sources by both banks and non-bank financial companies, a credit positive as long as deployed prudently with adequate safeguards and testing. In addition, Treasury recommended that the Department of Education (DOE) establish guidance on certain minimum standards for federal student loan servicers, which we believe would reduce their regulatory risk, a credit positive, and that the CFPB rescind its payday rule, a credit positive for payday lenders.

The longest list of lending and servicing recommendations were with respect to the residential mortgage market: Treasury is encouraging the faster adoption of eNotes, which will improve mortgage credit quality and increase the liquidity of newly originated loans, a credit positive for mortgage originators and RMBS. In addition, the Treasury recommended that FHA and HUD address issues that have driven banks' retreat from the FHA-insured mortgage market, which would be credit negative for non-bank mortgage companies because of the potential for renewed competition from banks.

Below we highlight several of Treasury's specific recommendations and their implications (in bold text):

New credit models

Treasury recommended that federal and state financial regulators enable testing of new credit models and data sources by both banks and non-bank financial companies, a credit positive only if lessons of the past are remembered. New tools and technology can significantly underestimate risk, as happened in the run-up to the financial crisis. The predictive value of models can only be determined over long time periods through different market cycles and, in particular, during times of stress.

Treasury recommended that regulators, through interagency coordination wherever possible, tailor regulation and guidance to enable the increased use of new credit models and data sources. In particular, Treasury recommended that regulators provide clarity around the use in credit decisions of new data and modeling approaches that are generally recognized as providing predictive value and consistent with applicable law.

Student loans

Treasury recommended that the DOE establish guidance on certain minimum standards for federal student loan servicers, which we believe would reduce their regulatory risk, a credit positive. In addition, Treasury recommended that in the DOE's new Direct Loan Servicing contract, which is set for renewal in 2019, the DOE should require student loan servicers to make greater use of emails and provide guidance to servicers on how to use email appropriately to balance privacy and security concerns with the need for effective and timely communication. Recognizing innovations in communication, particularly with the high concentration of millennial student loan borrowers, would increase borrower satisfaction, reduce servicing costs and likely lead to lower default rates, a credit positive for student loan servicers.

Treasury was silent with respect to the role of the states in regulating student loan servicing. Currently Navient Corporation (Ba3 stable) is being sued by several states alleging that the company violated consumer finance laws in servicing federal and private student loans. Navient refutes these claims, contending among other things that the standards being asserted in the lawsuits are inconsistent with DOE regulations. On 12 March, the DOE issued guidance that said it believes that federal law pre-empts states' regulation on federal student loan servicing, and that state action undermines the uniform administration of the program. The states will look to the courts to weigh in on their ability to enforce regulations.

Payday loans

Treasury recommended that the CFPB rescind its payday rule, a credit positive for payday lenders. In October 2017, the CFPB published a final rule for payday, high-cost installment and single-payment auto title loans. The effective date of the rule is expected to be August 2019. However, on 16 January 2018, the CFPB issued a press release stating that it intends to engage in a rulemaking process so that it may reconsider the payday rule. Given that the timing of this process has not been specified, we believe that payday lenders will continue their transition to longer-term installment lending. If the CFPB makes the final rule less onerous, we would view it as credit positive for the sector in general, though some states are taking an opposite tack and tightening their consumer lending regulations.

If implemented in its current form, the CFPB's final rule will be credit negative for US payday lenders, because the loan affordability standards accelerate their transition to underwriting-based, longer-term installment lending, for which most lenders' current business models and capital structures are not well-equipped, owing to their lack of tangible equity. The rules will reduce the number of eligible borrowers, increase payday lenders' revenue reliance on lower margin products and increase their cost of doing business. Payday lenders' profitability is also likely to be constrained by restructuring charges incurred as lenders expand their product mix away from high-margin payday products.

Residential mortgage loans

For most of the decade following the financial crisis, technological innovation in the US housing finance markets lagged significant advances in other industries. More recently, as the aftereffects of the crisis and new regulation have waned, companies in housing finance have increasingly adopted new technologies in response to growing customer demands.

Digitized loan underwriting, e-mortgages, distributed ledgers, machine learning, smart homes, and mobile applications are just a few of the technologies with the potential to reshape major aspects of business across a variety of sectors.

New uses of technology will lift residential mortgage credit performance only if lessons of the past are remembered. Whether owners of residential mortgage risk – including residential mortgage-backed securities (RMBS) transactions, banks and GSEs – will benefit depends on the tools being deployed carefully and used with the appropriate caution. Assuming that is the case, the advances will likely improve overall credit quality in the next few years.

Treasury encouraged greater adoption of eNotes[3] or eMortgages, which will improve credit quality and increase the liquidity of newly originated loans, a credit positive for mortgage originators. The mortgage market has been working for years on digitizing the mortgage documentation and closing process. A full electronic mortgage closing encompasses several components and processes with respect to the promissory note, the mortgage, the title, and other closing documents along with notarizing necessary documents. Increased adoption of eNotes would be credit positive for both bank and non-bank mortgage companies.

We believe high rates of adoption of complete e-mortgage closings are still several years away given the need for acceptance at local county property registrars, state legislation governing e-notarization and greater acceptance among market participants to increase the liquidity of e-closed mortgage loans. However, we expect to see an increase in hybrid e-mortgage closings in which a majority of the closing process is digitized, such as closing documentation as well as the promissory note, but excluding the mortgage and the deed.

The benefits of an e-mortgage closing, including a hybrid e-mortgage closing, are many. An e-mortgage will increase the liquidity of newly originated loans by eliminating the "wet period"[4] and reduce processing, shipping and storage costs. A fully paperless mortgage origination process can improve mortgage data quality by replacing many of the manual tasks in handling, processing and reviewing paper documents that can introduce human error and fraud. Electronic originations can also benefit mortgage quality by making the note more easily accessible to servicers, which over time can help reduce delays in foreclosure.

Currently, Fannie Mae and Freddie Mac accept eNotes, but Ginnie Mae does not. Treasury recommended that Ginnie Mae pursue acceptance of eNotes. In addition, Treasury recommended legislation where necessary to authorize and encourage the use of electronic and remote online authorizations that would facilitate eNotes.

Treasury recommended that the FHA and HUD address issues that have driven banks' retreat from the FHA-insured mortgage market, a credit negative for non-bank mortgage companies owing to the potential for renewed competition from banks. Banks' market share of FHA-insured mortgage loans has decreased materially since the financial crisis. Many banks have completely ceased originating FHA-insured mortgage loans and others have reduced originations materially. As a result, the Urban Institute estimates[5] that the market share of non-bank Ginnie Mae mortgage originators has increased to almost 79%, roughly double what it was in 2013. The Treasury believes that the bank pullback is due in large part to the lack of clarity on how the FHA addresses origination and servicing deficiencies. HUD and the DOJ have increasingly applied the False Claims Act when pursuing deficiencies, resulting in very large fines being assessed against mortgage companies. Treasury recommended that HUD establish more transparent standards in determining which program requirements and violations it considers to be material. In addition, Treasury recommended several changes to standardize and streamline certain other FHA practices, which will reduce mortgage companies' costs.

Increased clarity with respect to the "rules of engagement" with FHA, which reduces the frequency and severity of fines as well as increases profitability, would be credit positive for both bank and non-bank FHA mortgage originators and servicers. However, increased clarity and increased profitability would also likely increase competition in the FHA mortgage market, a credit negative for non-banks with a high concentration of business in the FHA market.

Treasury recommended that Ginnie Mae reduce its counterparty risk with non-bank mortgage companies, which would be credit positive for the overall health of the government mortgage programs as well for surviving non-bank mortgage companies. We expect continued consolidation in the mortgage industry amid mixed profitability. Enacting Treasury's recommendation could accelerate consolidation.

Moody's related publications

23 July 2018: Financial Institutions: CFPB's regulatory sandbox is credit positive for fintech companies

22 May 2018: Banks - Europe: New EU payment rules will accelerate banks' digital transformation

25 April 2018: Fintech - Global: Bank of the Future: Innovative incumbents will thrive; laggards will be disrupted

12 April 2018: Cross-Sector – US: Housing-related industries lay foundation for 21st century technology

14 February 2018: Exchanges and Retail Brokers: Risk of Bitcoin futures is moderate at current volumes

12 February 2018: Banks: Fintech Credit News

8 February 2018: Cross-sector - Artificial intelligence: As AI goes mainstream, its potential to reshape sectors still remains years away

11 October 2017: Consumer Digital Payments – US: New payment technologies pose threat, but are unlikely to dislodge incumbents

12 April 2017: Credit Strategy – Blockchain Technology: Blockchain Has Potential to Transform Many Elements of Securities Trading

28 February 2017: Credit Strategy - Financial Technology: An Overview of the Fintech Regulatory Environment

21 July 2016: Credit Strategy – Blockchain Technology: Robust, Cost-effective Applications Key to Unlocking Blockchain's Potential Credit Benefits

Endnotes

1 The report is the last in a series of four Treasury reports that respond to President Donald Trump's February 2017 Executive Order 13772 on financial regulation. The first Treasury report covered **banks and credit unions**, the second covered **capital markets** and the third **asset management and insurance**.

2 Robo-advisors are digital platforms that provide algorithm-driven financial planning with little to no human supervision or intervention. The algorithms, or decision trees, are derived from generally accepted investment theories focused on minimizing risk and maximizing return and recommend portfolio composition based on client responses to a predetermined set of criteria. The investment vehicles used by robo-advisors are often mutual funds and stock and bond exchange-traded funds (ETFs) because of their low cost and attractive liquidity. They are also capable of handling more sophisticated tasks such as tax-loss harvesting, investment selection and retirement planning.

3 An eNote is an electronic version of the negotiable promissory note that is digitally signed and electronically transmitted and stored.

4 The "wet period" is the time from when the lender disburses funds on the loan through the date that the promissory note, a copy of the mortgage sent for recording at the property registrar, and the title commitment are received and certified by the custodian

5 Urban Institute as referenced in the **July 2018, Housing Finance Policy Center Monthly Chartbook**

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