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Banking innovation in the US and the UK, and the future of financial technology

Financial Services

While there is reason to believe the experiment with open banking will remake the financial regulatory landscape in the UK, it is still an untested concept in the US. This article examines the open banking standard on both sides of the Atlantic, what it means for the US financial market, and what states are currently doing when it comes to fostering fintech innovation.

Introduction

The UK's Competition and Markets Authority (CMA) is requiring the nine largest UK banks and building societies to provide access to customer account information (using open application programming interface (API) standards known as the Open Banking standard) to fintech firms seeking to build platforms on top of the banks' data and services. Other financial services providers may participate in Open Banking on a voluntary basis. The Open Banking standard is just part of a wider change to the ecosystem in the UK since, as a result of the revised Payment Services Directive (PSD2), all payment account providers in the European Economic Area (EEA) are now required to provide third-party access to account information. **The hope among proponents of Open Banking is that it will touch off a consumer-centric revolution in financial services, with winners determined based on their success in making consumers more effective financial managers.**

Open banking is still an untested concept in the US. As the US Treasury Department noted in its recent report, the UK approach cannot be applied wholesale to the US financial services sector, which is larger, more varied, and shaped by different historical influences.* Perhaps the most significant of these differences is the US financial regulatory system, which lacks both an umbrella regulation (like PSD2) and a central regulatory agency (like the CMA) able to push down broad technological change, such as adoption of a standard API. Additionally, depending on their business models, non-bank fintech firms in the US may be subject to a patchwork of state licensing and supervisory regimes that require large up-front investments of time and money.

* U.S. DEPARTMENT OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: NONBANK FINANCIALS, FINTECH, AND INNOVATION (2018)

Nonetheless, issues of data privacy and security, transparency, and competition between banks and non-banks that underlie the Open Banking initiative are under serious study by regulatory agencies and industry participants in the US. The work underway includes public efforts by regulators and industry groups to outline a workable system of consumer financial data aggregation, private efforts by banks and fintech firms to develop partnerships and competitive offerings, and competing efforts by state banking regulatory agencies and the Office of the Comptroller of the Currency (OCC) to offer non-bank providers of financial services an alternative to state-by-state licensure.

What does the UK experiment with open banking mean for the US financial market?

Some of the impetus for Open Banking in the UK has gained traction in the US as legislators, financial regulators, and industry groups have focused on transparency, inclusion, and choice in the consumer financial services market. The creation of the Consumer Financial Protection Bureau (CFPB) in 2010 by the Dodd-Frank Wall Street Reform and Consumer Protection Act was a step in this direction. The CFPB has a Congressional mandate to level the playing field between banks and non-banks and to foster competition and innovation. The CFPB began studying issues around consumer data aggregation in 2016 and, last year, issued non-binding principles aimed at giving consumers greater insight and control with respect to their financial data. In December, the CFPB announced plans to allow approved companies to offer new products under temporary exemptions from regulatory requirements in the form of binding no-action letters and a product "sandbox." The program is an enhanced version of a similar program the CFPB launched in 2016, which attracted little interest from industry.

In addition to creating the consumer-focused CFPB, the Dodd-Frank Act contains the first US statute giving consumers a general right to electronic financial data. Section 1033 of the Act requires covered providers of consumer financial services to make consumers' data available to them in a usable electronic format and empowers the CFPB to issue implementing rules. The Dodd-Frank Act defines consumer to mean not only an individual but also a representative acting on an individual's behalf. If the CFPB interprets Section 1033 as requiring banks to give electronic access rights to financial services providers acting with the consumer's consent, it could provide a legal basis for a US analog to the Open Banking Standard—at least with respect to the subset of companies under the Bureau's jurisdiction.

The US Department of the Treasury recommended that the Bureau adopt this broader interpretation of consumer in the report it issued in July. The Treasury report sets out recommendations for fostering financial innovation, including developing a workable approach to consumer data aggregation and removing barriers to partnerships between banks and non-banks. The report describes the Open Banking standard as a "useful comparison point," though it also notes that there are significant obstacles to adoption in the US as well as several unresolved threshold issues. These issues include enabling consumers to understand, and revoke or limit, the access they grant to their information, allocating liability for data loss among the companies accessing a consumer's data, and protecting the security of consumer data.

On the same day that the Treasury Department released its report, the OCC announced that it would begin accepting applications for limited-purpose fintech bank charters. Although it takes a different approach, the OCC program, like the Open Banking standard, is intended to increase competition between traditional banks and non-depository financial services companies. To that end, the OCC limited-purpose charter offers successful applicants a single regulator and the same exemption from state interest-rate caps and licensure requirements as full-service national banks. As discussed below, however, the program faces significant legal and practical hurdles.

Is the OCC's limited-purpose charter a viable option for fintech?

Previously, non-bank fintech companies seeking to operate nationally in the US have had essentially three options—pursue individual state money transmitter licenses, structure the business to avoid licensure requirements, or become a full-service bank. The OCC's newly launched limited purpose bank charter program promises an alternative. However, the program, and would-be applicants, face significant uncertainty. First, there is a question about whether the OCC has the legal authority to charter non-depository fintech firms. Second, there is the risk that federal regulatory oversight will excessively limit the ability of fintech firms to generate an acceptable return on equity, change business plans, or expand activities.

Soon after the OCC first announced plans to begin accepting applications, the Conference of State Bank Supervisors (CSBS) and the New York Department of Financial Services (DFS) filed suit challenging the OCC's authority to charter non-bank financial services providers. Both suits were dismissed for lack of standing, and both were refiled in October 2018.

The legal controversy centers on whether the OCC's chartering authority under the National Bank Act (NBA) extends to institutions that do not accept deposits. The NBA authorizes the OCC to charter institutions engaged in "the business of banking" but does not define the phrase. CSBS and DFS, as well as some high-ranking Democratic Congressmen, have pressed the argument that the OCC's authority is limited to national banks engaged in deposit-taking and special-purpose banks expressly authorized by Congress, namely, trust banks, bankers' banks, and credit card banks. In other words, the OCC needs, but does not have, Congressional approval to charter non-depository fintechs.

The OCC, on the other hand, has framed its charter program as a modernizing move made necessary by the changing financial services market. According to the OCC, “there is no legal limitation on the type of ‘special purpose’ for which a national bank charter may be granted, so long as the entity engages in fiduciary activities or in activities that include receiving deposits, paying checks, or lending money.”

All indications are that both the CSBS and DFS suits will proceed to a decision on the merits. The resulting legal uncertainty is not an attractive prospect for any business, particularly a startup.

Further, the lens through which the OCC will view prospective applicants is necessarily colored by its regulatory mandate. The OCC, as a bank regulatory agency, is focused on stability and risk management. The OCC charter program requires applicants to show more advanced development of business plans and compliance functions than the sandbox programs available in other jurisdictions and some US states.

What are the states doing?

States have a wider range of options than federal regulators when it comes to fostering fintech innovation. Unlike the OCC, for example, they can license a variety of business types, not just banks, and they already license and supervise many of the companies that might be interested in a fintech charter. The problem has been that state licenses, unlike a national bank charter, do not confer exemption from the overlapping licensure requirements of other states. For that reason, the expense and time involved in obtaining money services licenses in multiple states have been a significant drag on non-bank financial services companies.

Although the states have made clear that they oppose the OCC’s charter program for various reasons, Georgia is the only state that has launched its own fintech bank charter program. The Georgia program, which is based on legislation passed in 2012, offers non-depository fintech companies direct participation in the payment card networks (e.g., Visa and Mastercard) without the need for a sponsor bank. The program is an interesting example of the chartering flexibility states have. However, no state charter can guarantee a fintech firm the same federal preemption powers that national banks enjoy.

Most of the activity at the state level is focused instead on reducing the licensure burden. First, some states, most notably Arizona, have implemented regulatory sandboxes. The Arizona program accepted its first participant in October, and it includes a reciprocity provision that would allow sandbox participants to operate in other states that have a similar program. Illinois is also developing a sandbox, and banking regulators in New England are reportedly exploring the possibility of creating a regional program.

Second, the CSBS has started work on revamping its current money transmission licensure platform, the NMLS, to allow collaboration among state licensing authorities and reduce needless duplication in the license application process. Last year, the CSBS announced a multi-state compact in which Member States agree that, if one of them has approved an applicant’s business in one of five key areas—IT, cybersecurity, business plan, background check, or compliance with the Bank Secrecy Act—the other Member States will accept that finding. So far, Georgia, Illinois, Kansas, Massachusetts, Tennessee, Texas, and Washington have signed on.

The compact is the cornerstone of an initiative the CSBS announced in May 2017 called Vision 2020, which aims to foster a streamlined state licensing process for fintech firms offering money services.

The CSBS already operates the NMLS platform, which regulators in every state now use to license non-banks offering money transmission and other services. The CSBS has said that it will use this platform as a base from which to create the new multi-state licensing system.

Vision 2020 is not the national platform that many fintechs and industry watchers wanted. As with any system based on varying state laws, it requires applicants to account for differences among the states from the licensing phase through supervision and examination. Additionally, it is not clear how many more states will join the multi-state compact, or how quickly. The CSBS has set an ambitious goal of universal adoption by 2020. The CSBS's ability to recruit a critical mass of states will largely determine the program's success and its competitiveness with the OCC charter, which has a significant head start.

There are reasons for a fintech firm surveying its options to prefer state licensure through a streamlined process like the revamped NMLS. First, state regulators are in regular contact with their licensees and tend to develop a deep understanding of their businesses, risk profiles, and management. Second, state regulators view their relationships with supervised entities through the lens of economic development, making them more approachable. The opportunity to engage in informal back-and-forth dialog with state regulators about potential new products and compliance issues is invaluable—particularly for fintech firms looking to get innovative products to market quickly.

Conclusion

There is reason to believe that the Open Banking initiative will remake the financial regulatory landscape in the UK, but, at the one-year mark, the program is still in a ramping-up phase. A recent survey by a UK research firm showed that three quarters of UK residents did not understand the concept of open banking, and a similar number would be concerned about sharing their financial information with a business other than their primary bank. Some commentators have suggested that this may be because, although there are flashes of innovation visible everywhere, no game-changing app or service has yet brought the Open Banking concept into the everyday lives of a large segment of UK consumers.

The US, on the other hand, is still in the early stages of working out the threshold issues. These issues are complicated significantly by the size and diversity of the US financial services market and the complexity of the regulatory framework— particularly the state licensing and supervisory regimes applicable to most non-bank financial services providers. State regulators are attempting to reduce state licensure burdens by offering sandbox alternatives and developing a streamlined, multi-state licensure process. It remains to be seen, however, what level of buy-in those programs will achieve among state regulatory agencies, which have grown out of their states' particular laws and are accustomed to operating independently.

The Treasury Department and the CFPB have engaged with the concepts that underpin the UK's Open Banking experiment, but there are practical obstacles standing between those concepts and their realization in the US. That said, US businesses are aggressively implementing new and innovative financial technology products and services, and consumers are adopting them, suggesting that market "pull" may help accelerate the US implementation of open banking.

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