

Fact Sheet: FinTech, Crypto, the Banking Industry and Regulation

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Introduction

The recent rapid and spectacular collapse of the crypto company FTX has [clearly shown—again—the fiction and lawlessness](#) of the crypto industry, as did other dramatic crypto-related events this year, including:

1. losses of \$2+ trillion,
2. the disintegration of so-called stablecoins.
3. multiple crypto bankruptcies and frozen customer accounts, and
4. numerous firms and individuals charged with blatant civil and criminal lawbreaking.

Fortunately, this crypto carnage has largely been kept out of the traditional banking and financial system [due mostly to the financial regulatory agencies](#). But, notwithstanding crypto's disreputable track record, this may be changing as many are still seeking to connect and integrate crypto with the banking system. Combined with the increasing bank-like activities of FinTech companies, the banking regulatory agencies have many novel risks to address that threaten the banking system from the inside and out.

In response to these events the heads of the banking regulatory agencies—[Federal Reserve](#) (“Fed”), [Office of the Comptroller of the Currency](#) (“OCC”), and [Federal Deposit Insurance Corporation](#) (“FDIC”)—delivered remarks regarding the rapid advancement and adoption of financial-related technologies and the novel risks they pose to consumers, the banking system, and financial markets. These technologies include both claims about crypto as well as other technologies that broadly belong to the FinTech industry, such as payment platforms and technology-based nonbank lenders.

As then-Acting Chair of the FDIC Gruenberg noted in his speech, previous advancements in financial technologies

“began with a social, financial, or economic need to be addressed...[and] were designed to operate in a manner that is safe and sound for banks and that provides important consumer protections.”

There are a number of such financial technologies among the current wave of advancements, and this type of innovation should continue with its risks being appropriately addressed and managed consistent with the law. But there are also many current technologies that disregard or are designed to circumvent regulations and consumer protections. These technologies must be kept out of the traditional financial system.

While the crypto industry is receiving much of the public attention, (as Acting Comptroller Michael Hsu pointed out in a speech: “in many policymaking and regulatory circles crypto continues to attract a disproportionate amount of attention and suck the oxygen out of the room”), the FinTech industry is already intimately integrated within the banking system and presents many unique and complicated risks. The banking regulatory agencies must address the complicated, interrelated challenges of these technologies with an analytic framework that strikes the right balance between enabling the real benefits of each technology to be realized, if indeed there are any, while simultaneously minimizing the downside risks.

This fact sheet examines the landscape of FinTech and crypto and their implications for the banking industry and public policy.



What is the FinTech Industry?

FinTech, generally speaking, is any technology that is related to the provision of financial products and services. It has been an integral part of the modern era of banking and has transformed business models and customer experiences. Over the last few years FinTech has developed into a multibillion-dollar industry and is projected to continue growing rapidly. The industry can be broken into three broad categories:

- Companies that offer bank-like products and/or services as their primary business;
- “BigTech” companies that offer financial products and/or services;
- Companies that provide technology services to financial companies, such as cloud services.

The substantial growth in the FinTech industry over the last few years began with a model of “unbundling” banking products and services, starting with various payment and funds transfer services. For example, the technology from companies like Venmo provide consumers with a simple means to execute peer-to-peer payments and bank transfers. Additionally, so-called BigTech firms have entered the payments industry with Apple Pay, Google Pay, and Amazon Pay.¹

Product offerings have expanded over time and now include consumer and business lending, mortgage origination, credit and debit card facilitation, and other services. The company Affirm offers point-of-sale credit to retail consumers that can be paid off quickly for no interest or over time with interest. Similarly, Brex provides lending and financial services to small and medium-sized businesses. Chime has partnered with smaller banks to offer no-minimum, no-fee Chime-branded debit cards on partner banks deposit accounts.

And just as there was an unbundling of banking products and services, there has been a “rebundling.” The company Blend offers a platform of various FinTech software services to enable banks to create customized, integrated online and mobile interfaces. Additionally, both Google and Amazon offer loans to their business clients in addition to their payment services.


What Are Cryptocurrencies and DeFi?

Cryptocurrencies are digital assets that are claimed to have at least some of the properties of a traditional currency, including especially its security and confirmability in conducting financial transactions. This is claimed to be achieved through the underlying distributed ledger technology, which creates digital records in a manner that is supposed to be free of manipulation or modification. Crypto is typically divided into three main types: cryptocurrencies, tokens, and stablecoins.

Most cryptocurrencies and tokens so far have shown to be nothing other than volatile and speculative fictions more similar to gambling or Ponzi schemes than traditional assets or investments. Similarly, so-called stablecoins, which are claimed to hold a stable value and thus be able to function more meaningfully as a currency, have not maintained their stability or consumer confidence, with several even failing entirely this year as the market for crypto collapsed.

Some in the crypto industry have also attempted to essentially copy the structure of the traditional financial system by offering bank- and financial market-like products and services under the notion of a “decentralized” platform. Theoretically, DeFi platforms should enable secure, verified financial transactions such as lending

¹ All companies mentioned herein are for illustrative purposes only and there is no express or implied endorsement of any type of any company, product, service or activity, which is hereby expressly denied.



between two or more parties without the presence of a third party to facilitate the transactions. As with other crypto claims, this concept as well has yet to be realized, with much of the crypto industry being highly concentrated.

Read more about crypto and the crypto industry in our [fact sheet](#) on the crypto company FTX's dramatic rise and collapse, our [comment letter](#) on FTX's application to offer direct clearing access to margined futures contracts, and our [fact sheet](#) on cryptocurrencies.

What Are the Potential Benefits of FinTech, Crypto, and DeFi?

FinTech

There are two advantages over the current system that the FinTech industry seeks to deliver. The first potential advantage is increased connectivity. Internet and mobile technologies allow products and services to be provided more broadly and efficiently. This enhances the potential to increase customer access, including to un- and under-banked consumers and small businesses as well as lower-income individuals and underserved communities. There is also the increased connectivity between FinTech products and services and across platforms. This creates so-called network effects where customers can explore, identify, and utilize a broad range of products and services easily and almost without cost.

The second potential advantage, which amplifies the effects of connectivity, is reduced costs and increased availability of data processing and storage. With larger, more robust datasets and greatly increased processing capabilities, more meaningful results can be produced and at a faster pace as compared to legacy techniques. For example, the FinTech company Blend claims their software reduces the time needed for the average loan application and approval process by seven days. This (if accurate) can be a significant advantage because many banks rely on legacy data storage and processing systems that are relatively inefficient.


Crypto and DeFi

On the other hand, there have yet to be any benefits realized from crypto and DeFi. Even the most basic claimed benefit of faster and cheaper payments has not come about. The instability of crypto make it nearly impossible for such assets to achieve many of the alleged benefits. Additionally, users of these assets still have to convert them into fiat currencies to be used in the economy, adding inconvenience and fees. Also, financial products and services offerings from crypto companies lack stability and credibility due to their reliance on crypto. Furthermore, the industry has had a massive amount of consumer protection issues given that lawlessness is at the core of the industry, as detailed [here](#).

However, the underlying distributed ledger technology may prove to be beneficial, and, if that technology and its implementation becomes more efficient, benefits might indeed be realized. Already, some [large banks](#) are using the technology to make their own processes more efficient and offer unique products to clients.

The FinTech Industry Has Been Changing the Banking Landscape but Fortunately So Far Crypto Mostly Has Been Left Out

While the FinTech industry has a presence throughout the financial industry, including in personal investment, it is having the largest effect on the banking industry, simultaneously competing with it, integrating with it, and creating new challenges and risks for it. That is because FinTech companies are following the law and directly competing with banks, developing partnerships with banks, acquiring banks, and being acquired by banks. Each of these activities is changing the landscape of the banking industry.



Payment-focused FinTech companies, whether peer-to-peer or point-of-sale, make their money by charging various fees to consumers and retailers. These are fees that, in many cases, previously were being earned by banks. For example, users of Venmo can transfer money to each other instantly via so-called digital wallets, which store money for users as if it were cash in a wallet. And because Venmo is owned by PayPal, money in these digital wallets can be used directly with many online vendors to pay for goods and services.

This results in lost income for banks. If consumers were using a bank to conduct these transactions, the bank would earn transfer fees when money was transferred from bank to bank as well as debit card interchange fees when debit cards were used for the purchases. Additionally, money that sits in digital wallets is money that could be in a bank account and serve as a source of funding for profitable loans or other financial activities of the bank.

To combat this competition, seven of the country's largest banks partnered to develop the bank-based peer-to-peer payment system Zelle. In 2021 nearly [\\$500 billion was transferred using Zelle](#), twice the amount of the closest peer-to-peer payment competitor. Based on that success, some of the banks in the partnership reportedly would like to [expand the service](#) to facilitate payments for retail purchases.²

Also, partly in response to competition from digital wallets (and partly due to the [public](#) and [regulators](#) highlighting the issue), many banks have [reduced or eliminated](#) overdraft and other account-related fees on deposit accounts to make them more attractive. Still others have begun to offer online-only bank accounts that charge no fees at all.


Another key banking market entered by FinTech companies is that of consumer lending, and they have been very successful. The FinTech mortgage origination process [has been shown](#) to be significantly faster than traditional bank mortgage originations and yet to also have lower delinquency rates. Additionally, FinTech lenders are [more likely](#) than banks to offer mortgages to consumers with lower income and credit scores and to offer personal loans to individuals who recently had been denied credit by another lender. That, along with other factors, is likely why nonbanks originated [71% of mortgages](#) in 2021—up from around [20% in 2007](#)—and around [40% of personal loans](#) in 2018, a figure that has probably increased since then.

In the face of this competition, banks are trying to adopt if not embrace the advantages that FinTech would bring to their business models. However, it has been difficult for banks to compete with rapidly developing FinTech companies given banks' reliance on legacy systems, processes, and structures. Improving their technology and updating their platforms requires banks to spend a lot of money, hire specialized development staff, and train existing staff on any new systems and processes that are developed. Therefore, rather than acquiring FinTech companies, large banks have been developing their own in-house technologies and small banks have been seeking partnerships.

[Nearly two-thirds](#) of banks and credit unions entered into at least one FinTech partnership over the past three years, and nearly 40% of those that have yet to form partnerships had plans to do so this year. However, even with the development of these partnerships, banks have cited difficulties integrating the technology with their existing systems as well as a lack of staff expertise, still leaving them a step behind independent FinTech companies.

In addition to products and services, banks connect to FinTech companies through lending. Banks have been providing funding to nonbank financial companies at a rapidly increasing rate, with 22% growth in such loans in

² It should be noted that fraud on Zelle has been controversial, as reported here: "[Banks Plan to Start Reimbursing Some Victims of Zelle Scams.](#)"



2021 [as reported by the Fed](#). Nonbank financial companies, including FinTech companies, utilize the funding to originate loans such as the mortgage originations cited above.

The largest FinTech firms are taking yet another approach by acquiring banks or even seeking their own bank charters. LendingClub acquired a bank last year, after 12 years as a nonbank online lending platform, to take advantage of the cheaper funding source of bank deposits—reportedly, [a 90% savings](#) for them—and the ability to warehouse its own loans. SoFi applied for a national bank charter from the OCC but eventually acquired a bank to expedite the process.

Crypto largely has been kept out of the banking system so far, which is fortunate given the collapse and widespread carnage over the last year. But that nonetheless is changing, bringing the risks of crypto into the banking system. Recently, Bank of New York Mellon [announced](#) they would start holding certain crypto in custody for select clients. Additionally, the payment company Mastercard [announced](#) a new product that will allow bank customers to use their bank deposits to trade crypto.

What are the Risks of the FinTech and Crypto Industries?


The many risks that could arise from these technologies are unknown at this point. Of course, similar financial activities carry similar risks, even if implemented in a novel or more advanced manner. But these new technologies and business models also can create new risks or materially exacerbate existing risks. Additionally, as these firms grow and become more connected with banks and the broader financial system, they can amplify or pose systemic risks that threaten the financial system, the economy, and taxpayers.

When FinTech and crypto companies offer the same or similar products and services as banks, they have the same risks associated with those products and services. First, lending by these companies carries the credit risk of borrower defaults. Second, their day-to-day operations and financial obligations to their clients, vendors, and counterparties creates liquidity risk. Third, any holdings of financial market instruments such as securities or derivative agreements, whether by FinTech firms or stablecoin companies, introduce the risk of market value losses to the company as well as liquidity risks. Fourth, there are always the operational risks of mis-coded algorithms, cybersecurity incidents, or other events.

If these companies are connected to the banking system, their risks will spill over and compound the risks already faced by banks. As for FinTech companies, some offer loans to individuals (e.g., mortgage or personal loans) that are funded by loans from a bank, and so the bank bears the risk of the FinTech company defaulting. Importantly, since FinTech companies partner with or are utilized by many banks, concentration risks can increase along with the number of partnerships, including especially from any risks embedded within a FinTech company. Alternatively, any single FinTech company can grow large enough to be systemically important on its own.

For crypto companies, the level of those risks inherently is much higher due to the nature and design of crypto, which compounds and complicates these risks. For example, the credit and liquidity risks from loans provided to crypto companies by banks or crypto companies' own liquidity management issues can be exacerbated by the volatility and instability of the underlying crypto. These would lead to exacerbated losses and liquidity concerns at the related banks. There can also be risks from trade and settlement facilitation or even asset management services especially if bank clients are given loans that are collateralized by crypto portfolios whose value is volatile.

Additionally, also because both industries offer similar products and services as banks, there is the risk that either or both industries could grow to become another material form of shadow banking and could create existential



issues for the banking industry. If a significant amount of money sits in digital wallets within the FinTech industry or in crypto (such as stablecoins), this would likely reduce the amount of deposits in the banking system, thereby reducing a key source of banks' funding and the amount of support banks could provide to the real economy. Similarly, lending and other financial services offered by competing industries would also reduce demand for banks' products and services.

These effects, if realized, would not only increase risks and concentrations in the FinTech and crypto industries but also could create a "race to the bottom" on risk management as banks compete to maintain market share, return on equity, and profits. That is, banks could try to compete by offering better terms on products and services that are not in-line with safety and soundness principles or to boost their return on equity by engaging in ever-riskier activities.

The most currently pressing risks within these industries, however, are related to consumer protection, privacy, and cybersecurity. The ease of use and broader reach to more customers has increased the incidence of fraudulent transactions, especially when the fraud involves peer-to-peer payments (with either crypto or FinTech platforms) on which [the transfer of funds is instant, final, and irreversible](#). FinTech firms can have certain biases that become [embedded in algorithms](#), such as discriminatory lending, or privacy incidents based on the significant amount of personal information they collect ostensibly to offer improved services.


What Are the Policy Considerations?

The pace and scale of FinTech and crypto growth has increased the necessity to answer many questions about the supervisory and regulatory landscape for the banking sector. Importantly, it has also raised questions about to what extent these companies should be able to interact with banks or even directly obtain bank charters and access to Federal Reserve Bank master accounts and related financial services.

The banking regulatory agencies have recognized the need to address the risks these industries pose to the banking system. The Fed has established a System FinTech Supervisory Program, and the OCC has increased the depth and frequency of its Bank Information Technology supervisory examinations. All three agencies—the [Fed](#), [OCC](#), and [FDIC](#)—have issued supervisory letters that require banks to notify the agencies of any crypto related activities and to seek supervisory approval based on legal and safety and soundness considerations. And they released a [joint statement](#) that outlines the risks they believe arise from crypto related activities and basically states that banks currently are not allowed to directly hold crypto or engage in activities that are highly concentrated in crypto.

As for FinTechs, the banking regulatory agencies jointly have issued [draft supervisory guidance](#) on banks' management of third-party relationships that include those with FinTechs and [a guide](#) to help community banks evaluate risks and benefits of relationships with FinTech companies. In addition, the heads of each agency have outlined certain key risks within these industries as well as some high-level principles for policy development in their recent speeches.

However, the federal banking agencies have not yet published official supervisory principles or regulations that are specific to the unique business models and risks of the FinTech and crypto industries or commented on whether the current framework is sufficient. Novel institutions and products present risks that could likely originate and manifest in novel ways, and so the current supervision and regulation frameworks may not be appropriate. If so, using the current frameworks could lead to under-assessed risks or even risks that are missed altogether, which could have meaningful consequences.



Although the banking regulatory agencies have indicated they currently are supervising activities and connections between banks and these industries, it is unclear what supervisory standards and principles are being used and whether they are sufficient to manage the unique risks. Therefore, the regulatory agencies should either fully explain why the current standards are sufficient and how they are being applied to the set of risks posed by these industries or should propose industry-specific regulations and/or supervisory guidance where necessary. Otherwise, risks that threaten financial institutions including banks, financial markets, consumers, and—if granted access to the Fed accounts—the Fed’s Reserve Banks and payment system may be un- or under-assessed.



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