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Ann E. Misback, Secretary,
Board of Governors of the Federal Reserve System,
20th Street and Constitution Avenue, N.W.
Washington, DC 20551.
VIA: regs.comments@federalreserve.gov

Re: Docket OP-1747, Proposed Guidelines for Evaluating Account and Services Requests
Docket OP-1749, Potential Modifications to the Federal Reserve Policy on Payment System Risk to Expand Access to Collateralized Intraday Credit, Clarify Access to Uncollateralized Credit, and Support the Deployment of the FedNow Service

Dear Federal Reserve:

In summary:

- I support the proposed guidelines and modifications.

[1] All opinions are strictly my own and do not necessarily represent those of Georgetown University or anyone else. I am a finance professor at Georgetown University with interests in financial markets, regulation, and technology. I served on the Fed's Faster Payments Task Force and the subsequent Governance Framework Formation Team. I am also the academic director for our Fintech Certificate Program. Over the years I have served as a Visiting Academic Fellow at the NASD, served on the boards of the EDGX and EDGA stock exchanges, served as Chair of the Nasdaq Economic Advisory Board, and performed consulting work for brokerage firms, stock exchanges, market makers, and law firms.

- New technologies need to be regulated differently to reflect their differences from older technologies.
- The Fed should make it as easy as possible for fintechs to connect to the US financial system as long as they do not present undue risks to financial stability, the payment system, or monetary policy.
- Easier access will spur competition and innovation in the US financial sector.
- Broader access will support financial inclusion.
- Network effects of broader access will make our financial network better for everyone.

Background

We are in the midst of a financial revolution. Modern computing and communication technologies make it possible to deliver financial services that are better, faster, and cheaper than traditional services. This provides the opportunity to provide the benefits of financial services to the unbanked and underbanked, as well as better, faster, and cheaper services to the already banked.

Many new entrants to financial services, known as fintechs, have popped up. Some of them have acquired or seek to acquire various types of banking charters and seek access to accounts and services at Federal Reserve banks. The Fed has proposed guidelines for assessing these requests for access. The guidelines are a common sense principles-based approach. In summary, the guidelines require:

1. The applicant must be legally eligible to access Fed services.
2. The services must not present undue risks to the Reserve Bank.
3. The services must not present undue risks to the payment system.
4. The services must not present undue risks to financial stability.
5. The services must not facilitate illicit activity such as money laundering or terrorist financing.
6. The services must not interfere with the implementation of monetary policy.

These guidelines provide a path for fintechs to connect to the US financial system and are a common sense step forward.

New technologies need to be regulated differently.

It is not surprising that existing participants in our over-regulated financial services industry will demand that new entrants follow exactly the same regulations that they have been required to follow. However, this is not always the best thing for society. Changing technology can mean a change to optimal regulation.

Ride-sharing services such as Uber and Lyft provide a good example of the need for differential regulation of new technology. As their services are similar to and compete with traditional taxi services, one might think erroneously that they should be regulated the same way. However, they are different enough that they should be treated differently. For example, New York City taxicabs have numerous regulatory requirements.[2] They must have bullet-resistant partitions to protect the drivers from robbery. This requirement made sense when it was enacted because cash-carrying drivers are targets for violent robberies. However, Uber and Lyft drivers in the United States do not take cash, and thus are far less likely to be robbed. Uber and Lyft have a pretty good idea of who is getting into a car, another deterrent to robbery. Thus, a bullet-resistant partition is unnecessary. Taxis are required to have taxi meters to determine fares. With Uber and Lyft, fares are determined in advance via GPS. A separate meter is unnecessary.

Thus, it thus does not make sense to blindly apply existing taxi regulation to ride sharing services. However, it does make sense to apply appropriate regulation to achieve the regulatory goals of consumer and driver protection. Regulations regarding driver qualification and vehicle safety should be comparable.

Similarly, new fintech entrants are offering different services than traditional banks. Traditional banks generally offer deposit, lending, and payment services among other things. They deliver their services in both traditional brick-and-mortar branches as well as online. Banks are risky because they engage in a both a liquidity transformation (converting long-term illiquid assets such as loans into demand deposits) and credit transformation (converting risky loans into low-risk deposits). Over the years, a regulatory framework has evolved with the policy goals, in the words of the proposing release, of "(1) ensuring the safety and soundness of the banking system, (2) effectively implementing monetary policy, (3) promoting financial stability, (4) protecting consumers, and (5) promoting a safe, efficient, inclusive, and innovative payment system." This regulatory framework has evolved with traditional institutions in mind. However, many innovators offer products that are very different from the traditional bank, and thus require a different type of regulation. For example, money market mutual funds (MMMFs) engage in far less liquidity and credit transformation than commercial banks. The average maturity MMMF assets is measured in days, not years, and they only hold very high quality liquid assets such as T-bills, repo, and high grade commercial paper.

<u>It is unnecessary at this time to burden innovative fintechs with costly CRA compliance.</u>

Incumbent banks may argue that the full panoply of Community Reinvestment Act (CRA) regulations should apply to all of their fintech competitors. This would be like requiring ride-sharing services to paint all ride-share vehicles taxicab yellow, which would be unnecessary. Yellow paint schemes and taxi medallions let customers know they were entering a licensed taxi with known rates and not a vehicle operated by a dangerous thief. Ridesharing apps perform this validation function by showing the license plate and picture of the driver.

The CRA was enacted as a means to undo the damage done by decades of explicitly racist federal housing policy. Brick and mortar bank branches in existence at the time of the CRA passage had evolved during a

[2] https://www1.nyc.gov/assets/tlc/downloads/pdf/rule_book_current_chapter_58.pdf

period of government mandated housing segregation. Federal government policy from the New Deal through the 1960s had explicitly encouraged racial segregation through regulatory policies that channeled mortgage finance into racially segregated enclaves, or worse yet none at all.[3] Branch locations had evolved in this environment, and most lending was branch based. Without regulatory action to reverse the impact of previous government regulation, the existing geographic footprint of the then brick-and-mortar banking system would have perpetuated the injustices of redlining. While one can and should debate the appropriate role for CRA-type policies going forward, there is no obvious need at this time to apply the 20th century Band-Aid of the CRA to 21st century fintech innovators that effectively have no geographic footprint at all. The Fed should not require new fintechs to be painted yellow.

<u>The financial revolution is changing how we think about financial services.</u>

Financial services provide a broad variety of benefits to society. Our financial industry provides a payment system that makes efficient exchange possible. The ability to borrow and lend provides a time machine for businesses and consumers that allows them to uncouple the timing of when they earn money and when they spend it. Our financial markets gather together the massive amounts of capital needed for investment in productive activities ranging from bridges and jetliners to semiconductors. Our financial markets also provide risk management products, ranging from traditional insurance to derivatives, that allow participants to reduce risks through diversification and hedging or to take on risks where the expected return outweighs the expected risk.

Technology is changing how we do everything, including financial services. Cheaper and faster computer power and communication ability, along with smarter algorithms and artificial intelligence provide the opportunity to overhaul financial services. We can and should rethink how we do things, and many of these services need not be delivered in the traditional bank wrapper. The crypto revolution may replace institutions with protocols for the delivery of financial services.

Technology is blurring the traditional boundaries between different types of financial institutions. Money transmitters are not banks in the traditional sense. Firms like Western Union have long been a niche part of the financial system, and a different state-based regulatory scheme has evolved around them. However, newer payment services such as PayPal, Venmo and the Cash App are quickly becoming new core payment rails in our economy of systemic importance. The card networks are also morphing from one-way debit and credit services into two-way money transmitters.

Likewise, stock brokers, mutual funds, and insurance companies are not banks in the traditional sense and have different regulatory regimes. However, their products serve many of the same economic functions as traditional bank services. Participants can store value in financial assets, tap into that value, and transfer it to others. New fintechs may not be seeking to offer the same menu of services in the same way,

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[3] For more details on the role of the federal government in exacerbating 20th century racial segregation, see *The Color of Law: A Forgotten History of How Our Government Segregated America*, by Richard Rothstein

and it is not always clear which regulatory buckets they fall into, or whether a new regulatory bucket is needed.

A changing world requires changing regulation. Regulators need to keep in mind the purposes of why they are regulating as they consider the impact of new technologies: Protecting consumers, economic stability, economic inclusion, and economic growth. Merely protecting the market share of existing incumbents should not be a goal.

Many financial products are network services in which broader networks benefit all.

There are many products whose usefulness grows when more people use them. These are known as network products. Imagine if you had the only telephone in the world – it would be a useless paperweight. But the more people who connect to a telephone network, the more valuable a telephone becomes. Other examples of network products are human languages, computer software, and, of course, social networks.

Payment services are a classic network service. The more people who can access a particular payment mechanism, the more usable it becomes. In order to maximize the value of payment networks to society, we need to maximize the ubiquity of the network. This is why ubiquity is the very first of the effectiveness criteria adopted by the Faster Payments Task Force.[4]

In order to achieve ubiquity in our payments network, it is necessary for competing networks to interconnect. This does not necessarily happen naturally. Indeed, because larger networks have advantages over smaller networks, larger networks have a strong incentive to prevent smaller networks from interconnecting with them in order to force users to forsake the smaller network and connect to the larger network. U.S. telecommunications history is a case in point: In the early days of telephone, rival phone companies refused to interconnect, leading to a fragmented and balkanized telephone system. Congress now specifically requires telephone operators to interconnect.[5]

The fragmented state of the U.S. payments system is a sorry situation. Square, Venmo, Zelle, PayPal, et al. do not interconnect. The US is far behind many other countries in moving towards a ubiquitous real-time payment system. We need to work towards an environment in which anyone can pay anyone at any time regardless of what network they are on.

[4] https://fasterpaymentstaskforce.org/meet-the-task-force/effectiveness-criteria/

[5] 47 USC 251

The Fed should require interconnection as a pre-condition for using Fed services.

Actions that promote interconnection will improve the U.S. payment system. Making it easier for fintechs to access Fed services, especially the forthcoming FedNow service, will promote the interconnection needed to achieve a ubiquitous and efficient payment system. As part of the "price" of connecting to Fed real-time services, the Fed should require users to adhere to standards that promote ubiquity in payments. For example, users that connect to Fed services should be able to send and receive to other participants no matter what system they are on. This can be done with simple routing to an address that includes the recipient's provider. For example, a user on Zelle should be able to send a payment to a phone number on Venmo, such as 202-555-1212@Venmo.

Easier access will support financial inclusion and innovation.

The old way of doing banking resulted in a significant fraction of the population that was unbanked or underbanked. It was not possible for traditional brick and mortar banks to serve the unbanked profitably, so the they didn't. Poor people could not afford the fees and minimum balances for deposit accounts, and high-cost banks could not cost-effectively offer credit in small amounts without charging prohibitive interest rates. The marginalized were thus forced to use high-cost "fringe banks" such as pawn shops, money transmitters, title loans, and check-cashing outlets for basic financial services. This unfairly forces the poor to actually pay more for basic financial services than wealthier people, thus increasing inequality.

It is the new entrants that will most likely bring real progress.

Technology is bringing down the cost of many things, from international phone calls to electric vehicles. However, it often takes new entrants with a different mindset to make it happen. It was not ATT that brought down the cost of international calls, it was services like Skype and WhatsApp. It was not General Motors that made electric cars happen, it was Tesla.[6]

In order to harvest the promise that fintech provides, we need to make it feasible for the innovators to come in and compete fairly with existing players. On the surface, the guidelines will do just this. The guidelines support legal entrants while ensuring that they do not impose undue risks on the Reserve Banks, the payment system, the economy, and monetary policy while not promoting illicit activities.

It should be noted that other countries such as the United Kingdom are opening their payment infrastructure to non-bank firms.[7] There is no reason the Unites States should not do so as well, with the appropriate safeguards as enshrined in the proposed guidelines.

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[6] GM did create the EV1 electric car long before Tesla existed, but terminated the project.

[7] https://www.bankofengland.co.uk/speech/2021/may/jon-cunliffe-omfif-digital-monetary-institute-meeting

The Fed should take a broad approach in interpreting its authority to provide access.

The devil, as always, is in the details. In particular, there will be issues concerning which institutions are within the Fed's legal ability to offer services. The incumbent players will undoubtedly fight a rear-guard action and push for a narrow construction of the Fed's ability to offer services to would-be competitors.[8] (I would if I were them.) Such a narrow construction would narrow the number of potential innovators that can provide useful enhancements to our financial system.

The Fed should take the opposite approach and use its broad regulatory powers to adopt a very broad definition of the entities that can access Fed services. To the extent that the Fed feels that it lacks statutory authority to offer services to various fintechs, it should lobby Congress for the ability to do so.

Speaking of details, the process should not be overly burdensome and bureaucratic. The policy and attitude of the Reserve Banks should be one of helping innovative firms to access the Fed and not a barrier.

The Fed should adopt a scaled sandbox philosophy, but not fill it with quicksand.

Financial technology is changing. Different entities and protocols are emerging that are transforming the nature of financial services. The potential for tremendously valuable new financial services is enormous, both for the banked and unbanked. However, the proper way to regulate these new services is not always clear. For this reason, the Fed should adopt a scaled sandbox philosophy that allows new entrants the freedom to plug in their new business models to Fed services with simple principles-based guidelines to ensure that they do not present undue risks to the financial system. Experience with these innovators will demonstrate over time the appropriate way to regulate them as they grow larger.

However, extreme care must be taken to ensure that the sandbox is not filled with quicksand. The experience of some other countries is that the regulators have saddled their sandboxes with so much red tape as to hinder them. For example, here in the United States, our regime for crowdfunding is so restrictive that it is far below its potential.

Respectfully submitted,

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[8] For example, see https://bpi.com/wp-content/uploads/2021/06/Fed-Account-Access-for-Nonbanks.pdf