



*Advancing Economic Security
and Community Prosperity*



May 31, 2016

Office of the Comptroller of the Currency
400 7th St., SW
Washington D.C., 20219

RE: OCC Paper: Supporting Responsible Innovation in the Federal Banking System

To the Office of the Comptroller of the Currency (OCC):

We are writing concerning the OCC's recent paper entitled "Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective." In general, we welcome the OCC's development of a comprehensive framework to address innovation, and we believe, given the already fast pace of innovation, that it should be implemented swiftly. At the same time, we express concerns about the potential harm to small businesses, consumers, and communities if innovation is not checked by an adequate and appropriate regulatory framework.

General Comment:

The second and third questions posed in the Request for Comments at the end of the OCC Perspective paper require a general response to the accelerating innovation in the Federal Banking System. In order for the OCC to facilitate responsible innovation, it must learn to distinguish between responsible innovation that can benefit consumers, businesses, and communities and predatory innovation that can cause harm, such as toxic residential mortgage-backed securities and collateralized debt obligations. Moreover, the OCC needs to be significantly more aggressive in monitoring and assessing innovation to distinguish the good from the bad, both in the theory of the innovation and the practice of how it is used in the economy. The OCC cannot simply sit and observe while innovators create and unleash products and services that undermine the financial well-being of people and communities. "Unfortunately, there is a long history of companies (both banks and nonbanks) that leveraged less rigorous oversight into market advantages that typically disadvantaged consumers."¹

¹ Antonakes, Steven. "How Tech Innovators Can Influence Their Own Regulatory Fate." *American Banker*. May 20, 2016.

The first two guiding principles miss that point. They speak of “responsible innovation” without ever mentioning the other side of the coin: innovation that irresponsibly exploits consumers, businesses, and communities. Even responsible products, such as adjustable-rate mortgages can be innovated to be irresponsible. The OCC, therefore, must be vigilant in adoption of rules and procedures to prevent such unfair, deceptive, and abusive use of innovation from causing widespread harm, as it has in the recent past.

The exposition of the seventh guiding principle clearly demonstrates the extent to which the OCC misses the potential for innovation to cause harm. While it mentions bringing consumer groups into the dialogue in the first paragraph, the rest is about “innovator fairs” to bring together banks and nonbank innovators and help them navigate the regulations and supervisory expectations. Consumer groups and advocates are indispensable assets in taking a critical look at innovation and seeing the potential for good and bad. Consumer groups, CDFIs, and related organizations can serve as watchdogs against harmful practices, products, and policies on the one hand; and also as partners in responsible innovation that benefits local communities. These organizations must be an integral part of the dialogue at all times.

I. Regulators should aim to ensure that innovation does not result in a lack of transparency and accountability.

Innovation in the financial sector means that technology platforms and algorithms are in some ways replacing manual operations and human activity. We are concerned about the extent to which this trend will result in a loss of transparency and accountability. This phenomenon is perhaps most apparent in the area of loan underwriting. Under a low-tech (human-based) model, an underwriter can be expected to articulate the criteria for determining whether to approve or deny a loan, how the application of that criteria led to an approval or a denial in a given instance, and how the loan terms were deemed appropriate for that particular borrower. The technology platforms that are being utilized by non-bank lenders make the underwriting process much more opaque. This fact makes it more difficult to ascertain the safety and soundness of a particular loan decision and makes it more difficult to detect potentially predatory practices. As consumer advocates, we are concerned about whether loans are being made based upon a borrower’s ability-to-pay versus a lender’s ability-to-collect. In the small business context, under an ability-to-pay standard, a business can pay off the debt without compromising its growth and operation. Under an ability-to-collect standard, the small business borrower will be able to make payments on the debt, but the business and/or the owner(s) will suffer financial hardship. Regardless of whether a loan is being made by or through a fintech, a lender should be able to justify its decisions and to explain how a loan of a certain amount on certain terms can be repaid by a business without trapping the business in a cycle of debt or otherwise harming the business and/or its owner(s).

Unfortunately, we believe innovation is already outpacing regulation and oversight, and there are several pieces of information to support this. In the media, online small business loans have already been compared to subprime mortgages.² Accion Chicago, a Community Development Financial Institution (CDFI), in Chicago reports that more than 20 percent of its customers are seeking relief from a “problem loan” and that many businesses are within 60-90 days of having to close their doors. According to Accion, loans seem to be underwritten based on gross revenues as opposed to net revenues, but it is impossible to know for certain because the underwriting is performed by a fintech platform. The Federal Reserve’s 2015 Small Business Credit Survey reports that only 15 percent of small businesses that took out loans

² Forbes, “Why Online Small Business Loans Are Being Compared to Subprime Mortgages,” Dec. 10, 2015.

with an online lender were satisfied with their experience.³ And, Woodstock's analysis of 15 small business loan contracts from online lenders showed APRs ranging from 26 percent to 347 percent (Appendix A). Against this backdrop, regulatory reform seems past due.

Advocates in Illinois, including Woodstock, are advocating for legislation that would create a regulatory regime for non-bank small business lenders. Under SB 2865, non-bank small business lenders would be required to lend according to an ability-to-repay standard. The industry is vigorously opposed to the legislation for various reasons. Regardless, our effort to draft an underwriting standard in plain English has highlighted the fact that the underwriting standards of fintech companies are not readily translatable into English. They are algorithms. Put another way, policy-makers and fintechs speak different languages. The OCC will need to contend with this language barrier. To understand whether a particular innovation is fair for consumers, one must be able to understand and evaluate the innovation in human terms. It is not clear whether certain fintech processes can be translated into those terms. While there may be a place for proprietary underwriting, underwriting should be based on easy to explain principles that allow small businesses, regulators, and the public to assess possible harm.

Similarly, advocates in California and throughout the nation are concerned about the explosion of nontraditional lenders, the lack of clear regulatory oversight, and the impacts of these dynamics on small businesses and local economies. Just last week, Opportunity Fund released a report entitled "Unaffordable and Unsustainable: The New Business Lending", which analyzed loan applications from over 100 small businesses that sought to refinance debt that included 150 alternative loans. Key findings include:

- the average alternative loan carried an APR of 94 percent with one loan reaching a shocking 358 percent APR;
- more than a quarter of businesses had loans outstanding with multiple alternative lenders;
- the average monthly loan payment for businesses was nearly double the net income available to the owners;
- disturbingly, among Hispanic/Latino borrowers, the average monthly payment was more than 400 percent of take home pay (which raises fair lending concerns to the authors of this letter);
- for businesses that Opportunity Fund could refinance, monthly payments fell by more than 60 percent and APRs dropped by an average of 85 percent;
- most of the refinance applications that were denied by Opportunity Fund were from businesses that owed so much money they could not afford to repay a lower cost and longer term loan.⁴

Other CDFIs in California likewise report having to expend precious capital to refinance businesses that got into bad deals with lenders that no doubt viewed themselves as "innovative." And the state's Department of Business Oversight Commissioner recently instigated a study and released the ensuing report of online and marketplace lending, remarking that "we want to make sure our regulatory structure adequately protects the interests of our consumers and small businesses, and works effectively for industry."⁵

³ "2015 Small Business Credit Survey." Federal Reserve Banks of New York, Atlanta, Boston, Cleveland, Philadelphia, Richmond, and St. Louis. March 2016.

⁴ Eric Weaver, Gwendy Donaker Brown, Caitlin McShane, "Unaffordable and Unsustainable: the New Business Lending on Main Street," Opportunity Fund, May 2016.

⁵ Department of Business Oversight, "California Online Lending Grows by More Than 930% Over Five Years: Increase Outpaces U.S. Rate by 236 Percentage Points," April 8, 2016, at: http://www.dbo.ca.gov/Press/press_releases/2016/Survey%20Response%20Release%2004-08-16.pdf

In addition, many people assume that algorithms are non-discriminatory and neutral. That is an unjustified and erroneous assumption. Decision algorithms can reinforce and perpetuate bias and discrimination, possibly even resulting in violations of fair lending and equal credit opportunity laws. As one example, it has been suggested that Macintosh (Mac) computer users may be viewed as more credit worthy than Personal Computer (PC) users, and underwriting algorithms may take this into account. Yet, it is also understood that Mac users are more likely to be white. If true, a seemingly race-neutral factor, choice of computer, could lead to disparate underwriting decisions, in essence baking fair lending concerns into the algorithm itself, with the customer, the public, and possibly the regulators having no idea that this is so. At the very least, the OCC must assess the algorithms to ensure that the facade of neutrality and objectivity does not conceal underlying discriminatory outcomes that result in disparate impact or fair lending violations.

II. Brick-and-mortar branches remain an important part of the financial system.

We support the OCC's statement in its paper regarding the ongoing importance of "brick-and-mortar" bank branches. Many lower- and moderate-income (LMI) people need convenient access to financial services through live interaction at branches with people who speak their language; are culturally competent; can answer questions and provide guidance and counseling; and can address particular needs such as customers who are immigrants, lack Social Security Numbers, lack English literacy, are elderly, have vision, hearing or other impairments; or are not computer, mobile, or smart phone users. A 2014 report by National Urban League, the National Council of La Raza, and the National Coalition for Asian Pacific American Community Development presented results of a survey of over 5,000 minority individuals.⁶ Only 11 percent of respondents were comfortable conducting financial transactions online or with a mobile device. Further, a 2014 FDIC paper on mobile banking shows that while there is prevalent use of mobile phones LMI individuals, such individuals are less likely to use smart phones as compared to the general population, and mobile banking has some significant disadvantages compared to branches for many in the LMI population.⁷ For example, the FDIC noted that one-on-one interaction is still important for the underserved, particularly for coaching and guidance.

In addition, bank branches are an important part of the local economy. A 2015 study by a University of California economist found that small business lending is 8 percent lower for several years after a branch closing and that this decline is more severe in low-income and high-minority tracts.⁸ This decline "translates into a two percentage point reduction in local employment growth rates."⁹ Therefore, we support the OCC's position on the importance of physical bank branches and believe that the OCC should grant negative credit under the Community Reinvestment Act (CRA) to banks that close branches in LMI areas or in communities of color.

Even though many LMI consumers have access to mobile phones, email, and the internet, such access is often intermittent, unreliable, costly, or uncomfortable for the consumers. The digital divide is real and

⁶ "Banking in Color: New Findings on Financial Access for Low- and Moderate-Income Communities." NCLR. 2014. http://www.nclr.org/images/uploads/publications/bankingincolor_web.pdf. Accessed March 16, 2016.

⁷ "Assessing the Economic Inclusion Potential of Mobile Financial Services." Federal Deposit Insurance Corporation. June 30, 2014.

⁸ Nguyen, Hoai-Luu. "Do Bank Branches Still Matter? The Effect of Closing on Local Economic Outcomes," October 2015. http://faculty.haas.berkeley.edu/hqn/nguyen_branches_20151001.pdf. Accessed March 14, 2016.

⁹ *Id.*

consumers still need access to branches and real people. The OCC and other bank regulators should work to reduce barriers and to otherwise make it easier for banks to open new branches, rather than focus mainly on making it easier for banks to rely on mobile and online technology to the detriment of branches and the communities that rely on them.

III. Technological innovation enhances the need for effective oversight of third-party relationships.

Some banks have pursued innovation by forming third-party relationships with fintech companies. The most well-known example of this trend is OnDeck Capital's partnership with J.P. Morgan Chase. It is too soon to tell whether this particular relationship will be in the best interests of the bank's customers, but we believe the trend towards innovation increases the importance of the OCC's monitoring of such relationships in accordance with its published guidance on third-party relationships. OCC Bulletin 2013-29 includes "Business Experience and Reputation" as one of the factors that a bank should consider before entering into a relationship with a third-party. It is fair to say that the fintech sector has suffered some hits to its reputation. A coalition of groups, including both lenders and advocates, developed the Borrower's Bill of Rights (BBOR), but not all fintech lenders agreed to adhere to it. Only very recently have certain online small business lenders agreed to start disclosing the annual percentage rates on their loans.¹⁰ In addition, the circumstances surrounding the recent, forced resignation of Lending Club's founder and CEO further tarnished the reputation of the fintech sector. The cumulative effect of these occurrences and the predatory practices of some companies have given rise to a reputation risk that threatens to weaken the public's confidence in banks that partner with fintechs. We, therefore, encourage the OCC to be vigilant in overseeing these partnerships.

Separate from reputation risk, we are concerned about actual consumer harm that fintech companies may cause – either on their own or through their relationships with banks. Suffice it to say that we believe that triple-digit APRs harm borrowers, so the OCC should strictly forbid banks from forming third-party relationships with companies that issue loans on such terms. Further, we are concerned that fintechs target more vulnerable communities. Woodstock released a report in 2014 that found that access to traditional credit by small businesses is disproportionately limited in LMI communities and in communities of color.¹¹ Fintechs are likely trying to fill that gap by offering financial products to these populations. As noted by the U.S. Department of the Treasury in its recent white paper, "While data-driven algorithms may expedite credit assessments and reduce costs, they also carry the risk of disparate impact in credit outcomes and the potential for fair lending violations."¹² Hopefully, the OCC's Innovation Initiative will prevent or limit third-party relationships that could result in consumer harm, and to the extent such harm occurs, the OCC should take appropriate enforcement action against the bank involved and should grant the bank negative credit under the CRA and refer potential fair lending violations to the Department of Justice.

There must be transparency and robust oversight with respect to bank relationships with third party vendors. These relationships may take various forms, but many come with the potential if not the intent for the bank to hide its involvement in dealings with problematic actors that bring profits but not scrutiny. Small businesses and consumers should have the right to know which lenders are involved in their loan,

¹⁰ "Online Small-Business Lenders Agree to Disclose Annual Rate on Loans." *Wall Street Journal*. May 5, 2016.

¹¹ Cowan, Spencer. "Dis-credited: Disparate Access to Credit for Businesses in the Chicago Six County Region." Woodstock Institute. August 2014.

¹² "Opportunities and Challenges in Online Marketplace Lending." U.S. Dept. of the Treasury. May 10, 2016.

and what is the nature of that lending relationship. In the Chase/OnDeck partnership, advocates are concerned not only about the reputational damage to Chase, and the terms of the product to be offered through the partnership, but also what happens to loan applicants who are denied the Chase/OnDeck loan and then may be vulnerable to problematic OnDeck marketing and products. To further transparency with regard to third parties, we will advocate for the CFPB to identify all parties to these transactions as it develops the new small business data reporting requirements.

Another area of risk in the context of third-party relationships is data security. The Federal Reserve Bank of Atlanta (the “Fed”) discussed this risk in a recent article.¹³ According to the Fed, “Banks will need to become more sensitive to safeguarding any systems containing customer data that their digital vendors have access to, given the fact that hackers are getting increasingly sophisticated at breaking those systems down.” Accordingly, the OCC should carefully scrutinize the extent to which relationships with third-party innovators creates risk of data security breaches.

IV. The public should be given access to data about innovations, including information about the nature of the technology and who it is affecting.

The pace and the complexity of innovation creates a risk that the public will lack knowledge of important developments. The OCC should make the public aware of approved innovations. Given the complexity of innovations, making them understandable to the public may prove challenging, but we believe it is important, particularly insofar as fintechs are using consumers’ personal data in innovative ways.

V. We are opposed to the granting of a “limited purpose” or special federal charter to fintech companies that would preempt state laws and regulations.¹⁴

Just as fintech companies are at the front lines of technological innovation, the states are often at the front lines of regulatory innovation. Granting a federal charter that has the power of preemption to fintech companies would undermine the valuable role that states can play in informing regulatory reform at the national level and, given the relatively limited federal regulation currently governing fintech companies, would be dangerous for consumers. By charging exorbitant interest rates and refusing to disclose APRs, some fintechs have already demonstrated an unwillingness to treat customers fairly. Further, there is no evidence to suggest that the lack of a federal charter is stymieing the creation and expansion of fintechs, so we believe states should remain capable of developing regulatory approaches in this area. If any sort of “limited purpose” federal charter is granted, we believe the CFPB should be the regulator that provides oversight, supervision, and enforcement of rules that establish a regulatory “floor” not a regulatory “ceiling.” States should be able to require chartered entities to comply with state laws and regulations. The developing regulatory framework must also better define the categories of actors in this market beyond assertions that they cover “marketplace,” “online,” or “fintech” lenders. Is the relevant factor here whether a lender is newer or preexisting, online or not? What is clear is that regulatory oversight must capture all relevant actors, including merchant cash advance providers that may be evading scrutiny due to purported non-lender status.

¹³ “Fintech Companies: Banks’ Allies or Rivals?” Federal Reserve Bank of Atlanta. Mar. 15, 2016. <https://www.frbatlanta.org/economy-matters/banking-and-finance/viewpoint/2016/03/15/fintech-companies-banks-allies-or-rivals>. Accessed May 19, 2016.

¹⁴ Any entity seeking a federal *bank* charter – whether as a fintech or otherwise – should be required to comply with existing laws and regulations applicable to entities seeking to become national banks.

VI. We support the OCC's decision not to grant a "safe harbor" for pilot projects.

Closely supervised pilot projects are a good way for the OCC to test the impact and effectiveness of proposed innovations, but the risk of consumer harm is too great for the OCC to grant a safe harbor for such projects. In its paper, the OCC notes that "cyber risk" is of special concern with respect to the implementation of new technologies. We believe such risk combined with the risk of financial harm due to poor or improper underwriting makes it inappropriate for safe harbors to be granted for pilot projects.

VII. A consumer-friendly complaint system should be available to enable consumers to file complaints about fintech companies or bank innovations.

Consumers themselves are perhaps the best measure of how innovation is affecting the marketplace. The OCC should require banks to actively solicit consumer feedback relative to innovations. For complaints, the CFPB's consumer complaint system could be utilized for collecting and handling consumer complaints about innovations and fintech companies. We support having the CFPB function as the centralized complaint-handling service. Among other things, we appreciate having the ability to review complaint data and consumer narratives online in a matter of seconds. This better informs our work on developing policies to protect consumers. Perhaps the OCC and the CFPB could work together to monitor and handle complaints about bank innovations. At the same time, the OCC should reform its complaint database to upload complaint data to its website so that consumers can easily search for complaints filed against banks, without having to make a formal request under the Freedom of Information Act (FOIA request).

VIII. To the extent the OCC forms a centralized office on innovation, it should consider the CFPB's "Project Catalyst" and the U.K.'s "Project Innovate" as possible models.

The CFPB's Project Catalyst resembles what OCC's office on innovation might look like. Project Catalyst aims to establish lines of communication with innovators. The lines of communications are designed, in part, for the regulator to understand emerging innovations and to provide feedback to the innovators regarding the impacts of the proposed innovations on consumers. Companies that have participated in Project Catalyst have agreed to share anonymized data about consumer behaviors and trends with the CFPB so that the CFPB can generate a realistic assessment of the innovations' impact.

Another model is the U.K.'s Project Innovate. Through its Innovation Hub, Project Innovate operates as both a clearinghouse and as a resource for fintech companies. As reported in the *Business Insider*, since the launch of Project Innovate's Innovation Hub, the Hub has provided guidance to 177 fintech companies but has rejected 150.¹⁵ The head of Project Innovate cautions, "Being innovative is not some kind of universal solvent that does away with the need to observe requirements that are there to safeguard consumers or to safeguard the integrity of financial systems. Innovation is not a licence to cut corners."¹⁶ We believe both Project Innovate and Project Catalyst can serve as models for the OCC's office on innovation.

¹⁵ Business Insider, "Britain's fintech regulator says: 'Innovation is not a licence to cut corners'," Jan. 13, 2016. <http://www.businessinsider.com/fca-project-innovate-head-bob-ferguson-on-fintech-innovation-is-not-a-licence-to-cut-corners-2016-1?r=UK&IR=T>. Accessed May 19, 2016.

¹⁶ *Id.*

Conclusion

Whether in the financial sector or elsewhere, innovation is inevitable. Some innovation will work in consumers' favor and some innovation, if left unchecked, will cause harm. The challenge for both regulators and advocates is to evaluate and understand innovation as it develops and to then swiftly take appropriate action to facilitate it, restrain it, or modify it. While consumers, small businesses, and communities are all vulnerable to abuses by fintech and other alternative lenders, this comment focuses primarily on the potential and real impacts to small businesses. We think innovation in the area of small business lending has already gone too far, too fast. We hope the OCC's Innovation Initiative will become actively involved in this space as well as in the other areas in which innovation is likely to impact consumers, and we hope that the OCC and the CFPB will work to provide necessary oversight to prevent consumer, small business, and community abuse while allowing positive innovation to flourish.

Thank you for giving us the opportunity to comment.

Very truly yours,

CALIFORNIA REINVESTMENT COALITION
MAIN STREET ALLIANCE
NATIONAL PEOPLE'S ACTION
WOODSTOCK INSTITUTE

About California Reinvestment Coalition

CRC is the largest statewide community reinvestment coalition in the country, with over 300 member organizations across California. CRC builds an inclusive and fair economy that meets the needs of communities of color and low-income communities by ensuring that banks and other corporations invest and conduct business in our communities in a just and equitable manner.

About Main Street Alliance

Main Street Alliance is a national network of small business coalitions working to build a new voice for small businesses on important public policy issues. Alliance small business owners share a vision of public policies that work for business owners, our employees, and the communities we serve. Operating as a program of the non-profit People's Action, Main Street Alliance creates opportunities for small business owners to speak for ourselves on issues that impact the health and well-being of our businesses, employees, and communities.

About National People's Action

National People's Action is a network of 29 grassroots organizations in 18 states working together to advance a racial and economic justice agenda for a new economy and true democracy.

About Woodstock Institute

Woodstock Institute is a leading nonprofit research and policy organization in the areas of equitable lending and investments; wealth creation and preservation; and safe financial products, services, and systems. Woodstock Institute works locally and nationally to create a financial system in which lower-wealth persons and communities of color can safely borrow, save, and build wealth so that they can achieve economic security and community prosperity.