

Chapter Two

A History of Fintech Regulation

Banks Are Special

When you walk around downtown Salt Lake City, you see, nestled in the mountain backdrop, buildings with names of regional banks that you wouldn't otherwise recognize. But, these banks are not ordinary banks. These banks sponsor some of the largest financial technology companies in the world.

Nothing about Salt Lake City suggests that it would one day become a launchpad for a transformation in financial services. And yet, housed in a state known more for skiing and scenic canyons than for financial disruption, WebBank, Celtic Bank, and a number of other Utah-based banks have helped catalyze the fintech revolution.

Why Utah?

One of the main reasons is that Utah has no state interest rate cap¹, making it a magnet for a peculiar kind of bank: the kind that doesn't really behave like a bank at all. Many of these banks don't operate branches nationwide or have ATMs at malls where you can withdraw money. They do, however, have a bank charter.

The bank charter, granted by federal regulators, is a very special piece of paper and comes with many privileges. Banks can take in deposits and get Federal Deposit Insurance Corporation (FDIC) insurance for those deposits. Those deposits can then be loaned out at a very low cost of capital. Banks can also lend that money across state lines without needing state licenses or being subject to individual state interest rate caps. In other words, the charter gives banks exclusive access to offer a range of financial products across the country in ways that nobody else can.

Let's say you want to start a lending company and you're not a bank. You form a C-corporation in Delaware called Lending, Inc., set up a website and an office out of your apartment in Brooklyn, and come up with a unique new underwriting model that you're convinced will accurately predict creditworthiness for subprime borrowers which are those with lower (generally less than 600) FICO scores. Customers from all over the country start coming to your website. Using your own savings, you start lending money to these customers at interest rates from 20% to 40% for these slightly riskier borrowers.

At this point, you're probably breaking laws in most of the 50 states. Let's say a customer living in San Francisco comes to your website and takes out a loan. Even though you're based in New York, the state of California sees you as entering its state to make a loan to one of its residents as if you had physically driven to San Francisco and made that transaction at a coffee shop in Dogpatch. State laws

1. As we'll see below in the Contributor's Corner from Kevin Leitão, former General Counsel of WebBank, the other reason Utah is such an attractive place for progressive banks is that it is a place that is able to cultivate and attract top tier talent.

protect their own residents so the customer's state laws apply to your business regardless of where and how the transaction is conducted.

California's Financial Code § 22100, more colloquially known as the California Financing Law, specifies that in order to be a lender in the state, you need to obtain a license from the California Department of Financial Protection and Innovation (DFPI). The license approval process, it turns out, is not easy. It can take 6 to 9 months and DFPI requires you, as the business owner, to provide your fingerprints and put up a surety bond to protect its residents. In fact, when you do more research, you realize that about half of the 50 states require a license to lend even a single dollar to their residents. And even if you do obtain that license, the state will still impose its own state's interest rate cap on your loans. So to run your business, you'll have to monitor potentially 50 different interest rate caps on your loans. You'll need to track each customer's state of residence and adjust your underwriting model accordingly. Even though you're convinced your model works, running a lending company now seems like a hassle.

Now, if you were a bank, you could skip all these steps.

Banks are special, anointed by federal regulators to fly above the state laws through a doctrine known as preemption.

At its core, preemption is the idea that federal law overrides, or “preempts,” state law when the two conflict. It comes from the Supremacy Clause of the U.S. Constitution which says that federal law is the “supreme law of the land.”

There are different kinds of preemption, but for fintech, the most relevant one is federal banking preemption which applies to national banks and state-chartered banks with federal oversight.

Because of preemption, both federal and state-chartered banks get to “export” their home state’s interest rate to all 50 states.² That means a bank in, say, New Jersey, which has an interest rate cap of 30%, can charge a resident across the Hudson River on the Upper West Side up to 30% even though New York has an interest rate cap of 25%. What’s more, banks don’t need to obtain any licenses to lend money outside their home state.

This is why Utah is such an attractive place for banks. Because it has no interest rate cap, banks can export that unlimited interest rate to residents of all 50 states.

So banks in states like Utah have the magic ticket to lend money nationwide at profitable interest rates.

What they don’t have?

The technology infrastructure to attract customers across the country from Salt Lake City.

2. While the National Bank Act of 1864 granted federal preemption to national banks, state-chartered, FDIC-insured banks gained a similar benefit with respect to interest rate exportation through the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). This reform was intended to put state-chartered banks on more competitive footing with their national bank counterparts, although national banks retained broader federal preemption powers beyond interest rates.

Contributor's Corner: Why Utah?

It was not just no interest rate caps. There are other states, like South Dakota, that have similar state laws. Utah was the ideal location for fintechs and banks to join forces after the 2008 financial crisis for a couple of reasons. It had *fin* and it had *tech*.

In 1969, the University of Utah became the fourth node connected to ARPANET, the first version of the Internet. WordPerfect was launched from Utah in the early 1980s. Novell Inc. was founded around the same time. The Utah Valley (south of Salt Lake City) was known as “Software Valley” and by the early 2000s as “Silicon Slopes.” Lending Club eventually moved a lot of their people to Silicon Slopes in 2019.

In 2008, Salt Lake City already had a major presence in financial services. A key reason for this was the Utah industrial bank charter. The industrial bank charter is the charter that WebBank and several other Utah banks have used to work with fintechs. Merrill Lynch, American Express, and others owned industrial banks that they used to offer bank products to their customers. When I joined Merrill as Chief Compliance Officer of their Global Bank Group, Merrill Lynch Bank USA had \$60 billion in deposits, mostly very low-cost deposits from brokerage account sweeps. Goldman Sachs and other institutions also had large back offices there.

So, Utah had its own tech culture. It also had fifty thousand financial services employees, mostly working in back-office functions, in things like operations and compliance, for global banks and brokerage firms. And, it was only an hour flight to the Bay Area.

Utah is also a state that loves innovation and economic growth. Utah elected officials and its regulators share that culture. They are open to new ideas and new opportunities.

Kevin Leitão, former General Counsel of WebBank

The *Fin* + The *Tech*: A New Kind of Partnership

Banks are built for balance sheets and compliance audits and not user experience and viral marketing. Especially coming out of the 2008 financial crisis, when credit had dried up, regulators recognized that banks would need to evolve to issue credit fast enough to meet consumer demand. In a digital-first world, it was the technology companies that had figured out how to attract customers to their products.

The "bank partnership model" was born from this unlikely pairing: a small bank with regulatory privileges and a fast-moving tech startup that knew how to build beautiful user interfaces and scale digital customer acquisition.

As we read in "Chapter 1: The Fintech Revolution," one of the first major bank partnerships was between WebBank and Lending Club and started in 2007. Prosper, a similar marketplace lending company that also partnered with WebBank, gained prominence during those years as well. These companies were technology platforms. They enabled customers to make loan applications on a website, pulled the customer's credit report through an Application Programming Interface (API), ran their own underwriting model, and matched customers with investors who could finance the loans. They did this all in seconds leveraging technology. What they didn't have the ability to do was issue the loans in the first place unless, of course, they went through all those hoops of licenses and interest rate caps. So they partnered with WebBank. WebBank issued the loan and stamped its name on the loan agreement. The fintech handled everything else.

While it wasn't officially blessed until many years later, regulators tacitly allowed the model to exist in those early years because they understood the banks' need to grow their customer base.

The Beginning Of The Decade Of Fintech (2010–2014)

What had started with LendingClub and WebBank quickly grew into a broader movement: marketplace lending. A wave of lending-focused fintechs emerged, each building on the same model.

Venture capital firms poured money into these startups during what was promised as the decade of fintech. And it wasn't just about lending. Digital-first banking startups like Simple and Chime gained traction. Money movement tools like Stripe and Square emerged. Coinbase started in June of 2012. The infrastructure layer began to shift as well. Plaid started stitching together the backend of the financial system with modern APIs. Companies like Affirm and Bread launched the BNPL movement in 2014, which eventually led to BNPL products being adopted in virtually every country on the planet from the U.K. to Saudi Arabia.³

If the 2008 crisis revealed the fragility and opacity of traditional finance, the 2010s became about rebuilding it with transparency and speed.

The Rise Of The CFPB And My Personal Gripe

Created in the wake of the financial crisis, the Consumer Financial Protection Bureau (CFPB) was designed to do what no other agency had managed before: protect everyday consumers from the kinds of abuses that had led to the housing collapse. Its founding was personal. Elizabeth Warren had spent years arguing for a centralized regulator focused on consumer finance like credit cards, mortgages, payday loans, and student loans.

3. People often ask why BNPL became so popular. The reason is this: BNPL solves the customer acquisition cost (CAC) problem of lending. By attaching itself to a retailer that wants to promote financing so it can sell more things (make more money), the BNPL provider doesn't need to market to the end customer. The marketing is done by the retailer. CAC goes down to zero.

Unlike older agencies with turf divided along functional lines (the OCC and FDIC oversee banks, the SEC oversees securities), the CFPB focused on the consumer's point of view. That meant it could go after anyone if they were offering consumer financial products.

In 2014, a small startup called Dwolla became one of the CFPB's first fintech targets. The action was about how the company described its security practices, a simple choice of words. The CFPB alleged that Dwolla had misrepresented how securely it stored customer data with claims that it had made in marketing materials. The company had said on its website that its data security practices "exceeded industry standards" and were "safe and secure" and asserted that its platform was safer than credit cards. Now, to your average marketing person, these would seem like perfectly reasonable statements. Dwolla, of course, had done what every start-up does when trying to get customer attention. It had embellished a little bit. But to the CFPB, these were misleading statements. The CFPB went to Dwolla and said: Prove It. Prove that your data security practices are "safe and secure" as you claim and prove that they "exceed industry standards." This was a case of substantiating marketing statements when offering financial products which is something we'll explore more in "Chapter 9: Marketing Basics."

The resulting \$100,000 fine wasn't massive but the message that fintech was on the CFPB's radar was unmistakable.

At the time, I had just joined the founders of Bread. My role, among a team of five, was to figure out the legal and compliance infrastructure that would lay the groundwork for our company. I remember the day the Dwolla fine came out. It definitely rattled us. A regulatory enforcement action is not a big deal for banks but it can be existential for a fledgling start-up, which relies on its reputation to attract both investors and customers in order to grow. We began to parse through every word on our own website. Had we missed something too? Was there something we said that could be interpreted differently? Any piece of marketing material now had to go through my review before it was posted. While I tried my best to offer alternative solutions for what we wanted to say (how great

we were, etc.), I was operating from a place of caution, and caution never makes for good marketing copy.

This tension between the CFPB and the fintech industry would persist for years. The CFPB has accomplished many great things since its founding but that initial shot across the bow set the stage for years of mistrust and suspicion between the agency and the fintech industry. My take, and this will of course get me in trouble with those of my friends who are former CFPB regulators, all of whom are insanely talented and qualified enough to disagree with me, is that the CFPB was motivated not only by its stated mission of looking out for consumers but by a degree of political ambition.⁴

Especially in the early years of fintech, the ethos of the industry was to do right by the consumer. Many fintech founders had witnessed what complicated financial products like CDOs and mortgage-backed securities had done to bank accounts and retirement savings, how confusing it all was for the average person. Credit cards, the backbone of the consumer financial system, were, and I'd argue still are, notorious for trapping customers into an endless loop of fine print.

At Bread, we had genuine intentions to work for the consumer. Our motto was “Bringing dignity to consumer finance,” ushering in transparency and fairness to a world that was mired in the mud of fees and gotchas. When I wrote our legal terms, Bread's founder and CEO, Josh, asked me to write it in a way that would be understandable to both a college student and a retiree. I introduced

4. Many critics believe Elizabeth Warren used her role in conceptualizing and setting up the CFPB to gain recognition, which she then leveraged in her successful 2012 Senate run. Richard Cordray, the CFPB's first confirmed director (2012–2017), was also widely seen as having political ambitions; after stepping down, he ran for governor of Ohio in 2018. While correlation does not equal causation, the CFPB was far from a sleepy agency run solely by career bureaucrats.

“In a nutshell” summary bullets for each legal provision. We distilled complicated financial concepts down to plain English. We didn’t implement any late fees, or any fees for that matter, to our product. We didn’t think fees were fair to the customer because many people end up paying more through fees than they initially anticipate. The interest rate on our product was fixed meaning that once you made a \$1,000 purchase using a 10% loan, your interest and monthly payment would be \$110 every month no matter what. It was impossible not to understand how the financial product worked. We worked to ensure that there were zero surprises. Across the country on the West Coast, our competitor, Affirm, ran a similar playbook which was to build the simplest and easiest to understand consumer product possible.

When it started looking at fintech as a potential target, the CFPB was, I’d argue, looking in the wrong place. We were the good guys, trying to do the right thing, and yes of course, building a profitable company and making money along the way. The ethos of fintech’s early years was to democratize access to financial products in a world dominated by seedy players. But for better or worse, fintech had also become a hot new trend, and who wants to go after faded and grey debt collection agencies and large banks when you can wage a philosophical war against the shiny fintechs who make for much flashier headlines.

The Case Of A Maddening Ruling (2015 Onwards)

In the early 2000s, a woman named Madden opened a credit card account with Bank of America. Like many Americans, she likely didn’t think much of it at the time. She used the card, missed some payments, and eventually the account became delinquent. Bank of America did what many banks do with defaulted accounts. They sold it to a debt buyer, in this case, a company called Midland Funding.

By the time Midland acquired Madden’s account in 2008, the balance was around \$5,000. Midland sought to collect on the debt and continued charging the 27%