

**Prepared Statement of Sarah Jane Hughes**

**for the Hearing on**

**“The Future of Banking: How Consolidation, Nonbank Competition and Technology Are Reshaping the Banking System”**

**Before the**

**Subcommittee on Consumer Protection and Financial Institutions**

**Chair, The Honorable Ed Perlmutter**

**Ranking Member, The Honorable Blaine Luetkemeyer**

**Vice Ranking Member, The Honorable David Kustoff**

**of the**

**Committee on Financial Services**

**Chair, The Honorable Maxine Waters**

**Ranking Member, The Honorable Patrick McHenry**

**United States House of Representatives**

**Washington, D.C.**

**September 29, 2021**

**The observations stated in this prepared statement do not reflect the views of the Trustees of Indiana University and have not been reviewed by representatives of Indiana University.**

## Introduction

Good morning, Chairman Perlmutter, Ranking Member Luetkemeyer, and honorable members of the Subcommittee on Consumer Protection and Financial Institutions of the Committee on Financial Services. It is a great honor to appear today to discuss how bank consolidation, non-bank competition, and technology are reshaping the banking system in the United States. I am grateful for the Subcommittee's kind invitation to join you.

Before moving to the topics slated for this hearing, I would like to introduce myself. My name is Sarah Jane Hughes. I am the University Scholar and Fellow in Commercial Law at the Maurer School of Law at Indiana University in Bloomington, Indiana. I have been a member of the faculty at the Maurer School since January 1989, focusing on teaching commercial law and the regulation of banks and other providers of financial services in the United States. During my time at Indiana University, I have written articles about banking regulation, payments law generally, the deterrence of money laundering and terrorism finance, foreign policy law enforcement through the federal government's sanctions laws and regulations, consumer credit and privacy, cybersecurity, national security, and cryptocurrencies. Prior to joining the faculty, I served for 14 years at the Federal Trade Commission, where I focused on consumer protection and consumer credit issues. The fields I teach and write about change constantly and command attention from the private sector as well as from Congress and regulators. I find these fields fascinating.

I will concentrate my comments on bank consolidation, the challenges consolidation poses for small towns and rural communities, how nonbank competition is changing banking, and the role that technology is playing in driving changes to banking services and availability, including the emergence of partnerships between insured banks and fintech companies and the new issues and benefit they may offer. I plan to address these issues in the order stated.

### Bank Consolidation

The number of federally insured commercial banks declined from more than 14,000 in 1986 to 8,300 in 2000. By 2019, that number had declined to 4,519,<sup>1</sup> with 799 national banks remaining as of August 31, 2021.<sup>2</sup> This decline was due to several factors, most prominently consolidations through mergers and acquisitions as well as consolidations in several rounds because of resolutions of bank failures by the FDIC. Very few banks simply closed their doors of their own choosing, although if one drives through small towns in Indiana, for example, one can see beautiful vintage, former bank buildings, still displaying their Greek columns and architectural merit. Indeed, bank consolidation is not a new phenomenon in the United States. Many of the remaining commercial banks are community national banks or state-chartered banks that serve smaller communities.

The result of consolidations in commercial banks during the period following the Financial Crisis/Great Recession from 2007 to 2010 left many communities with no locally

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<sup>1</sup> Some of this information came from a fabulous tool published by the Federal Reserve Bank of St. Louis through 2018, and by regular reports from the Federal Deposit Insurance Corporation known as the FDIC Quarterly Banking Profile.

<sup>2</sup> Office of the Comptroller of the Currency, Financial Institution Lists, Aug. 31, 2021, <https://www.occ.treas.gov/topics/charters-and-licensing/financial-institution-lists/index-financial-institution-lists.html>.

owned banks – or even full-fledged branches of larger banks. Those that remained included both federally chartered community national banks and state-chartered community banks. Both types of banks continue to offer excellent services to their immediate communities, including loans to small businesses and individuals, but according to many news sources, they are challenged by the costs of technology and regulatory compliance. My family and I have had relationships with community national banks and state-chartered banks as well as with major national banks over more than 45 years. Several of these community-oriented banks serve Bloomington and its environs in south-central Indiana in Indiana’s 9<sup>th</sup> Congressional District and neighboring areas.

In my family’s 32 years in Bloomington, we saw a locally owned national bank be acquired by a strong regional bank, and in turn, that regional bank was acquired by one of the United States’ largest banks. We also saw the entry to this market of a strong regional bank based in Ohio, branches of a state-chartered bank, and one *de novo* state bank sponsored by local business interests. We also had a savings and loan merge with another in-state association. If I missed mentioning any, it shows how hard it is to keep track of the changing environment in banking – even for someone interested in the field.

#### Emergence of Non-Bank Competitors and Their Business Models

Non-bank competitors to banks have been around for more than 100 years, but they have grown rapidly since the Big Three automobile manufacturers launched their own consumer finance arms. Additionally, other installment personal-loan, purchase-money-loan, mortgage lenders, and more recently, a new crop of non-bank lenders in the payday and title loan industries have emerged. For the most part, these providers have been subject to state licensure and supervision. Many of these state-licensed providers began in brick-and-mortar locations but, more recently, some have operated exclusively online.

Two other categories of non-bank providers include “industrial loan companies” (ILCs) and fintech companies. The ILCs have been in existence since the early part of the 20<sup>th</sup> Century and the latter are 21<sup>st</sup> Century innovators. As of March 31, 2020, the FDIC reported that there were 23 ILCs operating in five states.<sup>3</sup> This also represents a decline in the number from just prior to the Financial Crisis/Great Recession. Most ILC’s employ business models in consumer lending or credit card operations – many to support the needs of their non-bank parent companies.

ILCs may not take retail deposits and must have obtained FDIC deposit insurance before they operate. Even though they obtain their charters from the States, the FDIC is their primary federal regulator. ILCs and their parents are not subject to consolidated supervision by the Board of Governors of the Federal Reserve System – one of the primary benefits of this type of otherwise state-chartered entity. This is largely because their parent companies are engaged in activities that are not banking or otherwise “financial in nature.” States have expanded the powers of ILCs and industrial banks since the late 1980s so that they match the *lending* powers of commercial banks.<sup>4</sup>

It is hard to estimate how many fintech companies exist, but as of April 2021, the American Fintech Council (AFC) announced that it had more than 75 members. For the fintech company memberships, the AFC rules require having one year of operating history. Some of the members are large and well-known firms – nearly household names -- by now. Others are not yet

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<sup>3</sup> Fed. Dep. Ins. Corp., Parent Companies of Industrial Banks and Industrial Loan Companies, 85 Fed. Reg. 17771, 17773 (Mar. 31, 2020) [hereinafter “Parent Companies Proposed Regulation”].

<sup>4</sup> *Id.* at 17772.

in that category. Fintech lenders that are members of the AFC must observe additional rules that include offering financial services products that

- “must not be characterized as something otherwise to avoid regulation,”
- are not “‘payday’ or ‘high-cost installment loans as defined by the CFPB,’”
- adhere if small business financing “to the responsible lending standards of the Small Business Borrower’s Bill of Rights,” and
- “advance standards of fairness and nondiscrimination.”

Fintech companies generally offer longer loan periods and make larger loans than non-depository providers, such as payday or auto-title lenders, offer. In this respect, fintechs’ average loans may be closer in size to smaller personal loans offered by credit unions and banks.

Among the more prominent fintech providers are Square, SoFi, Lending Club, and Varo. Of these Varo now holds a national bank charter, which it obtained *de novo*. Lending Club acquired the tech-friendly Radius Bank as of February 1, 2021, and renamed the bank LendingClub Bank, N.A. on July 1, 2021. Lending Club, the fintech company, is the largest personal lender in the United States. SoFi is not a bank. Square Financial Services operates as a Utah-chartered ILC as of March 2021. It had flirted with applications for a full national bank charter in recent years.

Fintech companies’ technologies and specialty platforms offer cost savings that can be passed on to customers. They often have limited physical presences where their customers are – that is, they do not operate traditional branches or Main Street locations. They are not subject to the same reserve requirements that the Federal Reserve System requires of all national banks and state-member banks and are not governed by the Community Reinvestment Act. Many fintech

lenders use algorithms to determine whether to make loans, how much to lend, and how much to charge loan customers.

Fintech companies are well-equipped through their proprietary technologies to bring new customers on board quickly and economically. They also must have technology facilities to meet federal AML/CFT and Customer-Identification-Program responsibilities. Unlike banks with branches, they do not need permission to move locations or to open or close locations.<sup>5</sup> They need different types of security, space, and equipment and must operate at high volumes with relatively few employees. They do not need permission to embark on new lines of business or offer innovative products, as national banks often do.

The nimbleness of fintech companies enabled them to process Payroll Protection Program (PPP) loans that Congress authorized in the March 27, 2020 CARES Act. Reports indicate that fintechs were able to supply PPP loans to many small and minority-owned businesses that lacked sufficient banking relationships to get PPP loans from insured commercial banks.

Many fintechs make small-business or consumer loans only when they have commitments from investors to fund specific loans. Thus, they are in some senses new-age “loan production offices” (but without the brick-and-mortar offices) that larger banks formerly had in areas of the nation where they were not allowed to situate or did not have branches. Loan production offices performed many of the upfront tasks involved with underwriting loans, but the final decision to lend came from the bank itself. Today, fintechs may need the concurrence of a

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<sup>5</sup> The FDIC publishes its requirements for opening, closing, or moving “banking offices” at <https://www.fdic.gov/regulations/applications/resources/offices.html>. That site makes it clear that “loan production offices” are not “branches.”

bank to which they hope to sell loans or, as noted above, commitments from investors to fund specific loans prior to the loan closing.

Many commercial banks use fintech vendors to help them perform certain tasks – and this is a promising avenue for bringing future innovations to commercial banks. This is particularly true for smaller commercial banks for which the cost of developing or acquiring some technologies can be significant. These technologies can help commercial banks reduce expenses associated with customer onboarding, fraud detection, and other risk-management tasks. These tasks are labor-intensive.

I spoke about three weeks ago to a CEO of a well-regarded small bank in the Midwest whom I had met at the Annual Payments Symposium sponsored by the Federal Reserve Bank of Chicago some years ago. He had specific concerns about the rising costs of processing checks that his customers still write in significant numbers. After a while, I asked if he had considered finding or creating with similarly situated banks a technology product that specialized in check-processing solutions. He had -- but he wondered if a consortium of small banks organizing to identify such a company and then using it would violate any antitrust laws. Then we discussed a “bank service corporation” (BSC) in which banks have been authorized to own stock since 1962 under 12 U.S.C. §§18 and 1861. The requirement is that the shares of the bank service corporation be owned by at least two banks. We agreed that it was worth considering.

We also discussed using a fintech vendor, which proved to be another route without the necessity of forming the bank service corporation or finding other banks to join in it. Both were plausible solutions that did not dispense with banks’ duties to manage the risks of the solution. Additionally, both solutions entailed subjecting the BSC to the same types of examination by the banks’ primary regulator as the banks would undergo themselves. Thus, in this conversation, we



identified fintech companies as a means of making more efficient and effective traditional functions that banks carry. This conversation stopped short of certain types of “partnerships” between banks and fintech companies that have become prominent in discussions about the future of banking, particularly in the past few years.

### Bank-Fintech Partnerships

Everyone attending this hearing knows that banks and fintechs want to operate in partnership with each other. There are benefits to both directions of such partnerships. The COVID-19 Pandemic may have increased the benefits of using technology provided by fintechs to generate, if not originate, loans. Opportunities to use fintechs to help with other functions exist, but the main focus of many fintechs is originating or servicing loans to consumers and small businesses.

Federal bank regulators have responded to the desire for bank-fintech partnerships by issuing regulations and guidance. Let me mention the most recent steps from federal bank regulators in reverse chronological order.

In August 2021, the Board of Governors, the FDIC, and the OCC issued “Conducting Due Diligence on Financial Technology Companies: A Guide for Community Banks.” This Guide demonstrates several concerns that bank regulators have about these relationships. These are:

- The initial phase in which a bank collects and analyses “information to determine whether third-party relationships would support [the bank’s] strategic and financial

goals and whether the relationships can be implemented in a safe and sound manner consistent with applicable legal and regulatory requirements.”<sup>6</sup> and

- The “scope and depth of due diligence performed by a community bank will depend on the risk to the bank from the nature and criticality of the prospective activity.”<sup>7</sup>

The Guide offers alternative means by which this type of risk management may be performed by insured banks even when the prospective fintech vendor or partner is relatively new to the market. The Guide also makes clear that ultimate compliance with the legal and regulatory requirements imposed on banks – including consumer protection and safety-and-soundness requirements – remains the banks’ responsibility.

In October 2020, the OCC published its final “National Banks and Federal Savings Associations as Lenders” Rule – known colloquially as the “True Lender” Rule.<sup>8</sup> The True Lender Rule was intended to resolve remaining questions about which entity – the chartered depository institution or their fintech partner -- originated specific loans and, consequently, whether the exportation of interest rates allowed to national banks and state-chartered banks under 12 U.S.C. §85 and 12 U.S.C. §1831d, respectively, was allowed – that is, whether federal or state interest-rate laws govern these loans. The Rule provided that lender is the bank that either (1) is named in the loan agreement as the lender or (2) funded the loan.<sup>9</sup> Whoever is the lender on this basis was the party responsible for compliance with federal laws for the loans.<sup>10</sup> The Rule also provided that “[i]f, as of the date of origination, one bank is named as the lender in

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<sup>6</sup> August 2021 Guide, at 1.

<sup>7</sup> August 2021 Guide, at 2.

<sup>8</sup> Office of the Comptroller of the Currency, National Banks and Federal Savings Associations as Lenders, 85 Fed. Reg. 68742 (Oct. 30, 2020) (codified at 12 C.F.R. §7.1031) [hereinafter True Lender Rulemaking].

<sup>9</sup> 12 U.S.C. § 7.1031(b).

<sup>10</sup> *Id.*

the loan agreement for a loan and another bank funds that loan, the bank that is named as the lender in the loan agreement makes the loan.”<sup>11</sup>

As Members of this Subcommittee are aware, the True Lender Rule drew praise and criticism. On May 11, 2021, the Senate passed a resolution<sup>12</sup> to repeal the True Lender Rule under the Congressional Review Act,<sup>13</sup> which also enjoins subsequent promulgation of the same or a similar rule unless specifically authorized by a law enacted after the disapproval.<sup>14</sup> The House passed the resolution,<sup>15</sup> and the President signed it.<sup>16</sup> Thus, the opportunity that the Rule would have provided to fintechs is dead – unless this Congress or a subsequent Congress reauthorizes it specifically.

The second OCC is the “Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred”<sup>17</sup> (“Valid-When-Made Rule”), which was published on July 22, 2020. It was not subject to a Congressional Review Act resolution. The FDIC published its final companion rule on the same date.<sup>18</sup>

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<sup>11</sup> *Id.* § 7.1031(c).

<sup>12</sup> S.J. Res. 15, 117<sup>th</sup> Cong. (2021), [https://www.senate.gov/legislative/LIS/roll\\_call\\_lists/roll\\_call\\_vote\\_cfm.cfm?congress=117&session=1&vote=00183](https://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=117&session=1&vote=00183) (Roll Call; Vote Summary).

<sup>13</sup> 5 U.S.C. §§ 801-808 (2020).

<sup>14</sup> 5 U.S.C. § 801(b)(2) (2020) (prohibiting reissuance in substantially the same form unless specifically authorized by a law enacted after the date of the disapproval of the original rule).

<sup>15</sup> S.J. Res. 15, 117<sup>th</sup> Cong. (2021), <https://www.congress.gov/congressional-record/volume-167/house-section/page/H3100> (Cong. Rec.; Vote Summary).

<sup>16</sup> Remarks by President Biden Signing Three Congressional Review Act Bills, June 30, 2021, <https://www.whitehouse.gov/briefing-room/speeches-remarks/2021/06/30/remarks-by-president-biden-signing-three-congressional-review-act-bills-into-law-s-j-res-13-s-j-res-14-and-s-j-res-15/>; <https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/30/bills-signed-s-j-res-13-s-j-res-14-s-j-res-15/>.

<sup>17</sup> Office of the Comptroller of the Currency, Permissible Interest on Loans That Are Sold, Assigned, or Otherwise Transferred, 85 Fed. Reg. 33530 (June 2, 2020) (codified at 12 C.F.R. §§ 7.4001 and 160.110) [hereinafter Valid-When-Made Rulemaking].

<sup>18</sup> Fed. Dep. Ins. Corp., Federal Interest Rate Authority, 85 Fed. Reg. 44146 (July 22, 2020) (codified at 12 C.F.R. § 331.1-4).

The True Lender and Valid-When-Made rules largely resolved the uncertainties experienced in secondary loan markets that were caused by a decision from the United States Court of Appeals for the Second Circuit, *Madden v. Midland Funding, LLC*.<sup>19</sup> The Valid-When-Made Rules clarified that assignees of bank-originated obligations may charge interest “permissible before the transfer ... after the transfer.”<sup>20</sup>

The OCC cited the National Bank Act authority to make loans, enter contracts, sell loans made, and transfer obligations under contracts made.<sup>21</sup> The power of assignees of contracts such as loan buyers to enforce terms, including interest rates on loans, was the issue in *Madden v. Midland Funding, LLC*,<sup>22</sup> which involved an assignee’s efforts to collect consumer credit card obligations bought from a Delaware national bank. The interest rate allowed by the agreement under Delaware law exceeded the interest rate allowed under New York’s usury law.<sup>23</sup> Thus, the Valid-When -Made Rule restored the rights of loan buyers to enforce loans they buy from national banks and federal thrifts as written. This is customary in contracts enforcement and an indispensable part of operating a market for loans originated by banks under Sections 85 of the National Bank Act and 1831d of the Federal Deposit Act.

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<sup>19</sup> *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015).

<sup>20</sup> Valid-When-Made Rulemaking, *supra* note 17, at 33530. The rule itself states: “Interest on a loan that is permissible under 12 U.S.C. 85 shall not be affected by the sale, assignment, or other transfer of the loan.” 12 C.F.R. §§ 7.4001(e). The companion rule for federal thrifts is at 12 C.F.R. § 160.110(d) (citing 12 U.S.C. § 1463(g)(1)).

<sup>21</sup> *Id.* at 33531, citing 12 U.S.C. § 24 (Seventh) (2020).

<sup>22</sup> 786 F.3d 246 (2d Cir. 2015) (vacating the holdings on preemption and denial of class certification, finding that the District Court erroneously analyzed the preemption issue).

<sup>23</sup> *Id.* at 248.

The FDIC's Valid-When-Made rule provides rights to buyers of loans originated by state-chartered banks.<sup>24</sup> The FDIC relied on Section 27 of the FDI Act<sup>25</sup> to allow state banks to export interest at rates permissible in the state where the bank is located.<sup>26</sup> Seven States challenged it on August 20, 2020.<sup>27</sup>

## Conclusion

Fintechs offer nimble organizational structures and bring new products to market fast. With the significant shift during the Pandemic to contactless payments and online processing of loan and credit card applications, fintechs helped many businesses obtain PPP loans and other financial services that consumers and small businesses needed.

Fintechs do not offer the same services as commercial banks offer. Fintechs rely on algorithms, not personal relationships, to judge applicants for their loans. They do not offer retail banking services that consumers and small businesses require, including cash services or certification of checks (which law students have needed for bar applications in the past). I mention cash services because they remain important to many types of businesses, including cannabis businesses, restaurants, farmers' markets, and local festivals that bring needed tourism income to many communities such as those in south-central Indiana.

Community national banks and state-chartered banks are lifelines for their respective communities. I am a passionate fan of both types of banks and would like to see Congress find

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<sup>24</sup> Fed. Dep. Ins. Corp., Federal Interest Rate Authority, 85 Fed. Reg. 44146 (July 22, 2020) (codified at 12 C.F.R. 331.1-.4). For an explanation of how this rule relates to the OCC's Valid-When-Made Rule, see Nicholas J. Podsiadly, FDIC General Counsel Memorandum: Final Rule on Federal Interest Rate Authority, *passim* (June 25, 2020), <https://www.fdic.gov/news/board/2020/2020-06-25-notice-dis-c-mem.pdf>.

<sup>25</sup> 12 U.S.C. § 1831(d) (2020).

<sup>26</sup> *Supra* note 16, at 44146, 44158 (codified at 12 C.F.R. 331.4(a) (2020)).

<sup>27</sup> People of the State of Calif., et al. v. FDIC, Case No. 20-CV-5860 (Aug. 20, 2020).

ways to help these valuable community assets continue the roles they have been playing across the United States for more than 150 years.

I appreciate the invitation to appear before the Subcommittee today and I look forward to your questions, which I will try to answer. Thank you, Chairman Perlmutter, Ranking Member Luetkemeyer, and Members of the Subcommittee for your attention.