Lax Supervision of FinTechs Harms Consumers

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In late April, the Consumer Financial Protection Bureau announced that it will be stepping up supervision of nonbank financial companies to help protect consumers and level the playing field between banks and nonbanks. This is a welcome development, because FinTech companies that claim to be promoting financial inclusion and benefitting low- and moderate-income households may, in fact, be doing the opposite.[1]

Investigative reporting, complaints and survey data and recent lawsuits demonstrate harmful aspects of consumers' experience with neo-banks (FinTechs that offer deposit-type banking services on the internet) and with FinTech lenders. In addition, new research papers by academic economists and legal scholars provide even more rigorous evidence of potential harm to consumers.

This note offers a preliminary blueprint for heightened supervision of FinTech firms. The note reviews the evidence on problematic aspects of the consumer experience, dividing it into four areas of concern:

- Risks to consumers from crypto assets and decentralized finance
- Exploiting consumer weaknesses;
- Predatory or deceptive practices and hidden costs; and
- Lack of cyber-risk safeguards and fraud

More aggressive enforcement of consumer legal protections, and more comprehensive regulation and supervision of neo-banks and FinTech lenders, can uncover and discourage, or even put an end to, the kinds of harmful practices that have been observed.

Risks to Consumers from Crypto Assets and Decentralized Finance

Crypto assets, including cryptocurrencies, and the technology behind them, known as blockchain or distributed ledger technology, have many financial services industry applications. Decentralized finance (DeFi) platforms offer blockchain-based financial services for holders of crypto assets. These services include deposit-taking and borrowing, as described in a newly released report from the International Monetary Fund (IMF).[2]

Although the uses of crypto assets and blockchain technology are often wholesale or institutional in nature, use of crypto assets has expanded rapidly among retail consumers. Survey data indicates that young, lower-income and minority individuals comprise a disproportionate share of those who have ever invested or traded cryptocurrencies. According to a July 2021 survey conducted by NORC at the University of Chicago, 13 percent of Americans purchased or traded

[1] The CFPB's decision follows upon cautionary remarks about FinTechs earlier this month to *Business Insider* by the chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Senator Sherrod Brown.
[2] *See* chapter 3 of International Monetary Fund (2022).

cryptocurrencies in the prior 12-month period. Their average age was 38; 44 percent identify as minority, 55 percent do not have a college degree and 35 percent have annual incomes under $60,000.

Cryptocurrencies often are touted as a catalyst for financial inclusion, both for expanding investment opportunities to a broader spectrum of the population and potentially for delivering banking services to segments of the population that would otherwise be unbanked. However, such financial inclusion benefits of cryptocurrencies remain largely hypothetical; for instance, to date there is no evidence that cryptocurrency or DeFi platform use has benefitted the unbanked population in the U.S.

What is clear though is that crypto asset prices are highly volatile, as documented in the IMF report and elsewhere, making the holding of these assets very risky.[3] Retail investors, particularly those who are younger or lower income, may not adequately assess or weigh this risk and its personal finance implications prior to investing or trading in crypto assets.[4]

Retail deposit accounts on DeFi platforms also expose consumers to substantial risk, and this risk may be less transparent than the volatility risk of cryptocurrencies. As described in the IMF report, "the liquidity of DeFi platforms could become insufficient during periods of market stress ... A more extreme outcome would be equivalent to a bank run—when participants rush to withdraw liquidity from the platform."

Worse, the non-transparent nature of this risk is exacerbated by the platforms' use of misleading terminology and marketing. A previous BPI blog post, Nelson (2021), emphasizes the non-transparent nature and potentially illiquid nature of "stablecoin" deposits.[5] Issuers of stablecoins, a privately issued, digital coinage, have claimed misleadingly that the coins are backed "one-for-one" by "safe assets" they term "reserves." However, as explained in that post, these "reserves" (which include commercial paper and bank certificates of deposit) are subject to substantially greater liquidity risk compared to what constitute reserves at traditional banks (risk-free cash or deposits at the Federal Reserve, or their close substitute, Treasury bills).[6]

Exploiting Consumer Weaknesses

Saunders (2019) posits that "the ease of online platforms and the targeting of vulnerable consumers may make it easier to incur unaffordable debt," thus aggravating or exploiting behavioral weaknesses such as impulse buying or present bias (the inclination to prefer a smaller present reward to a larger later reward). For example, FinTech companies are not required to check a borrower's ability to repay the loan.

Di Maggio and Yao (2021) present evidence that online FinTech lending may indeed have such undesirable effects. The paper examines whether consumer loans originated by FinTechs exhibit different performance than loans granted by traditional institutions in the 15 months following loan origination. The analysis shows that FinTech borrowers are more likely to default than similarly situated borrowers from traditional banks. This higher delinquency rate is most pronounced for borrowers with a low credit score, a high interest rate and thin credit file.

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[3] See, for example, Doumenis, Izadi, Dhamdhere, and Katsikas (2021).
[4] Also see Disparte (2018).
[5] Liquidity risks of stablecoins are also highlighted in Gorton and Zhang (2021).
[6] Further, some stablecoins are marketed as savings products, guaranteeing the principal amount provided, but may not adequately disclose the risks that the issuer may not be able to meet this guarantee, especially during a crisis. Indeed, because of such practices, DeFi platforms have begun to face legal challenges.

Investigating the reason for this higher delinquency rate, the study finds that FinTech borrowers are using the additional funds to support other expenditures, as their total indebtedness increases more than that of similarly situated individuals borrowing from traditional institutions after loan origination.[7] The authors conclude that "the increased ease and speed with which borrowers can have access to credit are particularly appealing to certain households that tend to use these funds, in conjunction with other forms of credit, to sustain their consumption, which ultimately makes them more financially vulnerable."

Another study, Guttman-Kenney, Firth, and Gathergood (2022), finds evidence of adverse effects on consumer indebtedness within the rapidly growing, buy-now, pay-later (BNPL) segment of FinTech credit products. BNPL is a credit product that enables consumers to defer payments interest-free into a small number of (typically four) installments. Using a credit card transactions dataset from the U.K., the study finds that in 2021, almost 20 percent of transactions by BNPL firms ultimately were transferred to active credit cards with a typical interest rate of 20 percent.[8]

Moreover, this transition to credit card balances is found to be "most prevalent among younger consumers and in the most deprived geographies." The authors suggest that their findings "raise doubts on consumers' ability to pay for BNPL." Thus, evidence shows that, contrary to its branding as an interest-free deferred payment product, BNPL frequently leads to greater indebtedness consistent with the view that BNPL exploits behavioral biases.

Hidden Costs, Deceptive Practices and Predatory Lending Relationships

FinTech banking and credit products are often characterized not only by innovations in technology and use of data but also by innovations in packaging, pricing and marketing. The latter, in turn, can hide significant costs or risks to consumers and at times may cross the line into deceptive or predatory practices. Moreover, many FinTech companies focus on subprime borrowers.[9] This population tends to be lower income and financially more vulnerable to hidden costs or deceptive marketing.

A particularly egregious example is the case of the FinTech lender Lend Up, which was sued by the CFPB and subsequently shuttered its business. Lend Up had offered loans to below-prime consumers and those with thin credit files with the professed goal of helping its borrowers build credit and qualify for larger and lower-rate loans over time. The CFPB alleged that the company engaged in illegal and deceptive marketing and failed to provide timely and accurate adverse action notices as required by the Equal Credit Opportunity Act.

As noted by Saunders (2019), "some FinTech products are designed to avoid consumer protection laws while others claim that existing rules do not apply to them." As examples, the study points to FinTech products that evade Truth-in-Lending Act disclosure requirements and "avoid disclosing a clear APR by offering a line of credit with fees but no explicit interest rate" or by encouraging "voluntary tips" for the service in lieu of required fees.

BNPL products also, in a sense, avoid having to disclose an APR, based on the claim that they are deferred payment products, not loans. Yet, as noted above, many consumers end up paying interest on BNPL balances, so that arguably, the transparency around BNPL is inadequate in comparison to traditional credit products.

[7] Also, FinTech borrowers are more likely to purchase a vehicle in the first few months after loan origination.

[8] A March 2022 survey by Morning Consult of active BNPL borrowers in the U.S. found that the same proportion, 20 percent, missed their January payment.

[9] See, for example, Newest FinTech unicorn is a credit card, betting against big banks (cnbc.com); Self Financial raises $50M to help the subprime consumer build credit and savings at the same time | TechCrunch; and Beyond Payday Loans: More Startups And VCs Bank On Subprime Lending Alternatives (crunchbase.com)

Moreover, Mierzwinski and Litt (2022) examined complaints to the CFPB about Buy Now Pay Later programs. The study found that complaints spiked during 2021, and on reviewing them concludes that "hidden fees, late payment fees and debt collection problems can harm consumers" and that the products may not have adequate chargeback protections.

Odinet (2021) documents cases of FinTechs, in partnership with some state-chartered industrial and commercial banks (mostly chartered in Utah or Kentucky), that specialize in high-rate lending with APRs as high as 200 percent, a level often associated with predatory, payday lenders. The author argues that these partnerships are instituted to evade state interest rate ceilings.[10]

The latter paper includes a case study of one such FinTech, Elevate, demonstrating that, as occurs with payday lenders, borrowers frequently roll over their loans. Such rollovers generally are viewed as an indicator of a borrower being caught in a harmful credit relationship. Evidence has also been put forth that marketing of high-cost loans by FinTechs often involves deceptive tactics.[11]

Cyber-Risk Management and Fraud

The faster and more convenient payment and borrowing services touted as advantages of FinTechs may come at the price of less effective management of cyber risks compared to banks. One important reason is the strict regulatory and supervisory environment in which banks operate, spurring them to develop strong protections against money laundering and cyber risk. Moreover, banks have become adept at effectively managing cyber-risk to meet supervisory expectations while also meeting consumer expectations around quality of banking services.

Since FinTech companies are not as closely supervised, they may be less successful at achieving this balance. Consistent with this view, a much higher incidence of fraudulent transactions at FinTechs compared to traditional banks, within the context of the PPP program, is documented in Griffin, Krueger, and Mahajan (2022).[12]

A recent investigative report from Click2Houston.com suggests that neo-banks are not adequately managing cyber risks. According to this report, the Consumer Financial Protection Bureau has received numerous complaints from neo-bank customers who were locked out of their accounts for lengthy periods due to deposits mistakenly flagged as "unusual activity," or who suffered losses from fraudulent transactions that were not reimbursed.

Finally, cyber risks are another major risk associated with DeFi platforms, as highlighted in the IMF report. For example, the stablecoin issuer Coinbase recently received a wave of consumer complaints related to lack of customer service and lack of account security leading to hacks.

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[10] State-chartered banks generally are permitted to charge out-of-state borrowers the same interest rate allowable for in-state borrowers. FinTechs, as nonbanks, "are not free to uniformly make high-cost loans online and across state lines in contravention of the decisions of state legislatures about the proper and safe cost of borrowing." The partnerships with banks allow FinTech firms to get around these limitations.

[11] For example, a lawsuit filed by the Attorney General for the District of Columbia against the online lender Opportunity Financial, LLC in April 2021 alleged that the firm "violated District law by misrepresenting its high interest loans as fast and easy cash and falsely claiming that its loans would help struggling consumers build credit. Instead, OppFi charged over 4,000 District residents exorbitant interest rates of up to 198%—more than eight times the District's 24% rate cap." The suit was settled in December 2021.

[12] The study develops indicators related to potential misrepresentation by PPP borrowers, such as non-registered businesses, multiple businesses at residential addresses, and abnormally high implied compensation per employee. FinTech loans are observed to be nearly three times as likely to have at least one primary indicator of likely misreporting and nearly five times as likely to have multiple indicators.

Conclusion

A growing body of evidence highlights consumer protection concerns associated with neo-banks, FinTech lenders, cryptocurrencies, and DeFi platforms. One substantive concern is that rapid expansion of cryptocurrency trading and investing may expose younger and lower-income individuals to risks that they may not be fully aware of or prepared for.

Studies and survey evidence suggest that FinTech lenders may exploit consumer weaknesses, such as lack of financial knowledge and behavioral biases, in ways that can lead to overborrowing and higher default rates. This problem may be particularly acute for younger consumers and for those with low- or moderate incomes.

Evidence also suggests that some FinTech companies are engaged in predatory or deceptive practices, or that there may be hidden costs to consumers associated with the use of some FinTech products. Another concern is that FinTech companies may have less effective fraud protections than banks.

There are other potential harms to consumers from FinTech products and services than those discussed here, although they tend to be more hypothetical (lacking in evidence). Additional discussion of FinTech-related consumer protection issues can be found in Saunders (2019). Supervision of FinTech companies should incorporate consideration of the full set of concerns.

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