Testimony Before the Senate Banking Committee By

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April 28, 2021

Chairman Brown, Ranking Member Toomey, members of the Senate Banking Committee, it is a pleasure to be with you today to discuss the economic benefits that arise from allowing financial institutions of various kinds to partner with each other in providing lending services to their customers. This partnering is especially advantageous when it occurs in the context of an integrated national market for loans, which has produced enormous improvements in market efficiency and financial inclusion.

I emphasize that the gains from flexible partnerships among financial intermediaries in providing various aspects of banking services not only result in improvements in aggregate efficiency and better loan pricing for consumers on average; the gains also include greater financial inclusion for our unbanked or underbanked citizens, and that is particularly apparent in the new partnerships that are developing between traditional enterprises and new fintech firms. At the end of my statement I provide an appendix, which I will not present orally, but which I ask you to admit as part of my written statement, which summarizes in detail how fintech firms, in particular, are contributing so much to improvements in financial inclusion.

The understanding that it is advantageous to encourage an integrated national market that permits diverse businesses with different comparative advantages to work together is not new. In the Supreme Court's unanimous Marquette decision in 1978, empirical evidence of these economic advantages informed the Justices' opinions, and since then, over the past four decades, a massive amount of evidence in support of this proposition has been published in top economics journals.

Recently, a non-partisan group of forty-seven leading scholars of banking working at America's greatest universities summarized this literature in an amicus brief, which was filed in support of the Office of the Comptroller of the Currency's (OCC's) defense of its "true-lender" rule.[1] My testimony here today will summarize for you that consensus, which is remarkably clear and unequivocal. While economic analysis often provides a mixed and inconclusive picture, in this case, the conclusions about the advantages of an integrated national system are unambiguous and the magnitude of the effects described are large, which explains why a very prominent group of non-partisan bank scholars found it so easy to reach rapid agreement on their strong conclusions.

Economic Advantages of Banks' Partnering with Others To Provide Loan-Related Services

As background, the OCC's "true lender" rule clarified that a bank that originates a loan retains the consumer protection obligations related to making that loan whether or not it sells the loan to another party. This rule guards against fears of shady origination practices, "rent-a-charter" schemes, or predatory lending for consumer loans that are originated within the federal banking system and sold to others. The rule adheres to longstanding legal precedents by making it clear that the origination of the loan is the act of lending. The sale of the loan, like the sale of any asset, does not change that fact.

Some state authorities have sought to impose new limits on interstate banking by claiming that the act of selling a loan somehow changes who the original lender was and potentially invalidates the terms of the loan, which were valid when made. A key goal of this legal theory appears to be preserving the ability of the state to enforce usury laws that limit interest rates on loans to its residents. For example, a national or state bank in South Dakota can originate a loan with a borrower in California at a rate above the California usury ceiling, and then sell it to another lender.

[1] These scholars are faculty at the following institutions: Babson College, Boston College, Columbia University, Cornell University, Dartmouth College, Fordham University, Harvard University, Indiana University, London Business School, Louisiana State, New York University, Northwestern University, Ohio State University, Stanford University, University of Akron, University of California—Berkeley, University of California—Irvine, University of Chicago, University of Florida, University of Kansas, University of Maryland, University of North Carolina, University of Pennsylvania, University of Texas, University of Virginia, University of Washington, Utah State, Vanderbilt, Washington University in St. Louis.

Ever since the unanimous Supreme Court Marquette decision in 1978 it has been clear that a federally chartered bank headquartered in one state may originate loans in other states, and when doing so the bank is not bound by the usury laws of the states other than the one in which it is headquartered. The new challenge to interstate banking invents a new theory that somehow the terms of a loan at origination, such as its interest rate, are rendered impermissible as the result of the sale of the loan.

Obviously, if this new theory were upheld in the courts, it would wreak havoc on the national market for loan sales. But why should anyone care? Why does the ability to sell a loan matter to individual consumers?

As I alluded to before, forty-seven prominent academic economists specializing in banking and bank regulation have just provided the answers to those questions in a brief filed in support of the OCC's position in the case in question.[2] Their cogent analysis, summarizing decades of academic research on the social gains that have been reaped from the growth of the loan sales market that occurred after the Marquette decision, deserves widespread public attention. My summary of their argument includes many direct quotations, which are excerpts from the brief.

Their central insight is that the competitive abilities to originate loans, to hold loans, or to perform other services related to loan, can differ across different financial service providers. One bank may be positioned well to originate a particular loan while a different bank may be better positioned to hold it. The divergence of comparative advantage in origination and holding loans reflects "diverse regulatory frameworks, information processing capabilities and access to capital."

"Therefore, a bank's pool of local loanable funds will not necessarily always match the loan demand generated by the supply of local investable projects. Some markets will have an oversupply

[2] "Brief of Amicus Curiae in Opposition to Plaintiffs' Motion for Summary Judgment and in Support of Defendants' Cross-Motion for Summary Judgment," U.S. District Court, Northern District of California, Oakland Division, Case No. 20-cv-05200-JSW, Hon. Jeffrey S. White, Filed January 21, 2021.

of good borrowers that cannot be funded by banks, while other markets will have an excess of funds due to the lack of good borrowers. The ability to transfer loans between institutions improves efficiency and production in both types of markets, by allowing funds to flow across space. Local institutions can exploit local information to make good origination decisions, whereas other institutions having excess local funds are able to hold more good loans than they would otherwise be able to make to (their) local borrowers."

"If … the usury law of the loan buyer's state applied to the loan, the market for loan sales would be significantly disrupted: an institution in one state could legally make the loan but institutions in other states may not purchase it with the same pricing. Consequently, the integrated secondary market for loan sales would be reduced and fragmented across groups of states with similar usury laws. Therefore, to preserve a well-functioning market for loan sales, the OCC's Rule should be maintained."

Why does preserving efficiency in the loan market matter? "Economists have found that a well-functioning secondary market for loans has three benefits and these benefits would be mitigated if loan sales are restricted. First, loan sales expand the supply of credit by giving originating banks the opportunity to finance loans less expensively. The expansion of the banking system's aggregate lending capacity and the allocation of capital to the most productive projects regardless of location have important macroeconomic implications, such as greater economic growth."

"Second, loan sales reduce the risk of lending amongst banks by allowing greater diversification of lending portfolios. By buying loans from around the country, banks can reduce their exposure to the geography-specific risk in their immediate area. Banking system risk can also be reduced by sharing it with non-bank buyers of loans."

"Third, the expansion of lending and lowering of risk made possible by loan sales should lead to more financial inclusion and broader access to credit. Studies have shown that loan sales reduce the interest rates that borrowers pay on their loans and increase the likelihood that borrowers will receive a loan. These advantages should, in theory, be especially important for small and risky borrowers, who are often excluded from receiving loans when credit is constrained. Such financial inclusion has been highlighted as important for economic growth and a more equal distribution of wealth and income. Moreover, many innovative new ("fintech") lenders rely on loan sales as a means of leveraging their origination capabilities, which can carry particular benefits for less wealthy or higher-risk borrowers. Encouraging loan sales will allow innovative new lenders to originate loans on a larger scale. Limits on the viability of the loan sales market would therefore have adverse effects on the underserved by limiting their ability to receive lower cost loans as well as receive funds through innovative financial inclusion intermediaries."

In other words, if the market for loan sales disappeared, credit supply would be reduced, and banks would become riskier, leading banks to charge more for all loans. Furthermore, the borrowers who would be hardest hit by this change would be those at the lowest rungs of the credit ladder, the "small and risky borrowers," because loan sales are playing a particularly important role in expanding financial inclusion, particularly for new fintech lenders.

The amicus brief points out that interstate loan sales are not a sideshow in our financial system. "The benefits of loan sales are clearly indicated by the fact that loan sales constitute a central component of the banking business. And while some loan sales would remain legal regardless of the court's ruling, the activity and depth of the secondary loan market would be limited if the court required that sold loans conform to the usury laws of the purchaser's state."

So, the benefits of interstate loan sales to consumers, especially the most vulnerable borrowers, *are* substantial. But shouldn't we worry that allowing loan sales across state lines undermines the effectiveness of usury laws? Doesn't that aspect of loan sales harm consumers? The brief, and the research it references, shows that more than four decades of research on this question provide a clear answer: no.

"The academic literature on the relative benefits and costs of maintaining usury rates provides a useful context for the decision. Usury rates attempt to restrict any potential market power that banks can use to disadvantage borrowers. However, usury ceilings also could differentially curtail loans to riskier and lower-quality borrowers, thus pushing them towards less-regulated types of borrowing. Empirical research quite broadly supports the notion that the latter effect dominates: that riskier-looking borrowers (who are often minorities or others with limited financial access) are hurt when usury ceilings are binding and benefited when they are loosened or eliminated. Interpreting the National Bank Act in a way that, contrary to the statutory scheme and the OCC's interpretation, allows usury laws from states not connected to the original loan transaction to frustrate loan sales, therefore, is likely to reduce the economic advantages of the secondary loan market in ways that adversely affect income and wealth distribution within the economy."

As I noted at the outset, rarely does economic analysis provide such clear, unambiguous conclusions. But in this case, scores of academic studies over many years repeatedly have reached the same conclusions. Well-intentioned advocates of limiting the interstate loan sales market in the interest of helping the poor need to read this amicus brief and the studies it cites.

To the many insightful points made in the amicus brief I want to close with two of my own observations. First, advocates of usury laws sometimes point to borrowers' lack of information as a rationale for usury laws. For example, a borrower that would qualify for a loan at 8% may not be aware that he or she would qualify for that loan, and a lender might trick him or her into agreeing to a loan with a much higher interest rate. This sort of trickery is possible when loan markets lack competition, and when borrowers lack information about their own credit risk. As the appendix to my testimony shows, the role of new fintech entrants in strengthening competition and empowering borrowers with new sources of information are precisely the reasons that fintech firms are making important contributions to financial inclusion. Rather than rely on usury laws and try to limit fintech-bank partnerships and thereby reduce the supply of credit, the right approach to dealing with potentially abusive credit practices is to encourage new partnerships with these new borrower-empowering fintech providers.

Finally, there is a broader point that also deserves emphasizing, which the authors of the brief did not make. The federal banking system was created in part to guarantee that Americans can participate in a national credit market by virtue of their status as American citizens. By maintaining a federal banking system, we ensure that citizens have the economic freedom to enter into contracts with federally chartered banks if they wish to do so. When they do so, they are aware that federal bank regulators, such as the OCC, maintain a strong and credible commitment to monitor those banks to ensure that credit and other banking services are provided in a manner consistent with safe and sound banking, as well as ethical treatment of consumers. In my experience as a public servant, and in my research as a historian of the OCC, I can affirm that this commitment is real, and that it should be a great source of pride to our country. It makes the economic freedom to engage in a federal banking system especially meaningful and beneficial for consumers. The federal banking system is not just a collection of banks, it is and always has been a source of economic freedom that empowers individuals and in doing so keeps our financial system, economy, and nation strong.

Appendix: Fintechs as Levers for Financial Inclusion

Not only are new unbundled fintech providers more profitable and efficient than traditional banks, their technologies are proving to be very promising for improving access to financial services for many people who have not been served well by traditional banks, especially lower-income people. They can do so either as stand-alone service providers or acting in partnerships with other banks.

The U.S. banking system serves about 80 percent of American families' needs to make payments, save, and borrow. But what about the other 20 percent, the so-called unbanked and underbanked? What barriers explain why the normally reliable pressure of market competition has not led banks to compete for the business of such a large fraction of the population? How are fintech banks (a term I will use to refer both to chartered and non-chartered, "shadow" fintech banks) breaking down some of those barriers?

Historically, the barriers that have kept the unbanked or underbanked from becoming fully integrated into the formal financial sector consist of several supply-side and demand-side factors. On the supply side, these include challenges lenders face in differentiating borrowers' risks, the high transaction costs of serving small-dollar customers, and the costs of regulatory uncertainty (which are often defined on a per-customer basis, and therefore, disproportionately disadvantage small-dollar customers). On the demand-side, factors such as the limited financial resources of low-income customers, their limited experience with financial service providers, and their preferences for particular kinds of products can limit access.

With respect to demand-side factors, how have fintech banks improved financial access for the unbanked or underbanked? According to an FDIC survey, 13 percent of unbanked households state that banks do not offer products or services that they need. For example, a majority of unbanked or underbanked households live paycheck to paycheck, cannot afford the high standard minimum balances or account fees banks require, and do not live near branches.[3] To meet some of these demands, fintech banks have developed different products that may be particularly attractive to unbanked or underbanked households. In particular, fintech banks provide novel products with low-cost fees or and smaller minimum small dollar amount loans. For example, some offer free overdraft protection (typically limited to up to $100)[4] or 0 percent APR cash advance that requires no credit check and no monthly fee (limited to $250).[5] Many now offer bank accounts with no monthly fees, no overdraft fees for limited overdraft protection, and no minimum balance fees, as well as no ATM fee access for in-network ATMs.[6] The common denominator of these products is that physical cost savings from operating as a fintech provider make it more economical to serve small-dollar amount customers, which is particularly advantageous to low-income customers.

Other fintech banks have designed products to smooth spending in the face of high-frequency fluctuations in customers' incomes. Because there is a lag between the days wages are earned and the day that employees are paid, some fintech banks have attracted unbanked and underbanked customers by offering "paycheck deposits."[7] Instead of depositing paycheck funds into a customer's account with the traditional delay (waiting for the funds to clear from the employer's bank), these fintech banks deposit the funds as soon as the transfer instructions are received, taking on the minimal risk that the employer's bank is unable to fund the transaction. This decreases the customer's waiting time by two days. Other fintech banks offer customers access to their wages in advance of the pay day on terms that are generally far superior to payday lenders or to the costs of paying traditional bank overdraft fees.[8]

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[3] Indeed, about 9 percent of unbanked household cite inconvenient location or inconvenient hours as the reason for not having a bank account.
[4] Chime.com; Varomoney.com; Dave.com.
[5] Moneylion.com.
[6] Chime.com; Varomoney.com; Dave.com; Moneylion.com.
[7] Chime.com; Varomoney.com; Dave.com; Moneylion.com.
[8] Even.com and Payactiv.com.

Fintech banks also cater to unbanked and underbanked customers' demands by designing innovative and convenient means for customers to access services through mobile phones, therefore obviating the need to be near a branch. Because the majority of unbanked and underbanked households have mobile phones, fintech banks have been able to attract many low-income customers by offering mobile phone access.

Consumers with limited financial experience sometimes make financial decisions that damage their credit record and leave high-cost lenders as their only option. Financial education and counseling services can reduce these costly mistakes. While academic evidence regarding the impact of financial education and counseling has been mixed, there is evidence that certain approaches provide benefits. In particular, education appears to be most effective when it is targeted to a particular borrower's needs and is delivered at the time the knowledge can be used.[9] For example, research has shown that mortgage counseling conducted at the time a mortgage is originated can reduce default rates.[10]

Many fintech banks provide precisely this form of financial counseling as part of the loan products they offer. They use a wide range of educational services to build relationships with customers that have limited experience with financial transactions. One online lender offers lower rates for completing their online courses on managing debt,[11] while another online lender prominently advertises "community support" whereby borrowers are connected with free and trusted financial counselors.[12] Other fintech banks produce free content for customers or potential customers to help explain when and how their products fit into a well-managed financial plan or to

[9] Fernandes, D.; Lynch, J. G., Jr.; and Netemeyer, R. G. (2014) "Financial Literacy, Financial Education and Downstream Financial Behaviors." *Management Science* 60: 1861–83.
[10] Agarwal, S.; Amromin, G.; Ben-David, I.; Chomsisengphet, S.; and Evanoff, D. (2020) "Financial Education versus Costly Counseling: How to Dissuade Borrowers from Choosing Risky Mortgages?" *American Economic Journal: Economic Policy* 12: 1–32.
[11] Lendup.com.
[12] Oportun.com.

instruct customers on managing finances and debt more generally.[13] Finally, many comparison shopping fintech banks provide free tools for consumers to evaluate alternative debt scenarios, such as debt consolidation, or to create a plan to reach a savings goal.[14] To reduce confusion or misunderstandings that can undermine trust, some fintech providers have developed products that alert customers when they are at risk of being charged a fee, thus helping to reduce fees and improve their decision making.[15]

With respect to supply-side factors, many innovative fintech business models are reducing the costs of serving customers. These costs consist of physical costs and information costs. Physical costs are lower for fintechs because they avoid the high overhead costs of traditional banks, which is especially beneficial to small-dollar account customers.

With respect to information costs, many unbanked and underbanked customers are "credit invisibles"—people without formal credit scores. That lack of information makes it challenging to lend to them. For an estimated 26 million Americans, traditional credit products remain out of reach because they lack a credit score.[16] These "credit invisibles" often turn to payday lenders, pawn shops, or auto-title lenders, or end up paying high overdraft fees at traditional banks. Such borrowing is expensive, with APRs as high as 300 percent.[17] What's more, repayment of these loans often doesn't establish a credit score so experience in these markets brings borrowers no closer to cheaper credit. Instead, they end up in cycles of accumulating debt. Such borrowing amounts to over 280 million transactions per year and roughly $78 billion in revenue.[18]

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[13] Personifyfinancial.com; Saverlife.org.
[14] Nerdwallet.com; Lendingtree.com.
[15] Opportunities for mobile financial services to engage underserved consumers (FDIC 2016).
[16] https://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf.
[17] https://www.urban.org/sites/default/files/publication/57871/410935-analysis-of-alternative-financial-service-providers.pdf.
[18] https://www.urban.org/sites/default/files/publication/57871/410935-analysis-of-alternative-financial-service-providers.pdf.

An important aspect of fintech banks' ability to provide improved access to credit for consumers comes from their use of new sources of information.[19] By using information not traditionally found in a credit report, lenders are able to safely and affordably lend to customers with little or no credit history. Fintech banks such as Oportun and Upstart have advertised that using alternative data has allowed them to successfully provide credit to households who lack the formal credit scores required by most financial institutions. Some fintech lenders have started to use consumers' cash flow history—how much income flows into the person's bank accounts and how much spending draws out of them—to underwrite credit, while other fintech lenders use utility and telecom payment data to inform their risk-scoring. One study finds that roughly half of credit invisibles interested in obtaining credit have stayed current on all of their bills in the past 12 months.[20] By using such alternative credit data to approve loans, fintech lenders can offer lower prices than their traditional counterparts. A LexisNexus study finds that of the 24 percent of consumers in their sample without a credit bureau score,[21] 86 percent became scorable using RiskView, a credit score that uses alternative data. However, the proportion of unbanked and underbanked consumers who would benefit from such a score or other applications of alternative data is hard to estimate precisely.

We are seeing only the beginning of what fintech banks can do to improve the efficiency of the financial system and promote financial inclusion. The industry continues to evolve as new and better approaches enter the market. As with traditional lending, fintech lending entails safety, soundness, and fairness risks. But the financial services industry and its regulators are well equipped to handle these risks.

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[19] See Jagtiani, J., and John, K. (2018) "Fintech: The Impact on Consumers and Regulatory Responses." *Journal of Economics and Business* 100: 1–6.

[20] https://www.fdic.gov/householdsurvey/2017/2017report.pdf.

[21] Consumers who did not have enough credit history to be scorable because it either did not have recent activity on their credit, only nontradeline data, or no credit obligations open for a long enough duration.