

# Fintech, Regulatory Arbitrage, and the Rise of Shadow Banks

---

John Sedunov, Discussant

*Fintech: The Impact on Consumers, Banking, and Regulatory Policy*

September 28-29, 2017 – Federal Reserve Bank of Philadelphia



**VILLANOVA**  
UNIVERSITY

Villanova School of Business

# Overview

---

- This paper studies shadow banks in the residential lending market
  - Makes an important distinction between fintech and non-fintech banks
- Main Findings:
  - Market share of shadow banks in the mortgage market has increased dramatically
  - Gains have come from growth in lending to less creditworthy borrowers
  - Shadow banks were much more likely to enter markets in which traditional banks faced a higher regulatory burden
- Fintech Institutions:
  - Accounted for nearly 1/3 of shadow bank loan originations by the end of 2015
  - May possess advantages in determining interest rates
  - Originate loans with greater convenience for the borrower
  - Contribute to a large percentage of overall shadow banking growth
- Interesting insight as to *where* shadow banks and fintech firms have a comparative advantage



**VILLANOVA**  
**UNIVERSITY**

Villanova School of Business

# Causality

- Would be interesting to see some experiments that establish causality
- Example: Counties with more African American and Hispanic residents have larger shadow bank shares. Likely related to enforcement actions/lawsuits surrounding minority treatment
  - Possible that demand from minorities may draw shadow banks – plus, some shadow banks may operate nationwide (e.g., loandepot.com). This in contrast to the idea that shadow banks are *targeting* these areas.
  - Exogenous event -> enforcement actions within large minority areas
- Similar – claim is that shadow banks *enter* new markets where there is greater intensity of enforcement actions (Capital Adequacy, Mortgage Servicing Rights, Lawsuit Exposure)
  - Many shadow banks were already established prior to the beginning of the sample – so entry might not be what is captured here – can you capture new entrances?
  - Moreover, enforcement actions could mean that the bank is less able to continue with mortgage lending, so shadow bank share increases mechanically
  - Can quantify the impact of new regulation or new legal distress as it relates to loss of market share for a traditional financial institutions
  - What about large-scale regulatory changes (e.g. Dodd-Frank)?
  - Is the issue that traditional banks are retreating? Or that shadow banks are competing better? The former implies a strategy on the side of the traditional banks, the latter implies the opposite



**VILLANOVA**  
**UNIVERSITY**

Villanova School of Business

# Additional Cuts

- Political affiliation – Are states/communities with different political leanings more/less receptive to shadow banks or fintech firms?
  - Can add this to regional characteristics tables (i.e. Table 5)
  - Variables can include state governor and legislature, vote share during national elections, composition of congress representation (either total or for specific districts)
  - May speak to either: where shadow banks/fintech firms target *or* could give insight as to what party is more receptive to this type of institution
  - Can also interact with changes in regulation (and possibly examine the sponsoring party)
- Rice-Strahan Index (Rice and Strahan, 2010) – Can give an idea of restrictiveness of state banking regulation in addition to enforcement actions



**VILLANOVA**  
UNIVERSITY

Villanova School of Business

# Fintech Firms

- A lender is classified as a Fintech lender if all of the mortgage application takes place online. This business model may have changed over time (Use of internet Wayback machine is good!). Can you compare within firm? e.g. Before becoming a fintech firm, did the lender use traditional data? Did the lender always have different interest rates, etc.?
  - Not all firms were established within your sample period – e.g. Homebridge in 1989, Guaranteed Rate in 2000
- Isn't there a grey area in the classification process? While applying *entirely* online is different from applying *mostly* online, lenders who have a largely-online process are still different from those who do not. Consider a third classification?
  - E.g. loandepot.com
- Does one Fintech lender dominate the market (and thus the sample)? Can you provide some statistics on bank-by-bank volume?
  - One robustness check does examine Quicken Loans
- Would be interesting to see a comparison of the institution-level statistics between Fintech and non-Fintech shadow banks. Currently this analysis is primarily at the borrower/loan level. This additional comparison might help facilitate a discussion about core differences in business models

# Fintech Firms

- If Fintech firms use less traditional hard information (Table 9), then what do they use?
  - “fintech lenders may be better able to screen potential borrowers, leveraging alternative sources of information and the big data approaches inherent in technology based lending”
  - By their very nature, Fintech firms are hard information lenders. They have no contact with the borrowers other than through a form on their website – what else can they be using?
  - What are the types of “big” data that can be helpful to a lender?
- Do other institutions have access to similar back-office technology?
  - Might be helpful in understanding *why* Fintech loans have a lower rate of default, and why pricing is different
  - Does differing front-office technology lead to different models for credit risk?
- What are the technological advantages that Fintech lenders have to determine interest rates?
  - The paper shows fundamental differences between non-Fintech and Fintech lenders. However, more elaboration on the technical differences would be insightful. A different front-facing technology doesn’t necessarily imply a different back-office technology.

# Conclusion

---

- Overall, interesting paper with important conclusions!
- Results are especially relevant to policy makers as well as academics and investors
- Good luck with the paper! It was fun and enjoyable to read, and very informative!



**VILLANOVA**  
UNIVERSITY

Villanova School of Business