

# The Global Interdependence Center's Payment Systems in the Internet Age Conference

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San Diego, CA

February 6, 2017

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The views expressed today are my own and not necessarily those of the Federal Reserve System  
or the FOMC.

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Good afternoon and thank you. I'd like to start by saying that I'm a proud and loyal son of the Federal Reserve System's Third District, which encompasses the eastern portion of Pennsylvania, southern New Jersey, and Delaware. I'm proud of the people, the places, and our contributions. With that said, thank you for getting me out of that weather and inviting me to San Diego.

We're here today to discuss "payment systems in the Internet age," a subject that could occupy a full month's conference and that brings up interesting complexities for anyone interested or invested in the subject.

It is also something of a complex topic for someone involved in regulation, so I should note from the outset that the views I express today are mine alone and do not necessarily reflect those of my colleagues in the Federal Reserve System.

With that out of the way, I'd like to talk today about how fintech has evolved and the role it plays in the overall financial system. That involves going back to first principles, because whenever we're dealing with emerging areas of regulation, it's important to address what that oversight is and isn't addressing.

### **The Evolution of Fintech**

Those of us who've been watching the evolution of what we now call fintech can probably agree that it existed before the headlines it's garnered over the past five or six years. That, in fact, they reflect changes that have been in motion since the '90s and early 2000s.

I don't want to diminish the inventive spirit evinced by the tech sector. But it's important to remember that the application of technology to financial institutions and functions has been going on for some time. We sometimes forget, with the incredible innovation coming out of

Silicon Valley — and Silicon Alley, and Silicon Beach, and all the other hubs this country has produced — that the tech revolution is advancing into middle age, which is only to say that we've been watching the disruption of various sectors — even ones as staid and resistant to change as financial services — for a while now.

We've gone from hardware-oriented to software-oriented innovation, and IT has become much more sensitive and responsive. Internet capabilities have advanced by leaps and bounds just in the past decade, changing the game for front-end functions. This makes it possible for startups to reach consumers in a way that only banks could do 25 years ago. In many instances, this has inverted the relationship between consumers and service providers and banks.

So, if you ask anyone who's old enough to have witnessed the industry evolve since that time — a time when many of the people creating today's software were just being born — you'll hear that major change has come but also that, in some ways, everything old is new again. We're just finding new platforms.

Take peer-to-peer lending, an area that's captured particular attention. Lenders and lenders are connected in ways they haven't been before, and there's a spirit of inclusion and a feeling of active participation, which is wonderful. But even that movement is essentially adding a technological edge to something we've been doing since humankind embarked on a system of goods and trade in kind. In my day, it happened over beers at the corner bar, when Eddie asked Joey to loan him a 20. Peer-to-peer lending has been going on since time immemorial. What makes fintech different is that the scope of its ability to match people with one another is infinitely broader.

## **Defining Fintech**

Which brings me to what, exactly, we mean by fintech. While it doesn't have a fully accepted definition, I think we can all agree that fintech is more or less the application of technology to the financial services sector.

It may seem odd to define it, but there is honestly some confusion. And with so many firms calling themselves fintech, it's good to lay down a baseline. So, for the purposes of our

discussion today, I'll be talking about fintech firms as those that apply technological innovation to financial functions and systems.

### **Banking and Financial Systems: First Principles**

Also for the purposes of our discussion today, I am going to get even more basic and establish what those systems are, why they exist, and what underpins them.

The evolution of financial systems and intermediation has been studied and commented upon for centuries. It evoked renewed interest after the global crisis as people began to reexamine the purpose of markets and the role of the financial system.

While there is a lot to dissect with regard to the various innovations of financial vehicles and the ways in which institutions are structured, a financial system is fundamental to the human experience as we know it.

These systems evolved because humanity is driven to find comforts beyond subsistence-level living. We can't buy food or shelter in the modern age without a system of payments, finance, and credit. And our incorporation of a financial system has existed in some form for most of our history. Whether it was trading or banking, societies across the globe have operated on the premise of: You have something I want or need, and I will give you something in exchange. From the central agora to apps on our phones, whether it's a creditor's note or a series of 1s and 0s, the essentials of the system have stood the test of time.

At its most basic, the financial system exists to keep savings safe; to ensure that people and businesses can easily price, buy, and sell things; and to make certain that we can all use our financial resources to their best advantage, whether that means paying for food and housing, getting an education, expanding businesses, or investing our assets.

This is critical for all of us because a strong and sound economy can only exist when it's underpinned by a strong and sound financial system.

And what underpins a strong and sound financial system is trust.

Adam Smith said, "All money is a matter of belief," and it naturally follows that all financial systems are a matter of trust. A financial system can only exist if we collectively agree to it. A

system of savings, credit, exchange, and investment survives because we have faith in people we don't know, currency we have no individual control over, payment systems with inner workings we don't see, and institutions we grant power to — both to house and to regulate those systems.

Why do I mention these? Because they are central to the next steps for fintech.

### **Fintech: What's Next**

While I noted that fintech is just the latest iteration of changes we've been seeing for a few decades now, it is still new from a regulatory standpoint, and it's likely heading into uncharted territory. It's unlikely that increased oversight will be welcomed with open arms, but I should say now that it's actually in the interest of fintech firms.

In part because they exist in a business environment that is much more Silicon Valley than Wall Street, fintech firms, by and large, do not see themselves as banks. But many of them are, ultimately, financial institutions.

Banks, by definition, are institutions that take deposits and make loans. While many fintech organizations see themselves as mere facilitators, if they are providing the essential functions of a banking institution, that poses questions about regulation. And if they're subject to oversight, it's better for them to understand what it takes to be compliant from the beginning.

“Regulation” being the great bogeyman of the industry, I'd like to note that regulation is necessary for a functioning system. The trust that underpins the financial system is either earned or guaranteed by people or institutions. One of the ways of conferring that trust is the promise that mechanisms are in place to safeguard the system.

Fintech firms need that trust the same as any other bank or financial institution. This underlying expectation is why it's best to get in early on regulation. It's in these firms' self-interest to provide a layer of trust-building that regulation can offer, particularly those that are getting to a scale where negative events could have major consequences.

This is especially true because most fintech firms today haven't yet seen the down side of a credit cycle, and trust then will be shaken.

Any student of economic history has to acknowledge that, like death and taxes, a down side to the cycle is inevitable. The aftermath of the cycle's end will determine a lot of the character and contour of what sort of company can survive in this space. That alone should be cause for fintech to want some form of oversight.

What fintech outfits don't want is regulation that comes in after a crisis. That type of regulation almost always fights the last war, and that could mean tighter strictures and less room for innovation after the crash at the end of a credit cycle. Policymakers have too much experience with the old adage that history may not always repeat itself, but it often rhymes.

So, I think there are two things to focus on when talking about regulation: First, that it's structured to protect both institutions and the public. Second, that we consider what regulation already looks like and where we think it's headed.

## **Regulation**

I have to stress that as a Federal Reserve Bank president, I have no hand in drafting regulations. So, forgive me if I veer into armchair quarterbacking.

What I am able to do is talk more broadly about what's been proposed, the examples we have to look at in other countries and regions, and what I think is likely to occur.

The European Union has given us some comparison for the proposed measures from the Office of the Comptroller of the Currency (OCC), which remains the most comprehensive attempt at mapping out a strategy in the U.S. to date. In particular, a lot of commentary in the payments industry has drawn parallels between the European Commission's Payment Services Directives and the OCC's proposal to grant national bank charters to fintech companies.

Fintech firms vary widely in their business models: While some provide payments-related services, others offer loans to consumers and businesses, provide digital currencies, or offer financial planning or wealth management services.

For fintech firms whose business falls more on the payments end, there is some comparison to the European model. The Commission's Directives ask that these types of firms be licensed and satisfy other general requirements. The closest analogy we have in the U.S. is state regulation

and supervision of money-service businesses. Some fintech firms that fall under this umbrella are unhappy with the idea of having to obtain many, if not dozens, of licenses to operate around the country. The proposed OCC charter may offer them some relief.

On the other side, to the extent that the fintech firm is weighted toward making loans — especially to consumers — the Payment Services Directives don't quite correlate. For that, the better comparison is the Commission's Task Force on Financial Technology, which makes policy recommendations on fintech in financial services. It formally incorporates viewpoints from multiple regulatory bodies, not just banking regulators, which sets the European model apart from the OCC's suggested framework.

There is an open question about whether or who should supervise fintech lenders in the United States, made all the more complicated by the interplay between our state and federal regulatory frameworks. Most personal finance companies, for example, are licensed and regulated at the state level. Uncertainty about the boundaries between these two competing spheres of authority can be seen in some states' reactions to the OCC's proposal.

But, particularly if we're talking about loans to consumers, it's only a matter of time until federal consumer protections will come into play.

All of which is to say, it's complicated. But it continues to be, in my opinion, in the interest of fintech companies to be regulated.

This may sound like the particular nannying of a sometime regulator asking for more oversight. I'm not speculating at all that the Fed will be involved in fintech regulation. But I can say that none of us are trying to stifle innovation. If anything, you'll hear us praise the ingenuity and imagination that comes from the technology sector. But there are risks, and we should be talking about them. Regulation can't solve everything, and it can't anticipate or guard against every problem. But it can try.

For me, regulation is not just a question of protecting consumers; it's a question of protecting the innovators as well. It's in their best interest to have an established framework in which to operate. In part because the trust it engenders will underpin their essential role in the financial system.

## **Conclusion**

Again, this all comes back to trust and its critical role in the financial and economic systems. Whether it's Eddie borrowing a 20 off of Joey at the corner bar, or the loan officer at our local community bank, we trust people to act in accordance with an agreed-upon code, both the legal one enshrined in legislation and the moral one we've entered into as a society. Whether it's a structurally important financial institution or an app on our phone, we trust institutions to hold up their end of the bargain we struck when we deposited or borrowed funds. And whether it's administered by multiple agencies or a single body, at the state or federal level, we trust that there is a safeguard in place to guide and protect the companies we're entrusting with our economic livelihoods.