Regulating FinTech: The Path to Actual Financial Inclusion in the United States.

There's a clear disjunction between these companies' social impact missions of expanding financial inclusion and the lack of evidence to support their claims.

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Abstract

Over the past decade, financial technology (FinTech) has redefined the financial sector. FinTech refers to algorithms, software, applications, and other technologies that work to improve and automate financial services. This paper investigates FinTech's role in financial inclusion in the United States with data and qualitative analysis from government research and peer-reviewed reports. It concludes that despite FinTech's growth and success over the past decade, the industry has made little impact on financial inclusion for Black, Hispanic, and lower-class Americans. Some FinTech products trap these groups into cycles of debt, which further extends generational cycles of wealth inequality. The first section of this paper establishes the landscape of wealth inequality in the United States and analyzes the FinTech revolution. The following section examines how lending and algorithmic bias are reflected in FinTech services. Most notably, this paper concludes with solutions of how FinTech companies and the government can work to correct this inherent discrimination. FinTech companies can partner with nonprofits and introduce socially conscious practices to expand financial resources. The government must introduce FinTech-specific legislation and enforce current laws to protect underserved Americans and fix the inequalities that they helped create.

Introduction

The United States has a wealth inequality problem. Roughly 20 percent of American adults remain unbanked or underbanked, and that number only increases for Black, Hispanic, and lower-class populations. These inequalities derive from a history of redlining–an illegal practice in which loan providers restrict services based on the applicant's neighborhood and race–discriminatory lending, and selective financial services. Concurrently, the United States is experiencing a financial technology (FinTech) revolution. Since the 2008 financial crisis, the growth of FinTech and the adoption of digital financial services have created a wealth of financial opportunities. The FinTech industry is expected to grow sixfold from $245 billion to $1.5 trillion by 2030. However, the broad expansion of financial inclusion– the effort to make financial products and services accessible to all individuals– is not an inevitable outcome of the FinTech revolution. Although FinTech has experienced great success, America has not moved the needle to close the wealth gap. The ongoing issue of wealth inequality raises the question: who has benefited from the FinTech revolution?

FinTech companies widely promote financial inclusion as a special benefit of their enterprise. Eager to understand how they support their claims with metrics, I contacted fifteen FinTech companies to review their consumer data. Of the fifteen, only three responded, and none of the companies offered their data. These struggles, however, were not isolated to my research. In a joint study between Harvard and LSU on FinTech lending and the use of alternative data, the researchers stated that "empirical evidence on these issues is scarce" (Di Maggio et al., 2021, p.2). The universities could only conduct research based on information provided by a singular company. While guarding consumer data is a public obligation that FinTech corporations advertise, they offer no proof of their service to marginalized groups. No public reports demonstrate how FinTech increases financial inclusion for underrepresented groups. In fact, there is a clear disjunction between these companies' social impact missions of expanding financial inclusion and the lack of evidence to support their claims.

The only tangible data about FinTech companies reveals they intentionally target Black, Hispanic, and low-income households and allow them to engage in risky financial transactions. Since the current laws are outdated and fail to account for the new creation of technology, algorithms, and digital assets, FinTech operates in a regulatory gray area, which allows for these discriminatory practices to continue. FinTech is one of many American enterprises that touts American ideals of opportunity for all, but in reality has yet to step up. Both the Rev. Dr. Martin Luther King Jr. and Fredrick Douglass identified the non-fulfillment of the "promissory note" of the American ideals in the founding documents. Thus, the United States has a responsibility to correct this persistent failure and to protect its citizens. The government must ensure that the FinTech revolution is coupled with a revolution for financial inclusion and legal guardrails.

Wealth Inequality in the United States

The need for government frameworks and guardrails is clear. On the surface, the United States has a thriving banking structure, but underneath the world's largest GDP, America is failing a substantial portion of its population, with 121 million people who are credit-challenged, and 67 million financially underserved people who are unbanked or underbanked. Individuals who are credit-challenged typically have subprime credit scores or no credit files, those who are unbanked have not used any banking services, and those who are underbanked have bank accounts but have not used alternative banking services in the past 12 months (Gorham &

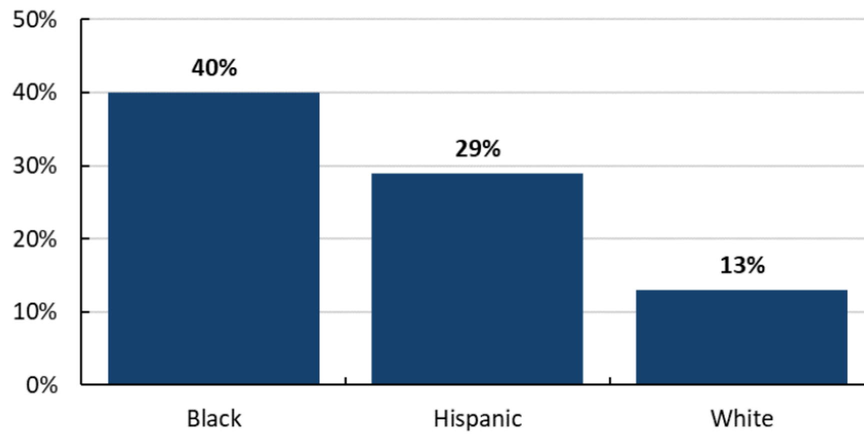
Dorrance, 2017, p.7; JEC Democrats, 2022, p. 4). Moreover, 57 percent of Americans – 137 million consumers – are financially unhealthy, which means they struggle to manage their day-to-day finances, establish a savings cushion, and make a plan to ensure their financial security and mobility (Gorham & Dorrance, 2017, p.7).

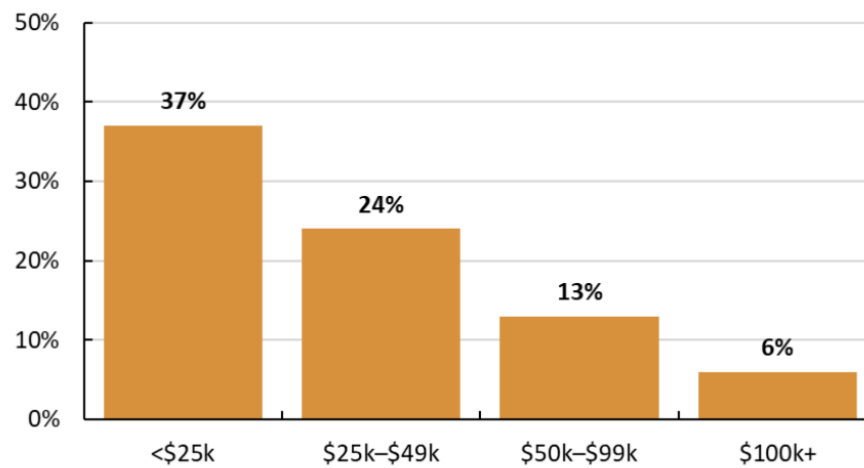
America's financial inclusion failures, coupled with historical inequities like redlining and discriminatory lending, have led Black, Hispanic, and lower-class Americans to be disproportionately excluded from and harmed by financial services. According to Federal Reserve data, 40% of Black Americans, 29% of Hispanic Americans, and 37% of Americans who earn less than $25,000 annually are either unbanked or underbanked, as compared to the national average of 20% (JEC Democrats, 2022, p. 4). Limited access to financial services forces the unbanked and underbanked to use nontraditional financial systems. For example, 56% of unbanked Americans use nonbank services for money orders, check cashing, or a bill payment system compared to 15% of banked Americans (JEC Democrats, 2022, p. 5). Despite their inclusive potential, the financial services that are typically catered to Black and Hispanic households can be extremely predatory and often neglect to explain financial risks. In 2018, financially underserved Americans were forced to pay roughly $189 billion in fees and interest on financial products (JEC Democrats, 2022, p. 5). In addition, the racial wealth gap is manifested in net worth and homeownership rates. The average white family has five times the wealth of the average Hispanic family and eight times the wealth of the average Black family. In 2019, the homeownership rates for young White families sat at 46%, compared to 17% for young Black families and 28% for young Hispanic families (Evans et al., 2021). Homeownership is a key factor in accumulating generational wealth, and the difference in homeownership rates further contributes to the racial wealth gap.

Extending beyond the United States, it is important to consider how America's wealth inequality issue compares to the rest of the world. Compared to leading democracies, the United States is behind in financial inclusion. In a report by Dr. Lucy Gorham and Jess Dorrance from the UNC Center for Community Capital, they state that in Canada, France, Germany, Japan, and the United Kingdom there is no significant difference in account penetration between adults in the poorest 40 percent of households and those in the richest 60 percent. Furthermore, the share of adults with an account in these countries exceeds 95 percent in the poorer group. In contrast, there is a data gap of 11% in the United States between the two groups, with only 87 percent of

adults in the poorer group having an account (Gorham & Dorrance, 2017, p.7). There is obvious potential for the United States to be a leader in FinTech and financial inclusion considering that the country has more access to capital, talent, and consumer demand. The present and future success of the FinTech industry indicates that there is no shortage of financial resources; rather, with FinTech and government collaboration, financial services must be offered equally to all Americans to address these inequities.

Figure 1: Race and Class Disparities in Banking Access

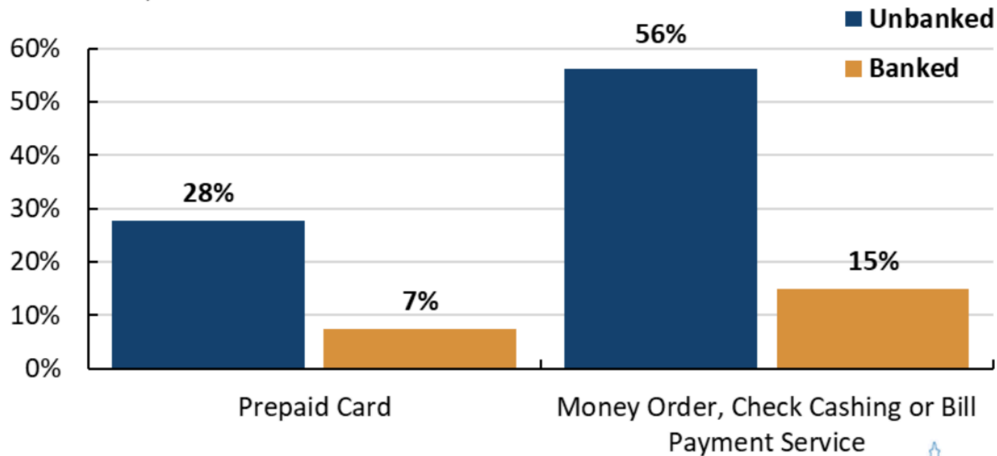




Source: U.S. Congress Joint Economic Committee Democrats (JEC Democrats), 2022, p. 4

Note: Original data provided by the Federal Reserve Board of Governors

Figure 2: Unbanked Households Rely on Nonbank Financial Services



Source: U.S. Congress Joint Economic Committee Democrats (JEC Democrats), 2022, p. 5

Note: Original data provided by a 2019 FDIC Survey.

FinTech Revolution & Inequalities

As financial discrimination persists in the United States, the advent of the FinTech revolution presents a new set of benefits and inequalities in the financial landscape. After the 2008 financial crisis, and as a result of the general distrust of traditional banks and financial institutions, Americans turned to FinTech for new financial solutions. The FinTech industry holds many benefits over traditional finance offerings, including increased data collection, the use of advanced technology, and that FinTech lenders process loan applications faster and have a more elastic loan supply. These advantages have led some FinTech companies to achieve large market shares in certain business sectors, including Rocket Mortgage (formerly known as Quicken Loans) which accounts for roughly 8-12% of new mortgage loan originations in the United States (Beck, 2020, p.10). In addition to its large market shares, convenience is another key benefit of FinTech. Mobile banking and payment apps are more efficient and allow for those with inflexible work hours or who are in rural areas to have a streamlined banking experience. Furthermore, digital financial services reduce overhead costs for FinTech, which can translate to lower banking fees, reduced lending rates, and automated transactions. Considering its

competitive advantages, FinTech has the potential to increase financial inclusion in many ways, including expanding access to credit.

However, FinTech's advantages are a double-edged sword, as these factors can lead to more consumer-specific targeting and thus more discrimination. Evidence shows that data-driven does not necessarily mean bias-free. FinTech's expanded data sources can be used by algorithms to amplify inequalities and cement analog forms of discrimination in the digital sphere (Evans et al., 2021). A report published by the U.S. Congress Joint Economic Committee Democrats stated that "Black and Hispanic Americans are more likely than their white counterparts to be invested in unconventional assets, like non-fungible tokens" (JEC Democrats, 2022, p. 11). The report found that people of color are also more likely to select cryptocurrencies as part of their investment strategy, and Black and Hispanic Americans are more than twice as likely as white Americans to state that cryptocurrencies present no risk. However, digital assets present a series of consumer risks. Cryptocurrencies experience drastic price swings, which renders them inconsistent sources of wealth creation. Regardless of whether the nonbank platforms intend to mislead their Black and Hispanic consumers, these underrepresented groups must be equally informed of the risk that is attached to their financial transactions.

Solutions

What FinTech companies can do

Given the lack of comprehensive data to demonstrate FinTech's success in financial inclusion, companies must reassess how to fulfill their mission of increasing financial access for all. FinTech has the digital tools and business infrastructure to increase financial inclusion but lacks an effective social-impact strategy. There is a need for more research and investment in FinTech innovation for underserved communities. Similarly, there should be a greater investment in nonprofit organizations that educate underserved populations on financial literacy and connect people to financial services. Some nonprofits have recently formed partnerships with FinTech companies to improve financial inclusion efforts. Commonwealth, a nonprofit financial innovation lab, launched its Investor Identity Research Project in 2022 to examine how investor demographics can enable or prevent long-term wealth. The project is funded by The Nasdaq Foundation and partners with FinTech companies like Ellevest and Stash to understand financial accessibility, especially for Black, Hispanic, and female investors. There are often many barriers

to finance that FinTech companies do not account for as they build their products. Commonwealth understands these obstacles and works to create economic opportunities by redesigning FinTech products. Timothy Flacke, Co-Founder and Executive Director at Commonwealth said, “A nuanced and improved understanding of how investor identity influences investor behavior will better equip financial services firms and organizations to build inclusive products that enable more people to start seeing themselves as investors and participate in the capital markets,” (Elworthy, 2022).

By collaborating with nonprofits that work in diverse communities, FinTech companies can improve their outreach strategy and attract a larger audience to use their services. For example, when asked why they did not use digital financial platforms, many underserved customers cited the need for a brick-and-mortar location in addition to a mobile platform, lack of consistent access to technology, and the lack of company recognition and transparency. Guided onboarding and check-ins could help include more users who are concerned about engaging with FinTech. Alliant Credit Union in Chicago is a prime example of this solution in action. The credit union sent a mailer with step-by-step instructions and a $5 incentive check to 3,000 randomly selected customers who had exhibited little to no use of mobile check deposits. The results were quite successful. Alliant Credit Union incentivized their customers to learn about the platform and built trust with them, which increased mobile deposits by 40 percent. (Gorham & Dorrance, 2017, pp 40). If FinTech companies incentivize their customers to become financially literate through their platforms, it will lead to more financial stability and independence.

In addition to nonprofit partnerships, the use of alternative data can counteract FinTech lending bias. Traditional data typically includes lines of credit, utilization rate, length of credit history, loan payment history, and credit mix. Commonly used alternative data points include rent history, utility and cell phone bills, employment history, property ownership, phone number, and address stability. A report published by the U.S. Treasury specifically recommended the use of telecom, utility, or rental data for loan evaluations because consumers without credit scores tend to make regular monthly payments to these services and may benefit from reporting in these fields (U.S. Treasury Department, 2018, p. 136). A Harvard-LSU study found that alternative data can successfully identify borrowers with equal default rates to traditional data set borrowers. Despite equal default rates, the study revealed that those who were approved for loans with alternative data had a 60 percent higher probability of rejection when using traditional data (Di

Maggio et al., 2021, p.4). The borrowers who are most positively impacted by the integration of alternative data are the “invisible primes”—people who have low credit scores and credit histories, but also a low propensity to default loans (Di Maggio et al., 2022, p.5). Through the use of alternative data, FinTech companies can approve loans for more people. Furthermore, with a greater understanding of the communities that they have yet to serve, FinTech companies will be able to increase their impact.

What the government can do

In conjunction with FinTech reform, the government has a responsibility to increase financial inclusion. Given the magnitude of the wealth gap, and since it is unclear how FinTech companies are using their data, the government must apply existing legislation to FinTech companies and create new laws that are specific to digital financial services and nonbank companies to protect American civil rights. Currently, there are civil rights laws that apply to financial services: the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA). In recent years, the DOJ sued Meta (formerly Facebook) for discriminatory advertising in violation of the FHA, which suggests that FinTech companies can be held to similar standards with the ECOA and FHA frameworks. Additionally, the Dodd–Frank Wall Street Reform and Consumer Protection Act which prohibits unfair, deceptive, or abusive acts and practices (UDAAP) can be applied to FinTech.

While these laws cover certain regulatory areas of FinTech, the existing financial discrimination laws are a patchwork of incomprehensive regulations. The U.S. Treasury recognizes that state and federal FinTech laws are inconsistent and lead to various rulings across the country (U.S. Treasury Department, 2018, p. 70). To align the state laws, Treasury officials recommend that the government establish a FinTech Industry Advisory Panel, harmonize the multi-state supervisory processes, and redesign a Nationwide Multistate Licensing System (U.S. Treasury Department, 2018, p. 10). There have been attempts to implement these solutions, including the Federal Reserve Bank of New York’s creation of the Fintech Advisory Group in 2019 and the expansion of the Nationwide Multistate Licensing System (NMLS) to 21 states by adding licenses from Kentucky, North Dakota, and Wisconsin to its platform (The Federal Reserve Bank of New York, 2022). However, these changes have only scratched the surface, as the New York Fed’s Fintech Advisory Group disbanded in 2022, and the NMLS is still working

to develop a 50-state model to standardize definitions and procedures for money services business (MSB) licensure (Infinicept, 2022).

In addition to state-level legislation, the United States needs federal statutes that prohibit discrimination in other aspects of finance, including bank account fees and investment advisory services. Moreover, the government should review FinTech algorithms– similar to FDA safety inspections– to ensure that consumers are treated fairly. The U.S. Congress JEC Democrats made recommendations at the federal level including public banking models that integrate FinTech services, loans to help historically disadvantaged families purchase their first home, and Congressional rules to govern digital assets (JEC Democrats, 2022, pp. 1, 8).

Following the JEC Democrat's report, the United States has yet to integrate FinTech into public finance and lacks consistent digital currency laws across the country. Since 2020, however, there has been an increased focus on loans for Black and Hispanic communities. The loan opportunities are provided by large corporations, like Bank of America, along with the Federal Government. One example includes the Biden Administration's Downpayment Toward Equity Act which was introduced to Congress in 2021 but has not been passed into law (U.S. House Financial Services Committee, 2023, p.1).

There are also ways for the government to collaborate directly with FinTech. Economist Dr. Thorsten Beck recommends regulatory sandboxes for FinTech that allow for small-scale experimentation of new products in a controlled environment. In a regulatory sandbox, innovators can experiment with financial technologies and services under the supervision and guidance of regulators (Beck, 2020, p.16). In this case, the government would be able to craft regulations that are better suited to emerging technologies while balancing innovation and consumer protection. By addressing the need for regulations from the state and national levels, the government will be able to protect the civil rights of American consumers.

Regulatory recommendations

To ensure that FinTech has a positive impact on financial inclusion, regulators must establish comprehensive frameworks and oversight systems that balance consumer protection with innovation. Beck (2020) introduces a few FinTech regulatory options, including regulatory sandboxes and regulatory parameters. Evans et al. (2021) state that the government must apply existing legislation to FinTech companies and create new laws that are specific to digital

financial services and nonbank companies. Similar to Beck's research, they mention regulatory sandboxes as a government solution. The U.S. Treasury Department (2018) argues that the FinTech sector has great economic capabilities in the United States but requires more consistent regulatory statutes to protect Americans. The Treasury recognizes that the state and federal laws regarding FinTech regulation are inconsistent and lead to varying rulings in courts across the country. To align the state and federal laws, Treasury officials recommend that the government establish a FinTech Industry Advisory Panel to help improve state regulation, harmonize multi-state supervisory processes, and redesign a Nationwide Multistate Licensing system. Like the Federal Reserve Bank and Dr. Thorsten Beck's research, the Treasury recommends regulatory sandboxes as a way to balance innovation and consumer protection.

However, there are caveats to implementing regulatory sandboxes. Beck's report states that a majority of regulatory sandboxes are not focused on underserved consumers. Furthermore, Beck cited a report from the UN Secretary-General's Special Advocate for Inclusive Finance for Development (UNSGSA), which stated that the impact of regulatory sandboxes is inconclusive given the variability in how the sandboxes are created. If constructed with intentionality, regulatory sandboxes can help create proper FinTech regulations. In addition to the sandboxes, the JEC Democrats (2022) made several recommendations to shrink the wealth gap including public banking models that integrate FinTech services, alternative credit assessment models for the credit invisible, loans to help historically disadvantaged families purchase their first home, and Congressional rules to govern digital assets. While the United States has taken meaningful steps to improve FinTech regulations, there is a need for increased efforts and collaboration to achieve a financially inclusive society.

Discussion

It could be argued that more government regulations would ruin the free market values of the United States. Furthermore, some may claim that FinTech companies do not have a responsibility to change their practices to fix wealth inequality because they did not create these issues. Although the United States has elements of a free market, the country has a mixed economy that embraces the free market for capital use but allows for government intervention for the public good. For the government to serve the public good, it must provide services to all members of society, either through government programs or private organizations like FinTech

companies. The government has the opportunity to create a public banking model that offers high-quality digital financial services with a central mission of benefitting American society, which is in contrast to the private banking mission of maximizing profits. Moreover, introducing new laws and applying current regulations to FinTech companies is not exhaustive and would maintain the relationship between the corporate and government spheres. Statutes like the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA) should be applied more frequently to FinTech companies to protect American civil rights. More government oversight through regulatory sandboxes and company data audits will protect consumers, as this area of the market currently lacks legislation. To ensure that FinTech companies comply with government regulations, state, local, and federal governments must establish comprehensive frameworks, implement licensing requirements, conduct regular audits, monitor technological advancements, and enforce penalties for non-compliance. Penalties may include fines, suspension, or company termination. In addition, many FinTech companies have committed to make finance more accessible with their products, but have failed to do so. FinTech companies can maximize their customer base and serve all people by partnering with nonprofits and introducing models that incorporate alternative data. Given that FinTech companies have proven to be profitable and have a stable infrastructure, focusing on their impact mission would not be detrimental to their business models. In fact, the increase in customers would bolster their profits. These changes will not only strengthen the structure of FinTech but also create a more just financial world for Americans.

Conclusion

When it comes to financial services, having equal access and treatment is a civil right. Financial inclusion is much more than the ability to open a bank account, make an investment, or obtain a loan. It is essential to foster economic development, reduce poverty, and support financial stability. The current FinTech revolution presents a ripe opportunity to address centuries of discrimination and create opportunities for all Americans. An updated digital infrastructure with government regulations will allow people to enter the financial market in a protected manner. While it will not come without challenges, connecting people to capital and additional resources will help them take advantage of economic opportunities and have more financial freedom.

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