

## **Session 5: Banking, Capital Markets, and The Crypto Revolution: A Look Back and Projection of the Future of FinTech**

*Summary of Proceedings by Jordan Stapleton*

*Panelists: Joseph R. Cutler, Lawrence Kaplan, Youssef Sneifer, & Jill Williamson*

*Moderated by Joseph M. Vincent*

**Abstract:** In Session Five of the SITIE 2023 Symposium: Enabling Innovation in Law and Society, Joseph M. Vincent moderated as the four panelists, Joseph R. Cutler, Lawrence Kaplan, Youssef Sneifer, and Jill Williamson, discussed banking, capital markets, and the crypto revolution by looking back and projecting the future of the financial technology (FinTech) industry. The discussion commenced with a conversation on banking deposits, then moved into a discussion on cryptocurrency companies and the challenges they have faced in recent years in the banking industry. The panelists further discussed artificial intelligence (AI) technology's impact on FinTech, open banking, and challenges facing cryptocurrency (crypto) going forward.

### **I. Bank deposits**

Recently, there have been a host of factors, including asset-liability mismanagement and liquidity issues, that have contributed to the failure of several banks within the United States, such as Silicon Valley Bank, First Republic Bank, Signature Bank, and Silvergate. In all the discussions sparked by recent bank failures, there has been debate over whether the \$250,000 Federal Deposit Insurance Corporation (FDIC) deposit limit needs to be raised to protect more borrowers. The \$250,000 limit was set as a part of the Dodd-Frank Act in 2010, which raised the limit from \$100,000 to \$250,000. The purpose of deposit insurance is to protect depositors so that even if a bank fails, all accounts are insured for \$250,000 each. While even in the recent bank failures, the \$250,000 limit covered most deposits, it does not protect a small minority of depositors, which generally includes businesses. The challenge is that many companies have significantly more than \$250,000 in payroll accounts or operating accounts at a bank. Because businesses employ many people, there is a significant risk that not insuring business accounts at a higher level may have a significant impact on thousands, if not millions, of employees. A potential solution, discussed by Lawrence Kaplan, is to raise the \$250,000 limit under specific government programs that protect payroll and operating accounts to ensure employees receive their paychecks on time, even if a bank fails.

Lawrence Kaplan further discussed the benefit of deposit networks, a relatively recent innovation. These networks allow a depositor to place more than \$250,000 in their bank, and their bank will automatically sweep deposits above the \$250,000 limit to other banks so that consumers can protect deposits above and beyond the \$250,000 limit. Banks such as SoFi and WealthFront provide services like this, and these programs may allow a consumer to obtain FDIC protection on several million dollars in deposits, if not more. A potential concern with this

approach, though, is that consumers need to monitor where their deposits are placed to ensure they do not already have deposits at that specific bank.

It is important that the FDIC fund stays solvent so that if problems do arise, the FDIC can pay out for covered deposits. In previous bank failures during the financial crises, there were some problems with liquidity failures for public deposits that were underinsured, such as local county payroll deposits. The challenge now is that Congress would need to act to protect such public deposits. While some states have collateralized deposit programs and public deposit protection programs, there is generally deposit risk for public deposits. Protecting municipal deposits is something Congress needs to act on. In Washington State, the Public Deposit Protection Commission secures financial institutions with full collateralization requirements should the institutions become insolvent.

In June, the Director of the Consumer Financial Protection Bureau identified a risk of uninsured deposits held at FinTech firms such as Venmo and PayPal. Currently, no deposit-like protections exist for non-bank entities that transmit assets. These issues expand into the crypto industry, where there are similar questions about whether crypto assets should be treated as a secured or unsecured deposit or something else entirely. The terms and agreements of many of these companies define or fail to define how these assets are held; for example, PayPal states that a customer who holds deposits on their platform is an unsecured creditor. Each state regulates money transmitters, but often, many of them are not required to hold one for one assets on account. Therefore, state regulators could take further action to protect consumers' assets held with money transmitters. It may be beneficial to look to other countries' regimes for dealing with the non-deposit holding of funds compared to the United States' permissible investment regime. Finally, one potential criticism of this conversation is that focusing on the deposit insurance limit and liquidity and asset mismanagement issues and not the basic overall capital structure may only create new problems instead of improving the overall industry for businesses and consumers alike.

## **II. Digital assets and cryptocurrency**

The question posed in this segment was how the banking relationships of digital asset clients have evolved over the years and where things are headed. Digital asset companies have faced several challenges with the banking industry. Though many of the digital asset companies have not had issues with traditional corporate banking, these companies have faced difficulty with banking as a service provider. Many banks are wary and keep close track of the assets they will hold for a digital asset company, a practice which requires significant resources. Because banking regulators have issued guidance warning about the risks of cryptocurrency, there has been a shift recently in the ability of digital asset companies to obtain banking as a service, and even those banks that will provide such services are pushing stricter requirements.

Additionally, it is becoming more challenging for digital asset companies to enter into agreements for banking as a service due to unfavorable contractual terms, which creates substantial operational risks for digital asset companies. Specifically, digital asset companies that were banking with the regional banks that recently failed have faced significant difficulty finding other banking institutions to hold their funds. The Blockchain Association is currently searching

for crypto companies that have been denied banking services, and it has a place on its website to report such instances. It is considering bringing lawsuits because of these situations.

Difficulties in finding a bank and stricter requirements for onboarding a new bank as a digital asset company have introduced additional industry strain on top of the already challenging regulatory environment. Additionally, many of the banking service providers for digital asset companies have left the market and new providers have not materialized. Since few banks will hold deposits for digital asset companies, there is further risk because these cryptocurrency companies cannot diversify their deposit holdings over a range of banking institutions. The compounding issues of banking as a digital asset company, combined with the risks of the regulatory environment in which these companies already operate, have continued to hamper the growth of the crypto industry.

Another issue is that while many crypto exchanges now have “Know Your Customer” (KYC) requirements, banks are often looking at the customers of the digital asset exchanges, thus creating know your customers’ customer requirements. Banks want to know their digital asset customers’ customers to reduce their risk and ensure they are complying with regulators. But banks must expend significant resources to understand the customers of their customers, and therefore, many are not willing to take on such costs.

Further, there is debate over whether there is an Operation Choke Point 2.0. Operation Choke Point relates to an alleged issue under the Obama administration where the SEC was forcing companies not to bank with certain companies, such as payday lenders. The government was unofficially saying that banks should not associate with these undesirable companies. In the case of crypto companies, it seems that there is some inconsistency with Operation Choke Point in that banks are coming out with guidance regarding how to go about regulating and working with crypto companies and encouraging crypto regulatory frameworks.

The issue is that there is no clear guidance from government regulators. Regulators are currently cracking down on the crypto industry, but they have not yet come out with clear guidance or frameworks for crypto companies to follow. It is challenging to foster an environment of innovation when it is full of threats. Further, it is difficult to operate as a digital asset company when regulators such as the SEC are increasingly acting against cryptocurrency companies, largely asserting these assets are securities, but yet are not providing the pathway for crypto companies to conduct business in a regulated manner. Additionally, it is difficult when regulators are not providing a pathway for regulation, but also are not coming out and stating that they do not want to provide a path to make these activities legal. Thus, crypto companies are stuck in limbo.

### **III. AI technology and fintech**

Artificial intelligence has existed within the financial services industry for many years now, and it has already had a significant impact on the financial services industry. AI technology is still at its infancy, however, and the currently used AI technology is very simplistic compared to the technology that is upcoming. The current AI technology used by the financial industry is generally based on a model where AI is trained to complete specific tasks. Generative AI has the

potential to revolutionize the FinTech industry in ways we cannot yet fully understand, but it will likely solve systemic issues within the industry.

An important challenge going forward will be regulating AI in the FinTech industry. There are three potential approaches to regulating AI, as discussed by Youssef Sneifer: (1) adapt currently existing regulation to fit AI, (2) develop outcome-based regulation which focuses on specific outcomes over regulating the technology itself, and (3) not regulating AI because the technology is advancing too quickly, and thus, any regulation imposed on it would be outdated in a matter of years.

Additionally, there are several key principles to consider with AI and the financial industry. The explain-ability and intelligibility of AI analysis and results will be an issue as it may be difficult to understand how AI makes or arrives at certain decisions. Thus, it may be a challenge for regulators to ensure that a financial institution is using AI in a way that does not have the inherent biases that humans do, and it will be challenging to learn how to catch such biases in the technology.

Further, there are privacy challenges with AI, even beyond the fact that it uses personal information. First, in the financial context, AI developers are largely not developing the technology around the privacy rules that the Gramm-Leach-Bliley Act (GLBA) and the U.S. Securities and Exchange Commission (SEC) put on certain financial assets, which may lead to privacy and regulatory challenges in the future. Second, the cyber security rules impose specific constraints on the use of data that are not compatible with how AI technology operates. Third, there are specific permissions that provide a safe harbor for financial institutions to share data with each other, and there may be challenges in preventing this shared data from being imbedded in AI technology and toolmaking. AI companies may not necessarily fully appreciate how certain rules and regulations in the financial industry apply to the use of AI technology.

It will be challenging to apply existing laws and regulations to AI technology. While certain laws may apply, it may be difficult to incorporate technology-neutral regulations into the framework and properly regulate AI given the rapid advancement of the technology, failures on the part of legislatures to fully understand the technology, and the fact that AI developers may not be taking current regulatory environments into account fully when developing the technology.

#### **IV. Open banking**

The concept of open banking would allow, with the proper consent of a consumer, an individual's financial data to be securely shared with a regulated service provider so that the data can be better used in a manner that benefits the individual consumer. It would create a regime for service providers to put individuals' financial data in a format by which an individual may use their own financial data in a way that serves their own personal interests. It is possible, by taking an individual's financial data and inputting it into data modeling programs with the consumer's consent, that it could allow a consumer to use their data to democratize how financial services are being provided to them and how their data is being handled. Thus, this approach gives the consumer much greater access and control over their financial data. While this will require

regulation to be effective, it could ultimately change the financial industry in a value-creating way, to the benefit of the consumer.

## V. Cryptocurrency and its future challenges

Cryptocurrency relies on distributed ledger technology, which makes data more accurate by verifying the truth of the data on the open market, democratizes data by giving autonomous control to individuals, and removes the need for third-party providers to facilitate transactions. Distributed ledger technology allows for entirely decentralized finance protocols compared to the current financial system referred to as centralized finance, which is built around and relies on third-party providers. Many of the companies operating in the cryptocurrency market, though generally referred to as operating decentralized finance protocols, operate as third-party providers like in a centralized finance market. Joseph Cutler raised concerns that regulators will not delineate between truly decentralized finance protocols and cryptocurrency companies operating as centralized finance businesses, and thus, there will be regulatory shortfalls that will have significant impacts on the industry for years, if not decades, to follow.

A potential issue relates to *Chevron* deference and the role this judicial doctrine will play in the development of cryptocurrency and blockchain regulation going forward. *Chevron* deference, established by the 1984 case *Chevron U.S.A. Inc., v. Natural Resources Defense Council, Inc.*, grants deference to government agencies in the task of interpreting statutes. There are concerns that this approach allows unelected regulators to create laws and emboldens regulators to inappropriately simplify laws, taking positions that are not consistent with the words and intent of the statute. There is a Supreme Court case currently pending which may overturn the ability of courts to give *Chevron* deference. If this overturning happens, Congress will need to use incredibly specific language going forward, since statutes could no longer be interpreted by agency regulators in the same manner as is currently permitted. Thus, statute-specific language will become much more important and may limit cryptocurrency technology's future growth.

Another challenge facing crypto is that the current financial regulatory environment is heavily skewed toward the incumbents in the industry. The ability of FinTech to democratize data and break down the monopoly of the current banking industry means that it can provide significant value to consumers, but the incumbents and regulators continue to push down cryptocurrency and the associated technology. This attitude may potentially hamper crypto's growth, at least in the short term.

Overall, cryptocurrency has the potential to offer significant value to the financial industry and consumers, provided there is proper regulation and guidance to allow the industry to thrive. Currently, the U.S. lacks the necessary regulatory landscape and engagement from regulators to be an innovator and leader in the cryptocurrency industry and the monetary environment going forward, but there are several paths available to remedy this. Financial institutions, technology creators, crypto companies, and the government must work together to enable the future of FinTech.