Consumer Finance Monitor (Season 5, Episode 5): What Will 2022 Hold for Fintechs in the Consumer Financial Services Industry---A Discussion with Special Guest Todd Baker, Senior Fellow at the Richman Center for Business, Law & Public Policy at Columbia University

Speakers: Alan Kaplinsky and Todd Baker

Alan Kaplinsky:

Welcome to Consumer Finance Monitor podcast, where we explore important developments in the world of consumer financial services. Our podcast asked this called Consumer Finance Monitor and goes by the same name as our blog, which is called Consumer Finance Monitor, which we launched when the CFPB got stood up in July of 2011. I'm Alan Kaplinsky, I'm senior council at Ballard Spar. We've got a very exciting topic and a very exciting speaker for our show today. So first of all, let me tell you what our topic is going to be about. We're going to be discussing FinTech, and of course that's short for financial technology, and unless you've been living in a cave for the last several years, you would know what the FinTech industry is all about. But basically for those of you that have been in a cave, we're talking about the use of financial technology over the internet, as opposed to bricks and water transactions.

Alan Kaplinsky:

All these companies, this industry does business over the internet, it's all online. And I can't think of a better person to talk about the industry and what we're really going to focus on today is not so much the tremendous success that the industry has had in the last few years and why it's become the darling of wall street. But we're going to talk about this year, 2022, and some of the headwinds that we feel this industry might be facing. And our speaker today has got a lot to say on that topic. So without further ado, let me introduce you to our special guest Todd Baker. Todd Baker is an academic business executive and lawyer who works on business and policy issues arising from the digital transformation of financial services. He's currently a senior fellow at the Richard Paul Richmond Center for business law and public policy at Columbia Business School and Columbia Law School.

Alan Kaplinsky:

He teaches an advanced FinTech seminar for law and business students at Columbia and Stanford law schools. And he writes extensively on FinTech and banking topics for academic journals and other publications, including Financial Times, the Wall Street Journal, the Harvard Business Review and the American Banker. He's also the chair of the board of the credit committee at Axion Opportunity Fund, the nation's leading CDFI nonprofit small business lender. And he asks as an advisor to and an investor in venture capital firms and in a number of FinTech and banking startups. Before taking on his academic post, Todd had a 14 year career as the Chief Corporate Strategy and Development Officer at three large domestic and international retail, commercial and corporate banks preceded by two decades at two very prestigious law firms. So Todd, very warm welcome to you.

Todd Baker:

Thank you. Thank you. It's great to be here and it's great to have the opportunity to talk with your listeners.

Alan Kaplinsky:

Yeah, so Todd, before we crystal ball it and figure out where we're headed in 2022. And I'd say if we're judging by what's going on the stock market, that's usually a predictor, it's not a lagging indicator by any means. I'm wondering if you could tell our listeners about your interest in FinTech, what kinds of... Without getting into a lot of detail, what kinds of projects you've been working on study, et cetera, what has captured your interest about that industry?

Todd Baker:

Yeah, so when I retired from my last bank executive position, I saw there was a lot happening in the FinTech space. And when I moved into academics initially at Harvard, I focused on the ways in which FinTech could potentially provide better alternatives for low income working people to the system that we had at that point of bank overdrafts, payday loans, et cetera. So I was looking specifically at questions of liquidity solutions for low income working people. And I found some very interesting examples of that. Some of which we'll talk about a little today.

Todd Baker:

But I then moved on and I've done work in the small business space, really focused on the impact of FinTech, small business lending on the environment and the small business space. I've also looked pretty extensively at the question of whether data based and outcomes based consumer financial regulation is something that we may be looking to in the future. Published a paper recently on that with Corey Stone, who was a former CFPB executive. But I mostly focus on where this FinTech bank interface interacts with the more vulnerable bubble parts of the financial space. I'm not really interested in, in Fintech's that are doing a better job for rich people. I'm looking to see whether FinTech and try to take on some of the things that the banking industry has been notoriously poor at doing, which is dealing with folks who are living on the edge.

Alan Kaplinsky:

Right. Yep. I understand. So let's now swing into the topic. And as I mentioned during my introduction, it's really been a banner 15 years, I would say for non-bank Fintech's with hundreds of new Arabs every year, unprecedented levels of venture capital funding and a number of breakthrough FinTech companies, companies like Square, Stripe, Affirm, Coinbase, which I know when public last year and for people who don't know, they create an exchange for people who want to buy and sell crypto, cryptocurrency. But now it seems like last year was a long time ago. And I mentioned with the rocky start that the market is gotten off on. And so what do you think that 2022 holds in store for the non-bank Fintech's?

Todd Baker:

Alan it's pretty clear that big changes are coming. It's been a super benign operating and regulatory environment for FinTech over that last 15 years. But as Warren Buffet famously said, it's only when the tide goes out, that you learn who's been swimming naked. So we're probably entering that period where we discover which of the FinTech business models that have been supported by this massive input of capital are going to be able to make it on their own. And in the FinTech class I teach at Columbia and Stanford, I always show the students a group of slides to remind them of the fact that the FinTech revolutions really happened over that 15 year period we talked about. And it was in an unusually benign environment with falling and then historically low interest rates as the result of fed policy, a relatively strong top line, economic growth and low unemployment of very rapid credit growth.

Todd Baker:

Unusually long period of strong credit performance, probably the longest in my lifetime and booming equity markets, both public and private. And as you mentioned looking at the markets today, much of this is now beginning to reverse as government COVID stimulus is being withdrawn and some of the issues that exist in the economy are making themselves known in the absence of government intervention. So I think in this year, we're going to really start what I call the great winnowing when we begin to see which of these business models are resilient enough to handle a more environment.

Alan Kaplinsky:

Lett me ask you before we dig a little deeper in a drill a little further down on some of the things you mentioned. When the pandemic began in March, 2020, at least my reaction at that point right away, I guess I reacted like the stock market reacted and it was, "Oh my God, this is a disaster. This is going to affect everybody, not just the bricks and mortar companies, but it's going to be a disaster for lending companies, whether they're lending through bricks and mortar order or their lending online," people were being laid off and it looked like, of course, this way before we knew whether we were going to have a vaccine to get us out of it. Didn't you think that's when Armageddon was-

Todd Baker:

Well I'm very careful about predicting Armageddon because it's easy to be wrong. But it was quite striking how, particularly if we're talking about consumer credit, how it reacted and it's a function of sort of three things. One is government stimulus, which worked quite well. Secondly, changes in consumer behavior because it appears that consumers actually learned the lesson of the great financial crisis. And as soon as they saw trouble, they started de-levering rather than up levering. And so there was a significant... What you saw in consumer lending performance during that period was massive pay downs of consumer debt. So people took whatever resources they had and they did the smart thing, which was to pay are most expensive-

Alan Kaplinsky:

This is even before the stimulus, they started getting stimulus payments?

Todd Baker:

Oh yes. Yes. And a significant amount of stimulus was used to pay down debt again, the intelligent thing to do, but something that hadn't really been evident in the last crisis. The second thing is that lenders took a totally different approach, right? During the great financial crisis the mortgage folks particularly were extremely inflexible in dealing with borrowers. In terms of that they always went down the route of trying to foreclose in a falling market rather than doing workout plans or anything to try to deal with that. Well, certainly consumer lending service for just learned that lesson. And so they provided payment holidays, they were very open about going out and saying, "If you need help, we'll do a restructuring plan." And all of that actually worked extremely well. And as you see, if you look at the numbers, we're only now coming back to something like a baseline level of losses in consumer lending. It was below baseline for most of this period, which is, I certainly would not have expected coming into it. Right. So to your point.

Alan Kaplinsky:

Yeah. So you've mentioned some of the factors that we're facing, but what economic environment that we're facing on a macro level, what are the row bumps or speed bumps or that the industry is facing? And I know it's a long list. They're piling up on one another.

Todd Baker:

Interest rates and it's twin and inflation are probably the most important one. The fed is clearly going to be raising short term rates, but the prospects for the yield curve are very unclear. It's extremely flat now, could easily get inverted as concerns about the potential for recession grow. You know, and we'll talk a little bit about how interest rates affect individual types of Fintech's. But I think what's going on with rates is likely to be the biggest issue tied to increasing fear currently that there's a potential for or recession. The first real recession we'll have had, a cyclical recession rather than a crisis recession. The first one will had in a long time. Credit losses, as I mentioned, are beginning to normalize and may actually start moving towards a cyclical increase if some of those other pressures put strain on consumer finances, particularly around inflation. Public equity markets, as we mentioned, are cooling very quickly, especially for high growth, low profit businesses, which is something that describes most Fintech's.

Todd Baker:

And the crypto side is moving pretty much in lockstep with the technology stocks, which is interesting, because crypto was originally sold on the idea that it was a payment mechanism and then it was a value play where you were supposedly correlated against inflation. But now it looks like essentially that it's tech stock without any actual cash flow. So it looks like it's going to trade up and down as these tech businesses do. And the other side of that is the private equity markets sort of on the positive side, the private equity markets have gotten huge and have been providing enormous support to this sector among others, but very heavily in this sector. I believe last year FinTech was the largest single destination of private and venture money. So there's been significant support from the private side of the market.

Todd Baker:

And if we think about how those changes are going to affect different types of Fintech's, particularly on the consumer side, you have to think what happens when inflation goes up? Well, consumers start searching for yield.

Alan Kaplinsky:

You're talking about people with their bank deposits?

Todd Baker:

Yeah. They start thinking, "Well, now for how many years?" I joke to my students that I teach about the time value of money, but money has had no time value for the several years, right? So it's a little hard to run those formulas when the discount rate is zero. So in consumers, as rates rise, we'll start looking for where they can deploy their money for some yield as a hedge against inflation. And typically you see that in consumer deposit rates for banks and other types of money market fund investments will suddenly become likely attractive again.

Todd Baker:

Money market investments have largely been impossible to offer because the yield is too low and it doesn't make sense for the sponsor to provide it. And then you'll see other investors, institutional investors, also looking for new sources of yield and profit as the equity boom drops. And they're looking to deploy money outside of the equity market. So when that happens, historically you'll have a serious impact on consumer lenders particularly, and that will mean narrowing margin and something like a standard finance company cycle, where the cost of borrowing for finance companies goes up, however, their ability to charge more for their product is constrained, because among other things you have user laws in various states, which limit yields, you have just the optics of raising prices above a certain level for the banks who are not generally subject to user laws. But Fintech's have been very active in that higher yield space.

Todd Baker:

And as their funding costs go up, their margins contract and that significantly affects the profitability of their business. And it also reemphasize as something that has been largely forgotten during this period of zero cost money, which is that bank deposits are significantly cheaper than institutional sources of funding for lenders. So again, this is the old finance company bank cycle, which we've seen through many periods. Fintech's in the lending side are just versions of traditional finance companies. And so the advantage that bank funding provides is going to become greater during this period because bank deposit costs typically lag market interest rates by a significant amount. So you'll see lenders getting challenged. And I guess I should mention here that to the extent credit losses start rising, that's sort of the double whammy. So term consumer and car lenders will be affected the most to a lesser extent some of the other early pay access providers.

Todd Baker:

Because as you know, losses go up and cost of funding go up, the question is how much can they increase yields or maintain margin? And that's either their gain on sale margin if they're selling to the institutional markets or the margin on the balance

sheet to extent that they're balance sheet lenders. And then there's a separate issue for all the neo banks that are offering deposit products. So thank Chime, Dave, any of the hundreds of companies that are now-

Alan Kaplinsky:

The ones that have partnered with banks?

Todd Baker:

Yes. Right.

Alan Kaplinsky:

And you're not talking are about the ones that now very recently it's been announced that a couple of lenders have acquired banks?

Todd Baker:

Right. And Bravo for them SoFi and Lending Club, and others are going to be in a much stronger position because they've done that. But I actually mean what I refer to usually as synthetic banks that is to say FinTech front ends that are using a bank to fulfill a deposit product for their customers.

Todd Baker:

If you look at customer acquisition in the synthetic banking space, for a long time, customers were required by paying high rates, essentially using venture capital money to subsidize extremely high rates on deposits in order to bring in customers. And that's obviously a mass subsidy expense, but it has another negative aspect, which is, it encourages rate chasing by customers. So the customer you want is the core customer who's going to stick with you regardless. If the customer's looking every day to see whether Chime is offering a bigger subsidy than Aspiration than you've got a problem, because they're just going to run and you're going to have to pay the same amount to get the next customer. So the synthetic banks are going to be really struggling on customer acquisition, especially if they do, as I expect them to, start competing on rate for customer acquisition.

Todd Baker:

So the cost of that can only be paid by equity because of course they're not currently making any money in their core business, which is primarily funded through interchange. So they're going to be struggling as rates rise. And we'll see whether that model is really workable in a rising rate environment, given that the simple new banks as opposed to the SoFi's or others don't have any other real sources of revenue other than deposit associated revenues. So I think they're going to be potentially hurt here. Payments providers are kind of in the middle, consumer payments providers, because there's a certain amount of guaranteed revenue growth from inflation. Things cost more and you're getting a percentage of every transaction. So that's better. And this applies to the synthetic banks as well in terms of their interchange revenue from debit card transactions. But that's unlikely to make a significant difference in their business because to the extent that the economy slows, that has a countervailing impact. For those who are doing mortgage lending this again just starts to look like a standard rising rate mortgage cycle. And what that means is-

Alan Kaplinsky:

Business dries up right?

Todd Baker:

New business drives up. And so your gain on sale that you get from originating loans and selling them to Fannie and Freddy goes down, but the mortgage servicing rights, you own have more stability and provide you with some revenue. But typically

you see a significant wash out of mortgage lenders in a period like this, when the boom and refinance is gone, and then they deal with the expense issues associated with how they downsize their business effectively without creating problems.

Alan Kaplinsky:

Your thesis... Well, let's call it that. Does it turn on what you believe the duration of this inflationary environment will be? I'm mean if you were to believe the fed, the fed at least was saying not too long ago, that this was all because of supply chain problems, that it was transitory. And that as soon as these supply chain issues got straightened out, which some people think it's only a few months, maybe six months before that happens. Once that get straightened out rates are going to stabilize and they'll start coming down again.

Todd Baker:

Yeah. Well, this is clearly not your mother's inflationary cycle because you have this supply chain issue is you have the COVID issues around production in China that are economically structurally different from the last time, because the ability to overcome those issues is, is complicated by international supply chains. So yes, that clearly started things off, but this fed is now of the view that this inflation is no longer transitory and it's happening all over the world. It's not like it's a US only problem. The policy response that the fed knows from the past is to raise rates. And the impact of rising rates typically has a depressive effect on economic growth for some period. And these inflationary episodes typically last for some time, until they're resolved. And in this case, it will not just be a monetary policy issue, but all those other issues you referred to will have to get resolved, right?

Todd Baker:

Will supply chains become shorter, will the us economy be less dependent on imports from China? What will happen with energy prices, because we have another thing going on with the transition to energy? So it's a complicated situation, but I don't see a quick and easy answer to it at the moment. So my sense is it's going to last for a while. My history would say that the normal world has some level of interest rates in it and some level of steepness of the yield curve. At some point or other will have to see how FinTech does in that world, where money has time value and competition for funding becomes costly.

Alan Kaplinsky:

Yeah. Yeah. Now you mentioned a concern that even though rates are starting to go up and when the fed starts jacking, actually jacking up rates, the rates in the marketplace are going to continue to go up. And you said, you expressed a concern about flattening, the yield curve. The yield curve already is pretty flat. It's not very steep. When I read about the banking industry, at least up till now, people had been saying higher rates are going to be good for banks. The rates have been so low for such a long period of time that as long as rates don't go too high, and I remember periods of time when they were too high and that led-

Todd Baker:

My first mortgage, was it at 18%.

Alan Kaplinsky:

Yeah. Led a lot of failures of mostly thrift institutions who had a negative gap where they were tied into 30 year fixed rate mortgages and fixed rate and their short term and rates were going up. But now I keep hearing, "Oh yeah, this isn't going to be good for Fintech's and high growth companies, but it's really going to be pretty good for banks."

Todd Baker:

Well, a flat yield curve is not good for anyone banks to a real degree, live off spread between short term deposit rates and whatever longer term rate they're using for their lending. They typically are less exposed in those services in the old days because they don't have fixed rate loans, generally banks. And a bank theoretically does just fine at almost any level of interest

rates, as long as the yield curve is steep, right? Because that margin is greater. Obviously it differs with different products. Most banks have adjustable rate assets or relatively short term assets. And their liabilities are generally heavily in demand deposits, which have very short duration. So the question for anybody about interest rates is where's the pricing of my loans? And if you're say Marlet Funding and you're making five year installment loans, the probable duration of that loan is somewhere in the three year basis. And you're funding in the short term capital markets.

Todd Baker:

So the question is what's the difference between the three month rate and the three year rate. And the more spread there is there, the better it is for you and the less it is... So a flat yield curve is always bad for any lender. But everybody's individual situation will depend on what type of assets they're originating. Are they holding them or selling them? How are they valuing their servicing rights, et cetera. As an overall matter, it's not good for Fintech's because they rely on market funding. And so their costs of funding will go up and immediately, instantaneously more or less in the securitization or sale markets, whereas banks having a much more diversified funding base, particularly with a lot of zero cost transaction deposits will be much better off from a total cost of funding standpoint.

Alan Kaplinsky:

I guess one possible result of what you've described is for banks to acquire some Fintech's. Because banks, at least most people think, they're behind the eight ball when it comes to technology, that they've been slow on the uptake and the non-bank FinTech companies, their claim to famous technology. They consider themselves as technology companies more than financial services companies. So do you see that happening banks acquire some of these companies?

Todd Baker:

Well, we'll see companies that have good technology or a good product, but not a good business model are really excellent cases for acquisition. Their funders and the venture capital community will eventually give up on providing new funding and will look for another outlet. And both other Fintech's will engage in... For them, it's essentially re-bundling. They're putting together the old bank mix of assets and liabilities. And for the banks, it's about acquiring technology. Now I will say that having been a bank M and A guy for many, many, many years in my career, banks are notoriously bad at acquiring technology to companies and are holding onto the people that they need to make it work. Some banks are better today. JP Morgan is doing a really good job in trying to hold onto folks, but it's challenging. Because so long as there are alternatives out there in a booming market, gets a little easier when you can't switch jobs as quickly and you can't find for your new venture.

Todd Baker:

And many banks have been acquiring Fintech's primarily for products on the consumer side. And then you see it happening on business banking and corporate banking side when they're buying essentially back office type FinTech, but other Fintech's will also do that. And you've seen some of that. You saw it with one of the Fintech's Backs, Money Lion has already bought two or three companies with money that are raised. So yeah, I think we'll see a significant M and A, and it will mostly be companies that... Because it's very difficult for a bank to buy FinTech because it's all Goodwill, right? FinTech doesn't have hard assets typically. So most of the value is Goodwill. That's difficult from a capital standpoint, if it's really big company, but when the Fintech's distress and it can be bought for relatively little, it makes a lot of sense to do that. If you can hold onto the people and the technology that they're developing.

Alan Kaplinsky:

Let's talk about some of the more innovative products that Fintech's have been offering like earned wage access, which is considered an alternative to payday lending or overdraft fees charged by banks. It's run into some potential regulatory hurdles, but it seems like a product that makes a lot of sense to me, that people should be able if they want to access their funds, as soon as they perform the work and not have to wait until they next payday. And as long as they're not charge an exorbitant amount for that, it seems like a good deal. What's your reaction to that? And what do you think happens to that product in this new economic environment?

Todd Baker:

Yeah. Well first let me say that I've been a big proponent of those solutions and particularly the employer based ones. I wrote the first paper on them five years ago that got a lot of public attention. And I think the other side is there's now some real success in pushing back on the overdraft industrial complex at banks and banks are beginning to actually change their practices to make them more consumer friendly. But to the extent that the folks that use overdraft or payday loans or earned wage access, or some of the advanced payment things like Dave and others offer, they have a real need. And the some product is required to deal with these transient liquidity problems, which is I got to pay $50 to the doctor today and I don't get paid for three days. So a solution is required.

Todd Baker:

And if you look at the numbers, the earned wage access solutions are radically better, cheaper than any of the other existing solutions. So as a general matter, I'm a big supporter of providing these. I can't solve the problem that people don't make enough money to support living in areas like the Bay Area where I live, but I can do something to support solutions that help at not very great price. So as a general matter, I'm very supportive. Another point that I was going to raise that ties into this is we are seeing kind of the acceleration of regulatory attention to these new products. There's always a delay in the regulatory response to, to something new. The regulators are not real good at, at moving quickly, they want to take a look at what's happening and they're all looking at earned wage access, both the employer version and the non employer version.

Todd Baker:

And they're finding difficulties because it doesn't fit within the existing regulatory structures. It looks like lending, but it's not actually. There's a minor fee being charge. Gees, if I look at it under the truth in lending act, if you pay $1 and a fee and you pay it off in two days with your paycheck, it turns into a very large APR, and that's almost entirely irrelevant to the decision the consumer has to make. Because the consumer's perfectly happy to pay $1 to get $200 when they need it. And as I think you were referring to, there's been efforts, particularly in California to take a look at these and try to figure out, should they be licensed? If so, how, what are the standards that should be applied? And I think, well I'm hoping is that in this particular case will come up with a reasonable solution that allows products to be provided, licenses them appropriately to the extent that's needed, but doesn't try to kill something which is so much better than the existing alternatives out there in the market.

Todd Baker:

And I think that's the way that most regulators are looking at it because it's very hard to say that paying $2 is worse paying $80 in overdraft fees or $200 to your payday lender.

Alan Kaplinsky:

What impact Todd, do you think this rising rate environment and inflationary environment that has on a product like-

Todd Baker:

Well, it's going to stress consumers more to the extent to their basics, because the studies show that most people use this to pay for their basics, whether it be rent or food or whatever, and to the extent that that rises, it's going to put pressure on people's income and there'll be more demand for this, the only real issue. And this is an issue only for the non employer sponsor of ones, because the employer sponsored ones are largely credit, risk free. There's really not any risk and they don't underwrite. And but if you're looking at credit, it's not a credit problem. It's really not credit in my view, but it's a little different when you are you have the bank account and you're analyzing the bank account of the customer and you're providing my me a little early because in theory, if somebody wants to undo you, they can close their account before the repayment is made.

Todd Baker:

So there's a little credit risk there, not a huge amount, but there is credit risk there. So to the extent that pressures increase, credit losses increase, I think the non employer ones are going to be somewhat more stressed, but I still think the model is something that we should be trying to support as a way to provide access to earned wages. And then the real question is can these companies make money and be successful. Because up to now, it's difficult for them to generate enough revenue just from their wage access feature. So many of them are tying it to synthetic bank accounts, looking for the interchange, providing other services. And so that's something we're going to see across FinTech as the appetite for non revenue generating Fintech's in the investment community goes down, everybody's going to be looking for methods of generating revenue. And the challenge for many Fintech's is you have to do it in a way that isn't evil. You have to-

Alan Kaplinsky:

Well I mean, I agree with everything you've said about earned wage access, and I think it's become even more important as a product in light of the fact that yes, there aren't many legitimate payday lenders around anymore.

Todd Baker:

Correct.

Alan Kaplinsky:

Even though the CFPB was never able to finalize the regulation, would've required a underwriting of accounts and limits on numbers of transactions. That industry, it really went through a transformation that began probably seven, eight years ago, getting out of payday lending into installment lending. So the only real pay lenders, I think, are the offshore lenders and the ones that operate through tribes, that charge exorbitantly high interest rates, but they're not legitimate.

Todd Baker:

Yeah. And I think it comes back to the point that the need is there. And so what arsenal of capabilities can provide that help. Well banks who are cutting down their overdraft fees in significantly ways are maybe being helpful and Fintech's have been very helpful. And until we change the distribution of wealth and income in this country, folks are going to need that help. And the challenge is, can we do it in a way and can these Fintech's do it in a way where they survive through a downturn. And I'm hopeful about the employer sponsored ones because for employers themselves, there's tremendous evidence about how valuable that is as an employee benefit to their employees and how happy it makes them.

Todd Baker:

And now eventually, as you mentioned and this could be done today, but there's an awful lot of embedded infrastructure going the other way, you could have more or less instant pay for everyone. Now that's a double edged sword, right? Because you got to then remember to save for your rental payment or your mortgage payment. So I'm not a big fan of instant pay for everyone unless everyone is also working with a financial management app to try to make sure that they're saving the money they need to pay their vital payments.

Alan Kaplinsky:

Let's talk about a couple of other innovative FinTech products. Income share agreements as an alternative to a student loan. And maybe for our listening audience, there may be some people who don't know what those products are. Maybe if you could just briefly-

Todd Baker:

Well, it's classic financialization thing, which says, "Okay, instead of making a loan to you, I'm going to provide you with funding to go to school, and you're going to pay me 10% of your net income for the next X years, paying off the original amount I gave you and whatever the implied interest rate is on that for the future." And the good side of that is that it

transfers some of the risk from government lending to individuals credit risk lenders. And in theory, it means that they're taking the risk, that you might change jobs, lose your jobs, go into a less remunerative business, et cetera.

Todd Baker:

The downside of it, or the other way to look at it is it's essentially a version of indentured servitude that you're essentially, you've contracted to, with somebody to provide them part of your future income. So there are different views as to whether it's a good product or not. The CFPB is now filled with people who are very concerned with student loans. And I think they're going to look very, very hard at these products in terms of what the disclosure and UDAP issues are that exist with them. And it's clear that they're highly suspicious of them relative to guaranteed student loans. You, you probably have a better idea than I do of how high it is on the agenda of the CFPB.

Alan Kaplinsky:

But I would think, well, I think it's definitely going to be a priority because of Rohit Chopra, the current Director of the CFPB used to be, in a prior job under the Cordray leadership. He was the student loan on Budsman. I think he had a very senior job where he focused on student lending. And of course, Richard Cordray is now over at the Department of Education.. And I'm sure Cordray and Chopra communicate a lot about products that are of concern to them. And I would also expect on the political front, Elizabeth Warren has a little bit of influences as well. Let me turn to a third and final product I wanted to get your reaction to, and that is buy now pay later. That's another one that very recently has gotten a lot of attention, became a very hot product in the marketplace, a product that Wall Street seemed to love. And the CFPB very recently has sent a request for information to all the major buy now pay later companies. So they're obviously concerned about that too.

Todd Baker:

Right. And so it's always, for those of us who have a legal background as you and I do, Alan, it's always important to say, what do you mean by buy now pay later? Do you mean after pay or Klarna, which is four payments, no interest, the whole thing's over within a certain amount of time, or are you talking about point of sale lending, consumer lending of the type that a firm and others do? So point of sale consumer lending is just Sears robot version in 202,. Right? So nothing new there, except the technology that allows it to be done more easily at point of sale.

Alan Kaplinsky:

It's a layaway plan except you get the product up front.

Todd Baker:

Yeah, exactly. And I've done a little, a lot of looking at the history of consumer finance here. And one thing I can tell you is there's very little that's new under the set. And now by now pay later though appears to have been structured essentially to avoid truth in lending supervision. And in theory, it's a beneficial product for people, again, who need to make a buy and don't have the cash to that moment in do it from a debit account. And if the alternative is a credit card, that's potentially significantly more expensive to use. And the challenge with it is, and there are many challenges with it. One is sort of the behavioral question as to whether it's encouraging spending that is unwise. In other words, you're buying something because I'm not going to worry about when I pay it off, but I want it now and I can afford the first payment.

Todd Baker:

I just can't afford the others. And the second is, what do you do in a world where you are doing this regularly? How do you keep track of all of these debits that are coming from your bank account? And as you said, Wall Street went crazy about it because it was being touted as some new thing. And the value of all the BNPL companies is like a thousand times more than the actual market for BNPL. So things got completely out of hand. And now it's along with a lot of these other companies, the BNPL companies are being revalued. But I think it's a product that obviously has a lot of demand. It's being paid for by you

and me because we are paying a list price for the products that... I guess people have to understand, the retailer is the one who pays for the cost of providing this.

Alan Kaplinsky:

Yeah, because generally it's no interest charged.

Todd Baker:

And the retailer is paying the BNPL provider to do this essentially compensating them for the credit risk they're taking and the time value of money, risk that they're taking. So couple things to say, as credit risk rises and time value of money increases the cost to the retailer or the cost that the BNPL provider will want the retailer to cover is large. And so it's going to become less available or whatever, if what I suggested about the future direction of the economy is correct. Which is to the extent that credit losses are greater. There's some sort of recessionary situation and interest rates are higher all at the same time. That's not real good for BNPL, which again is a product that arose in a period where the cost of funding was almost zero and credit losses were historically low.

Todd Baker:

So I see it as in the same position of many other lending businesses. It has a different regulatory problem and legal definition problem. But from a business model standpoint, it's going to be the very pressured in this environment as well. And the regulators have clearly started looking at it, particularly from a disclosure standpoint and the UDAP a standpoint. So I think I anticipate that there's going to be significant guidance coming out of the federal regulators, primarily around disclosure type issues. And at the state level, it's a little bit in that same position as the earned wage providers, and the states are trying to decide what it is. Does it fit into their lending statutes? Do they need to change the statutes? I anticipate that there'll be a structural solution at the state lending level for the licensing of these providers within the next couple years.

Alan Kaplinsky:

Right. We're beginning to run out of time, Todd. And I did want to at the end circle back to crypto, that you said a little bit about, but we didn't, didn't really have time to get into it. And the year is started out very for crypto. It seems to be declining in tandem with the rest of the stock market, but you still have this blockchain revolution that seems to be very real and it's not going away. So what your feeling about that?

Todd Baker:

Yeah. So first let me say, I'm not going to say anything about several bank, digital currency, because that requires its own program. So I think crypto's two things, it's this trading thing around Bitcoin and a few others. And then it's the use of blockchain technology and coin technology for other purposes to create alternative payments rails, to deal with foreign exchange transactions, et cetera. But I would say a crypto crash, if it happens, will battle to scar the area and will make... The crypto industry is doing a lot of investing in lobbying in Washington. And to the extent that crypto gets bad reputation with its many supporters out there in the world, that will hurt their attempts to try to push this into the mainstream of finance. And I would say that legacy finance is catching up with... Because most of the things that crypto can do outside of the Bitcoin world involve speed, certainty, et cetera.

Todd Baker:

Those are things that legacy finance could have done, but didn't do because of embedded profit streams associated with deferred payment and other things. So the banking industry is, as usual as its own worst enemy in terms of innovation. And they've slow walked changes that would've made stable coins for example, useless, right? Why do you need stable coins when you can do something through the existing system that provides the same utility? So we're beginning to see that movement. And when fed faster payments comes out and other types of instant payment solutions become worked out that some of the advantage that some of these crypto and blockchain solutions have had will go away. Then there's this whole again, another

sort of theological movement towards so-called DEFI, decentralized finance, and that's about eliminating intermediaries. But if you look at what's going on, it looks like it's just many ways just shifting intermediaries.

Todd Baker:

The intermediaries are still there. They're a different position in the chain. And one always has to ask who's benefiting, right? I always used Ciceros famous victim qui bono, which he asked in the Senate about somebody who was criticizing. Who's benefiting here. It's really hard to tell where the money's being made. It is being made, but there's so little transparency that it's difficult to tell. And I think over this year, we'll begin to understand a little bit more about whether DEFI solutions can be applied outside the crypto trading business. Because for example, stable coins exist because they're on a blockchain. And so it was easy to trade when you were trading crypto and you wanted to go into a safety position, you traded into a stable coins. But it hasn't had a significant impact yet outside of that. And to the extent it has, it's been in centralized solutions, which really don't look all that different from things we're doing today.

Todd Baker:

So if that's helpful... I think the real question will be the public relations one, which is right now there there's a significant push in Washington in some quarters for recognition of the crypto business. And then there's a significant counter push for fairly repressive regulation. I note that many other countries have the same issue. China's essentially banded entirely and Russia seems to be on the road to doing that as well. So I I'll be quite interested to see what happens to the trading business because I think the chances of having a significant push to normalized crypto activity in the US are going to be dependent part on whether the current positive spin in the media and elsewhere on crypto returns.

Alan Kaplinsky:

Yeah. Yeah. Well, Todd, we've come to the end of about an hour, so we're going to have to wrap things up. So yeah, thank you very much for sharing your time and sharing your wisdom. And I know we will want to invite you back from Todd the time as we get deeper into 2022. And you'll either be able to say, "I told you so," or I'll be able to say what you got wrong.

Todd Baker:

Yeah, I'll come up with some excuse. Don't worry.

Alan Kaplinsky:

You'll have plenty of time to think about it. So I also want to thank all of our listeners today, for those of you that downloaded our show and just remind you that we release a new show every Thursday during the year, except for the Thursday that falls to during Thanksgiving holiday and Christmas. And again, remind you all to not only to follow our podcast show, which is available on any platform that you like to get your podcast, but also our consumer finance monitor. Thank you again.