PODCAST TRANSCRIPTION SESSION NO. 170/DAN QUAN

Welcome to the Lend Academy Podcast, Episode No. 170. This is your host, Peter Renton, Founder of Lend Academy and Co-Founder of LendIt Fintech.

Today's show is sponsored by LendIt Fintech USA 2019, the world's leading event in financial services innovation. It's coming up on April 8th and 9th, 2019, at Moscone West in San Francisco. We've recently opened registration as well as speaker applications. You can find out more by going to lendit.com/usa

Peter Renton: Today on the show, I'm delighted to welcome Dan Quan, he is the former head of Project Catalyst at the CFPB. That's their division that is focused on innovation and so I've been wanting to get Dan on the show for a long time, but while he was at the Bureau it was just not really possible.

Now he has left, he has actually just recently written an op-ed in American Banker which we talk about in some depth. We also talk about what the role of government should be in encouraging innovation, we talk about some of the wins that Dan had at the CFPB with Project Catalyst, why the work they're doing is important and really what it should look like going forward and how the government can really encourage financial innovation. It was a fascinating episode, I hope you enjoy the show.

Welcome to the podcast, Dan!

Dan Quan: Thank you, Peter, for inviting me.

Peter: Okay, so let's get started by giving the listeners a little bit of background about yourself and what you've done in your career to date.

Dan: Sure, again, thank you Peter for inviting me. This is a great opportunity to introduce myself to you and to your audience. Of course, we have known each other for quite some time. So I started my professional career as a management consultant helping Fortune 500 companies and large private firms to manage their financial risks posed by their pension plans.

Then since I always had an itch for politics and policies, I ended up going to Harvard Kennedy School and spent two years there and that’s where I developed a strong interest in consumer finance. So after Kennedy School, I worked for Professor Peter Tufano at Harvard Business School who is a guru on consumer finance. Around the same time, he left Harvard for Saïd Business School so he is now the Dean at Saïd Business School at Oxford.

I also came down from Boston to Washington DC and joined the Consumer Financial Protection Bureau or CFPB. At the CFPB, I started working in their policy shop called Research, Markets and Regulations, I was in the markets group, specifically on the payments team, managing emerging payments, mobile payments, cryptocurrencies, that kind of stuff. Then after about two years, I joined Project Catalyst and that was in the summer of 2013 actually, that was six months after the initiative was launched and had been leading office ever since.

Peter: So you were at the CFPB pretty much at the beginning then, I take it, right after it was founded, right. It says here, was it 2011 that you started there?

Dan: Yeah, that was July 2011 so I think two weeks after I started, maybe a week after I started, the CFPB officially opened its doors.

Peter: (laughs) Okay, so that was the very beginning. Tell us about Project Catalyst, that's sort of how I've gotten to know you over the years, running that effort inside the CFPB. Tell us about why it was started and what its mandate was.

Dan: Right, the mandate actually is very simple, has been very simple. I even think even with this new Office of Innovation when it was announced in the summer, the mandate hasn't really changed per se. So the mandate has always been to promote consumer friendly innovation, but honestly, back then, Peter, fintech was just a term. I don't think fintech, the term fintech, was as popular as it is now, as it is today.

Peter: Oh, for sure.

Dan: We literally, frankly, as a new agency, we sometimes call us a startup, we had no idea what we were going to do, but we just felt that this was the right thing to do. We see so many innovations coming up from Silicon Valley, from New York, from all parts over the country and the world that Washington DC just was not ready to really handle, to really...not to handle, not to understand to start with.

So we believed the first thing we should do is really try to understand them better and see what these people are trying to do and what sort of implications there are for policies, for regulations. So we had a flashy PowerPoint slides back then, but frankly we did not know what to do (Peter laughs) other than...yeah, more outreach or maybe running some pilots, maybe get some work data, maybe start developing the trial disclosure policy. I think that was just early on. So when I joined this initiative, I frankly didn't have a very full idea how we should make this office work.

The first thing I did was I told my staff, I want to be the first, and what that means is I want to be the first....we will not be the first to develop these innovative products and services. These are the jobs for the VCs, for the entrepreneurs, but I want to be the first. The Bureau wants to be the first to really identify these new things, the new trends and we want to be the first to think about policies, long term and short term.

So, naturally, we were...I think my idea actually worked and we were the first one, I believe, to look into cryptos, back then it was only bitcoin, that was even before ether was created. That was bitcoin and I spent a week in San Francisco, in the Bay area, meeting with Coinbase, with other financial VCs, entrepreneurs who were trying to think about how to take advantage of this new development which was really, really...even today, was still quite stunning for many of us in the financial services space.

I think I missed the first LendIt because I was in San Francisco with a very small private conference, I couldn't go, but I think I've attended LendIt ever since, every LendIt, I've never missed one and I think the Project Catalyst office was the first one that actually recognized the sort of the emerging trend in marketplace lending, in peer to peer lending. Even today, after...many of the companies in the peer to peer space have become so big they are sort of out of the normal portfolio of Project Catalyst. These founders and CEOs, they all tend to call me, email me when they have questions which shows how strong the relationship was built with these firms when they were still young and just coming up.

That was also very...not a surprise to a lot of people that Upstart, being a marketplace lending platform, was the first one that received a no-action letter from the CFPB. So those were the relationships that we were able to build over time, over the years, with these companies such that we understand what they are trying to do, we understand their pains, we understand the problems they're faced with and we're also trying to take that perspective back to the CFPB and to Washington DC and have a much bigger, larger conversation about these issues.

Hopefully, we can use the authority that we have to remove some of the uncertainties they are faced with, not to mention, alternative data, machine learning, consumer permission, and data access. I think the Project Catalyst office has done a fantastic job in really bringing these topics from thousands of miles away on the West Coast to Washington DC and have an open dialogue about these issues. So I'm very proud of the work that we have been doing.

Peter: So you mentioned Upstart there and I definitely want to bring that up because that was a pretty seminal moment in the industry when you...Upstart was issued that no-action letter from the CFPB. There had been question marks about it over the years because they're using alternative data and they've proudly kind of said that their underwriting is different to everybody else's. So, tell us a little bit about that particular process and how you were able to get comfortable with what they were doing and issue that no-action letter.

Dan: Well, all I can say is it's not easy (Peter laughs) and I have grown a lot of gray hair (laughs) during that process and after that process for sure, but honestly, I think the company, since I'm no longer a public official so I can talk about things more candidly, I'm very proud of the things that we have accomplished together on this no-action letter.

I think the company has done a lot of good work, I give Dave and his team, Allison and Paul a lot of credit for their bravery. So, speaking to a federal regular, in many people's minds is a huge risk and to give them everything that you...they must still have to, of course, you want to apply for something and get something in return, is also a huge risk for a lot of people. I think that the team has done a fantastic job in sort of trusting the Bureau, trusting the Catalyst office and trusting the Fair Lending office at the CFPB to really share information in a very candid manner.

We actually went through the process, we looked at the things they have done, the algorithm they have developed and frequently changed, adapted as they got more experience, got more data, got more loans on their books. And frankly, we finally got very comfortable that number one, there is a potential for this underwriting model to expand access to credit in a responsible way; number two, there's always fair lending risk and fair lending risk is not a static issue, it's evolving. You may not have a fair lending problem today, that doesn't mean you didn't have it yesterday or you won't have it tomorrow, but the key is really having a right process in place to monitor, to ensure when a problem emerges you have a way to handle that, to tackle that and I think that's really sort of the goal of a no-action letter to Upstart.

So I can tell you sort of three things, three takeaways, from this Upstart no-action letter.

Number one, I think this no-action letter shows machine learning and the use of non-traditional data, as controversial as they might seem on surface, they do have the potential to expand access to credit.

Number two, disparate impact, as a legal issue...there's a debate how this will be done, whether this should be done or not, but I think, I'm a very realistic person, I believe every institution, every lender should take its best effort not to discriminate against protected classes and I don't think anyone wants to do that, if you're a responsible lender, of course. So disparate impact...or fair lending is very important that every lender should think about day in and day out.

Number three, with these new innovative methods such as machine learning, such as the use of non-traditional data, or the combination of both, there is still a pathway to compliance. So just because you're using machine learning on non-traditional data that doesn't mean you are automatically violating the spirit or the matter of the law. In fact, there is a way for you to move forward, to comply. Of course, a lot of the things that we have done with Upstart during the process and also as part of the compliance agreement, that information is still confidential.

Peter: Sure.

Dan: But I hope through this experiment and hopefully, when the CFPB is thinking about launching its sandbox I hope there will be more firms that can get into the sandbox and work with the CFPB to test the new things. I think with Upstart we only covered an important, but also still a very limited area. I think there are a lot of areas that the CFPB can really help remove the regulatory uncertainty, or the mystery around these issues such that...not just firms like Upstart, the newcomers, but also incumbent financial institutions can also have a chance to really test these new things.

Because these are really, really powerful tools that it can not only, as I said, from the policy perspective, expand access to credit helping people like new immigrants, people like women, people like young people, 12:32 people who actually were called fallen angel who had good credit, but they fell, then they try to pick up and get back to the credit mainstream. I think these methods can be really, really useful to do that so that's a good public policy outcome.

From the business side, these methods can make the underwriting models more robust, can reduce defaults and what that translates into....you know, if you are big institution that's millions or billions of dollars in savings.

Peter: Right, right, for sure. So then I want to take a step back and you sort of touched on it, but I want to sort of talk about the role of government a little bit holistically. I mean you were in the CFPB for more than seven years, you know, you had a sort of a front seat role to the innovations happening in financial services and the CFPB obviously it's about consumer protection so you've got this, you know, protecting the consumer on the one hand and all of this exciting innovation happening on the other hand. So when you think about those two things holistically, how is the government supposed to balance those two things?

Dan: Yeah, it's a very important question. Frankly, I don't think anyone has sort of a perfect answer for that, I mean, there's no perfect answer so oftentimes, I use sort of the 5 percent rule of thumb. What I mean by that is an agency such as the CFPB or take any agency, the OCC, the FDIC, the Fed or SEC or CFTC, any of those regulatory agencies, they should spend maybe 95% of their resources and time thinking about or helping institutions that they supervise to comply with the nation's laws and rules such that people are not harmed, institutions are secure and safe, but there should be also another 5, maybe 10%...I don't know what the number is, this is just a very sort of...it's more of an idea.

They should spend some time not just within one office, maybe starting with just one office such as the Innovation Office or Project Catalyst at the CFPB, but ideally across all of the offices or divisions within the agency to really think about what's next, what's coming and the goal is not really about oh, I'm going to police all of these new things or any new thing is scary, new things can be very scary, I can tell you but they don't have to be, or at least the people who are actually thinking about these questions, shouldn't take a very adversarial position towards the new things. They should really think about, okay, so technology is going to change our lives, no matter what the government does or doesn't do, right, it's the fact. Now we can not really stop what technology will bring to our lives so a more collaborative attitude is that's really first, not take an adversarial position.

The second, try to understand, try to understand what these things are going to do to consumers, to the financial institutions of these products, to our financial system, if there are any safety and soundness issues that we should be concerned about. And number three, is there a way for us to allow these things to be further developed, to be tested. Maybe you'll think about a, you know, sort of sandboxing can come up, allow these things to be piloted and the reason is when you don't have a good amount of information about these new things, it is very dangerous for you as a regulator or policy maker to set guardrails to regulate these new things. I think nine out of ten times, whatever you were trying to do may end up in a not perfect place and you either over regulate or you, I should say, not regulate enough.

So I think there needs to be some kind of a balance between innovation and the consumer protection. And also, I want to say, one of the very famous VCs and entrepreneurs in Silicon

Valley once told us, I am not going to mention the name, what this person told us was pretty much since the financial meltdown from ten years ago with all the firms that he has seen and, you know, companies that have pitched to him, all the VCs, in general at large, who were actually reviewing these sort of deals/opportunities, by and large, there's nothing 100%, but by and large, 99% of these companies are really trying to do the right thing.

Peter: Right.

Dan: None of the companies are trying to harm people. Along the way, they may do stupid things, of course, but technology by and large, is trying to be developed by these people to help consumers, to really make the products and services more efficient, more effective. I think this is something that as regulators we should feel comfortable with. Frankly, maybe I have a very limited sample size, but frankly, most of the companies that I have dealt with, that I have spoken to, that I have met with and some of the CEOs/founders I have become personal friends with, I think they truly believe what they are trying to do; not trying to scam people or trying to harm people, they're trying to develop better products to make people's financial lives better.

Peter: Yeah, okay, that makes sense. So, you left the CFPB in July and we reconnected. You wrote an op-ed in American Banker just last week, as we're recording this in mid-September, and in it you laid out a pretty clear plan of what you think the CFPB sandbox should look like. I don't want you to sort of recite the entire article, but maybe for those that haven't read it just tell us some of the summarized…like the points, what you do think it should look like.

Dan: Sure. So, unfortunately the op-ed, you know, there is a word limit...

Peter: (laughs) Right.

Dan: ...it's only 800 to 1,000 words and the editor was very nice with me and she told me if you exceed the word count it's fine as long as it's not too lengthy...so, anyway, it's not a policy paper so I can not really put everything and give very detailed information for everything that I was trying to make, the points I wanted to pack into the op-ed. But maybe I can just break this thing down into maybe two parts; one is the long term, the other one is the short term.

So in the longer term, I think in a way this is probably the most important message. Unfortunately, this probably is not really appreciated by many readers because I think naturally, readers will think about...given the title of the op-ed is about the sandbox, but what I'm trying to say…maybe I'll write another op-ed in the near future about my views on the sandbox. I think the real hard work and what I call unsexy work is really think about the long term policies and rule making.

These are the things that are not sexy or tend to be controversial...or really does not attract much attention from the media, but the longer term goal for any agency, in this case this op-ed is about the CFPB, is really think about you have to run these experiments through the sandbox, you'll learn a lot, but what are you doing with the rules on the book that are sort of outdated, that are sort of impeding customer-friendly innovation. Are you willing to...do you have the will to change the rules and that's an important task to do.

In my view, in an ideal world and to use the analogy of driving...if you have proper insurance and a valid driver's license, you don't need to get the permission from the DMV every time you get on the road, that would be absurd. The same thing here, companies should have the comfort from their regulators that as long as they are doing everything in compliance, they shouldn't need to get permission from the regulator, but you know that's in an ideal world, we're not there yet. Hopefully, we'll get there someday, hopefully in my lifetime (laughs), but that's the much longer term goal. That's something that the Bureau should spend more time thinking about doing.

The short term, obviously, is all about the sandbox. I think the most important thing for the agency to really realize is, what exactly is the sandbox about so the first thing you have to do is really layout to the public, tell the public in a speech or in some kind of op-ed or blog post, tell the public what the sandbox...what kind of issues or problems does the sandbox try to address.

I think there's two things that I sort of layout for the public, for the Bureau and to the public, that is, regulatory uncertainty and regulatory fear. Uncertainty is something that has been talked about and written about for a long time, a lot of people are familiar with what that means. Regulatory fear is a term that I coined and this is from my experience when I was running the Innovation Office at the CFPB.

So many times companies would come to me and say, here's my product, it's new, never offered by anyone before and I've checked with my lawyers and they have told me that I'm doing everything in compliance with the rules that the CFPB is in charge of, can you give us a approval? I said, no, that's not my job because if you are in compliance with everything that you are doing then why would you worry about the CFPB? The answer is, well, my partner, especially my partner, if the partner is a bank, will say, what does the CFPB think because I'm not going to do something that has never been done before and get slapped with an enforcement action or supervisory action by the CFPB for doing this because I want to make sure they understand what we are trying to do here.

So I think this is a very sad reality because, as I said, if the rules are clear, you are doing everything in compliance, you don't need the CFPB to give you approval. I think in this case the rules probably are pretty clear, it's just that the novelty of the product they're very uncomfortable with. So longer term, again, I think you shouldn't come to the Bureau or any agency to do this, but in the short term a sandbox can be useful for the CFPB to take more initiative to encourage more trials, more pilots, more testing of new products and services, whether they need some kind of safe harbor or not. I think that's a very important thing for the CFPB to do.

Now I mentioned the approval authority in my op-ed, later on I'll also post a LinkedIn… because some people were asking me, where are the approval authorities in the three statutes that you referenced in the op-ed which are TLA, ECOA and EFTA. So I put out these provisions in my

LinkedIn post so a lot of people have seen that which is good I think. So this an authority that has been rarely used in the past, if memory serves, it was only used once or twice probably by the Bureau. I don't think the Federal Reserve ever used this before, but it’s a very powerful authority, in essence what it is is the CFPB can basically deem someone or some product in compliance with regard to, of course, these three statutes.

If it's beyond the three statutes, the CFPB does not have the authority to approve something and this product can be just one product or it can be a category of products. So the nice thing about this approval authority is really about...it's really that this kind of a certainty that the approval gives to the institution or institutions because unlike the no-action letter which is a staff recommendation, which is non-binding, the approval authority is binding, it's an agency action.

Of course, the downside is if somebody sues the CFPB, you know, you have to go to court to defend, but by and large, this has never been done before, has never happened before, but by and large, the courts in such cases, will most likely defer to the Bureaus because this is the statutory authority that Congress gives to the CFPB. Now, I'm not saying the no-action letter or the trial disclosure waiver policies are not important, but for sure, compared to the approval, they're less important, but they do have other usages that the approval authorities doesn't have.

So again, one is the three statutes, right...beyond that, if you want to do something, you probably will need the CFPB to issue you a no-action letter. The waiver authority or trial disclosure is also a very interesting thing and that’s the first thing that the new Innovation Office rolled out for public comment. I do think disclosures are very important, but I think, you know, importance is also a relative thing so compared to the no-action letter and the approval, I do think disclosure testing is less important, mostly because from my experience, again, this is about innovation, right. I've never heard anyone actually telling me that because of the disclosure rules here, I can not create or offer this new product, it's never been an obstacle for innovation, but there are legitimate complaints about the effectiveness or whether the disclosure rules, certain rules are too burdensome. I think these are very fair comments and I do encourage the Bureau to look into these things and figure out ways to improve disclosures, but if the office or if the Bureau in the sandbox is focused on innovation, if you spend more time on disclosures that is not the right use of resources.

So the Bureau should, in my mind, really focus on the approval and the no-action letter; these are the two powerful tools that the Bureau can further develop. Of course, the approval has not been developed yet, there needs to be processes in place to make it work. The no-action letter policy obviously, the scope and also develop things in the policy and a lot of people have written about it, I don’t need to repeat them, very good points to further enhance the effectiveness of the policy.

Peter: Right.

Dan: So these are the things that I'm trying to argue in the op-ed, but I do hope and I think this is a very important message. The Bureau should put focus on the long term goals of all of these exercises. There is a danger that when agencies roll out these sandboxes they think it will make them look innovative, make them look very forward leaning, make them look very good, but sandboxes are merely tools, they are not the end. The end is really making sure you have the right rules in place such that everyone can comply with and they don't have to come to you for any kind of permissions or one-time permissions or approvals.

Peter: Right, that's a very good point. I think the example you gave about someone working with a bank partner and the bank partner says, oh, that's never been done before, I don't want to be the first...it would be so great to have a framework in place where...for big banks or people to get comfortable so they don't mind being the first if they've got this kind of framework in place. I want to get your perspective on...because we live in obviously a very globally connected world and we know that there's plenty of different regulators around the world doing different things with sandboxes, particularly I'm thinking about the UK and Singapore specifically. How is your view of the whole sandbox concept being informed by what other countries are doing?

Dan : Right, so I have been in touch with the FCA, the Financial Conduct Authority in the UK, since probably four/five years ago. They actually came to the US, came to the Bureau to sort of learn from us, our experience with Project Catalyst and they later launched Project Innovate and they have progressed so fast as they are the true...what I think a true leader in...not just in sandbox…sandbox again, I don't want to talk too much about the sandbox. Two things they are the true leader in promoting innovation, in promoting fintech to benefit consumers and to benefit the economy at large.

Peter: Right.

Dan: In terms of my views being informed by them, the first thing we have to recognize is we have a very different regulatory structure in the United States and whatever the FCA or Singapore MAS has been doing, you can not really transplant what they have been doing to here, that's just not going to work. A large part of what they can do is really about licensing which the Bureau doesn't have any authority in issuing licenses. Chartering is the job of the OCC in the States and we don't have the charter authority and specific licensing is done to non-banking institutions are done at the state level and again, the CFPB doesn't have that authority.

So the specific policies in the sandbox at the CFPB are going to be very, very different and they are. Based on the blueprint that I devised for the Bureau before I left and based on what I argue in the op-ed, very, very different from the FCA or the MAS in Singapore, but I think the common theme here is this, and I think I've learned quite a lot from my friends and colleagues at the FCA, which is really their mentality and their long term thinking.

They have a very clear strategy, they are not just doing Project Innovate for the sake of being cool, being sexy, they're not doing sandbox...they were the first one, by the way, to launch a regulatory sandbox and they have done I think four cohorts so far. They are not doing this just to show that, hey, we are good. Actually, they are thinking very carefully about what exactly these tools that they're using, they're developing, they are fine tuning to achieve and I think along the way they have done a fantastic job in really changing the culture of the agency.

I think in this case, I wanted to give Tom Curry, the previous Comptroller of the Currency, the OCC, a lot of credit for, first of all, acknowledging the culture issue within their agency and I think that issue is not just with their agency, but I think it's across the board, every agency. This is the sort of 5% thing that I talked about previously; it is about a lot of agencies, most agencies, probably when they see these new things their knee-jerk reaction is, oh my gosh, I don't understand this so I don't want to deal with it so that is not really helpful.

I think the OCC, when it was under Tom, in the first white paper in response to innovation they acknowledged the issue and they wanted to figure out ways to tackle that and I think this is the issue that every agency has been struggling with. I think frankly, the FCA, my understanding is they also have a similar growth pain and they also wanted to address the issue, but I think they are probably the most successful in doing that and there is a lot for us to learn from them, us, meaning not just the Bureau but also all of the agencies, the regulatory agencies in the United States to learn from them, their experience.

You know, I truly think agencies need to be a bit bolder, be more brave to really embrace new things and to figure out the way to really balance the innovation and consumer protection. I'm not saying that the FCA is perfect, I am sure they have made mistakes, but I think they are really, in my mind, the most powerful leader in this space and I think there is a lot for the regulators in the United States to learn from.

Peter: Right, I completely agree. So we're running out of time, but before I let you go...you left the Bureau a couple of months ago now so what are you doing and what's next for Dan Quan?

Dan: (laughs) Probably writing more op-eds. (Peter laughs) So listen, Peter, I have...as I said, I have strong (inaudible) in the fintech space for quite some time, I've built a very strong network, I have made a lot of friends in the space and I truly, truly am very passionate about what I'm doing here, what I've been doing and the issues that I've been advocating for and the fantastic business models that I have witnessed. Some of them starting from the very, very beginning, really ideas on a piece of paper and those firms have become very prominent, very big in doing what they have been doing.

So really it's too early for me to say where I will ultimately land. I can say I'll continue to be active in the fintech space and when the right time comes, I'll let you know.

Peter: Okay, that's good news, I mean, we certainly would love to have you still actively involved in our space. You have done a tremendous job over the last several years of really encouraging innovation in fintech and also for fintech companies to proactively engage with regulators. I think that's been a real gift to the industry. Anyway, we'll have to leave it there, Dan, I really appreciate you coming on the show.

Dan: Thank you very much, Peter, for having me.

Peter: Okay, see you.

Dan: Bye.

Peter: You know, it's not easy thing for government to really balance this consumer protection and encouraging innovation. I think Dan sort of lays it out pretty well here in what his vision is to be able to do that. I think, from my perspective, we certainly do not want to stifle innovation. This country has had some amazing technological breakthroughs, not just in finance, but in other areas over the last several decades and some of the American companies are some of the largest companies in the world because they were able to produce innovation that was better than what others were doing.

It's not a guarantee that that will stay going forward, there's lots of other countries and foreign companies that are looking to really beat the US in the innovation area, particularly when it comes to financial services. So I hope Dan stays in the industry, it sounds like he is. I think his sort of expertise is something that we really need in this industry as we try and bring more innovation, more responsible innovation into finance.

Anyway on that note, I will sign off. I very much appreciate you listening and I'll catch you next time. Bye.

Today's show was sponsored by LendIt Fintech USA 2019, the world's leading event in financial services innovation. It's coming up on April 8th through 9th, 2019, at Moscone West in San Francisco. Registration is now open and we're also taking speaker applications. You can find out more by going to lendit.com/usa

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