

# Commentary: FinTech and the Liberation of the Community Reinvestment Act Marketplace

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## Abstract

*Observers of the Community Reinvestment Act (CRA) have for many years noted the pressing need for reform of the law's principal unit of analysis—the assessment area. As noted on prior anniversaries of CRA, the geographic basis for assessment areas has become increasingly irrelevant, given the disparity between where deposits are held and where the business of banks actually takes place. What was once an observation on a growing trend is quickly becoming a historical footnote, thanks to the way financial technology, or FinTech, is rewriting how and where financial services are provided. To date, FinTech organizations are without community reinvestment obligations. The impending oversight of the FinTech market presents an historic opportunity to rethink assessment areas, while using technological innovation to more equitably distribute CRA investments to the people and communities most in need.*

## Introduction

The ongoing disruption of the banking industry has raised a lot of questions, including how the banking industry will continue to fulfill its community reinvestment obligations in the face of relentless change. As described throughout this issue of *Cityscape*, the Community Reinvestment Act (CRA)<sup>1</sup> of 1977 places one or more requirements related to lending, investment, and service requirements on banks. This legislation was passed to combat practices of denying credit to business and residents (often minority and/or low income) within defined geographies by literally mapping a red line of exclusion (that is, *redlining*) around these areas (Federal Reserve Bank of Minneapolis, 2017).

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<sup>1</sup> Pub. L. 95–128, 91 Stat. 1147, Title VIII.

For 40 years, CRA has provided a critical lifeline for community development efforts in underserved communities, while ensuring stable and accessible funding for small businesses, housing, and community facilities. An effective solution at the time, this framework for the equitable distribution of financial services has become complicated by two related trends in the ensuing years: changes in who provides financial services and where those services are provided.

In particular, changes in technology have led to anywhere-and-anytime financial services enabled by web or mobile apps, created by banks and nonbanks alike, that make branch networks less relevant than in 1977—particularly for granting credit. This trend predates the 2007-to-2009 financial crisis (hereafter, the recession); data compiled by authors at the Federal Reserve Board found an increase in the median distance for a consumer loan between the location of the borrower and the location of the financial institution from 7 to 22 miles, or 214 percent, from 1992 and 2004 (Amel, Kennickell, and Moore, 2008).

The recession contributed to further reducing the reliance on bank branches, as the subsequent low-interest-rate environment pressured margins, and alternative means of providing financial services became more widely adopted.

Between the historical peak in 2009 and 2016, the number of bank branches nationally declined nearly 8 percent, an average of more than 1,000 branch closings per year (FDIC, 2017). The impact of technology on this consolidation is hard to ignore; mobile banking participation rates increased from 22 to 43 percent in the overlapping period between 2011 and 2015. Meanwhile, a rough parity developed during the same period in how customers interact with a bank. A 2016 Federal Reserve Board survey of banking customers polled respondents on whether they had used a branch, automated teller machine (ATM), and online banking during the past 12 months. The results indicated uses of 84, 75, and 71 percent, respectively, demonstrating relatively equal willingness to use alternative access to financial services (Federal Reserve, 2016).

Reflecting on the pressure to traditional banking caused by new technology, the former Chief Executive Officer (CEO) of Barclays, Antony Jenkins, noted that “the number of branches and people employed in the financial services sector may decline by as much as 50 percent over the next 10 years” (Williams-Grut, 2015), which is corroborated by World Bank estimates that the total number of U.S. branch locations will contract an additional 33 percent by 2025, when taking into account population changes (Citi, 2016).

Despite these trends, CRA’s primary unit of analysis is unchanged since 1977 and continues to focus on a bank’s geographically defined *assessment area*, where branches, ATMs, and offices are located. Banks self-define the assessment area, which represents the geographic area in which regulators measure, both quantitatively and qualitatively, a bank’s CRA activities. The problematic nature of the assessment area as the unit of analysis for CRA has been well understood by the community development field for many years—including previous reviews of CRA (Chakrabarti et al., 2009).

More recently, the emergence of the financial technology, or *FinTech*, sector raises a fresh set of questions as to whether CRA’s regulatory framework is outdated. The FinTech sector includes diverse applications, including crowdfunding platforms such as Kickstarter, education lending

platforms such as SoFi, and payment tools such as Stripe. The landscape of FinTech expands with each passing day. In broad strokes, FinTech includes everything in financial services to which technology can be applied and is most commonly focused on enhanced speed and better user experiences related to loan origination, credit evaluation, and payment services.

In this article, I highlight the challenges and opportunities of FinTech, given its influence in rewriting the rules of lending and eviscerating the geographic limitations of banking. I first discuss why a CRA framework is critical for FinTech and then why assessment areas are already falling short. I conclude by reflecting on opportunities for FinTech to help alleviate the geographic mismatch of CRA activities. Taken together, it is my argument that CRA continues to be a critical law but that it should be modernized through a broad and a fair framework that acknowledges how financial services are provided in 2017 and how they will be provided in the decades to come.

## Why FinTech Is Key to the Future of Banking

The growth of FinTech is best illustrated by Lending Club, which was founded in 2006 and is arguably the most well-known FinTech participant. Lending Club falls in a subcategory of FinTech called *marketplace lending*, in which the company originates the loan and unrelated individuals or firms then fund the loan by purchasing it in real time through the online platform. This model is in contrast to a *traditional lending model*, in which a bank accepts deposits at a brick-and-mortar location, originates a loan, and then funds the loan with those deposits.

Lending Club expanded rapidly following the recession (Crunchbase, 2016). The company's total originations grew from approximately \$77 million in 2009 to nearly \$19.5 billion by the fourth quarter of 2016 (Lending Club, 2016). In the process, Lending Club helped pave the way for other FinTech startups by showing venture investors the value of the sector. Its initial public offering was the one of the largest for 2014 and netted the company \$900 million at an \$8.5 billion valuation (Whitehouse, 2014).

Lending Club is only one example in a diverse and rapidly growing field. McKinsey estimates that between April 2015 and February 2016, the number of FinTech startups grew from 800 to more than 2,000—with upper-tier estimates putting the number of related startups as high as 12,000 (Dietz et al., 2016). Industrywide loan origination activity provides another measure of growth. FinTech data aggregator Orchard estimates that unsecured consumer origination in the sector totaled approximately \$9.8 billion in 2016, which represents a 312-percent increase over total origination in 2013 (Orchard, 2016). Despite this rapid growth, FinTech is still small compared with conventional bank lending, accounting for only 1 percent of all consumer lending activity, but it is expected to increase to 17 percent during the next 6 years (Citi, 2016).

Traditional lenders have not been passive in the growth of FinTech, however, and are both collaborating with and adopting innovations from the sector (Citi, 2016). Representative examples of this adoption include Citibank's internal Citi FinTech division and JPMorgan Chase's agreement with OnDeck for small business loan origination (Gandel, 2016; Rudegeair, Glazer, and Simon, 2015). More generally, banks have focused on adopting the best practices of FinTech in technology related to payments, credit evaluation, and mobile services.

Unlike traditional lenders, however, CRA compliance is not required of financial service providers that are not Federal Deposit Insurance Corporation-insured depositories, which includes most FinTech participants. As noted previously in the collaboration examples, FinTech often plays a complementary—and, in some cases, substitute—role for traditional banking services. This dynamic calls into question the ability of CRA to ensure equal access to financial services while relying on an outdated framework of banks servicing defined geographic areas.

## **New Frontiers in Redlining: The Case for Subjecting FinTech to the Community Reinvestment Act**

Until recently, the most widely applicable regulations for FinTech are laws related to consumer protection. Following the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act,<sup>2</sup> the Consumer Financial Protection Bureau (CFPB) is the primary oversight body for consumer protection. Its mission is to enforce and to make rules related to consumer financial protection acts, which include the Truth in Lending Act<sup>3</sup> of 1968 and Truth in Savings Act<sup>4</sup> of 1991, which require terms and conditions disclosure; the Equal Credit Opportunity Act<sup>5</sup> of 1974, a precursor to CRA that prevents discrimination on the basis of race, color, religion, national origin, sex, marital status, age, and receipt of public assistance; the Real Estate Settlement Procedures Act<sup>6</sup> of 1974, which requires disclosure and fee restrictions with regard to home loans; and the Fair Debt Collection Practices Act<sup>7</sup> of 1977, which restricts debt collection activities (Carpenter, 2014).

In addition to the laws mentioned previously, many states have usury laws that limit the maximum interest rate charged by institutions. State-specific laws, however, can be avoided when the lender is a bank based in another state with more flexible interest rate regulations (Rudegair, 2015; Beam, Kaplan, and Weissgold, 2011). Many FinTech lenders use the latter exception to avoid usury laws through partnerships with nationally chartered banks. In these instances, the bank serves as the legal entity that originates the loans, which are then sold to the FinTech company with payment provided by either their own funds or funds from an outside investor (in the case of marketplace lenders). To date, most efforts to regulate FinTech lenders have focused on these basics, such as a 2015 New York State court case that challenged avoidance of state usury laws for nonbank entities (Wack, 2016).

The dynamic mentioned previously is changing rapidly since the December 2016 announcement by the Office of the Comptroller of the Currency (OCC) that it would grant special-purpose banking charters for FinTech companies. Insight into the OCC's intent with regard to CRA-like obligations are outlined in a white paper that accompanied the announcement and a draft (at the time of writing) licensing manual released in March 2017 (OCC, 2017, 2016). Both documents acknowledge the necessity of accommodating responsible and inclusive applications of new technology.

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<sup>2</sup> Pub. L. 111–203, 124 Stat. 1376.

<sup>3</sup> Pub. L. 90–321, 82 Stat. 146, Title I.

<sup>4</sup> Pub. L. 102–242, 105 Stat. 2236.

<sup>5</sup> 15 U.S.C. § 1691 et seq.

<sup>6</sup> Pub. L. 93–533, 88 Stat. 1724.

<sup>7</sup> Pub. L. 95–109, 91 Stat. 874.

Notably, the draft OCC FinTech manual includes a requirement to specify, as part of a special purpose charter application, a Financial Inclusion Plan that would identify markets and communities touched by the organization's products and services. Appendix B of the document outlines regulatory expectations, including identification of geographies and customers served and the need for measurable goals for meeting the financial services needs of these populations. In draft form only and without applicants to review at this time, it is unclear how this Financial Inclusion Plan will be used in practice and whether it can provide the same protections afforded by CRA.

In particular, it is unclear as to how new regulation will address the most concerning aspects of FinTech, which are buried in the algorithms and data aggregation that are the foundation of new approaches to credit evaluation. The CFPB noticed this concern and has focused efforts on ensuring that third-party data used by financial institutions is available to consumers and that consumers grant permission prior to data use (Cordary, 2016). This line of inquiry is particularly important, given the many alternative metrics FinTech uses to evaluate creditworthiness. Discoverable examples (not buried in proprietary models) include indicators such as majors for international students, post-college moves, and trust scores based on social-network data (Dietz et al., 2016; ZestFinance, 2014).

On one hand, new approaches to granting credit have the potential to help previously underserved and unbanked communities, members of which may not currently qualify based on traditional credit metrics that conventional lenders use. On the other hand, it may lead to scenarios in which lenders deny credit because of a lack of access to broadband or a cultural avoidance of social media.

Moreover, rather than outright discrimination based on religion or race, one common link among these alternative metrics is that they bear closer resemblance to CRA's emphasis on spatial service areas. Data on individuals with both many post-college moves and seemingly untrustworthy social networks have a spatial aspect that could be pinpointed on a map and evoke the redlining of years past. Unlike years past, however, the identification of these groups is buried in big data algorithms that, without transparency and a regulatory mandate for inclusion, are impossible to characterize as either fair or exclusionary.

Beyond the invisible boundaries discussed previously that potentially limit (or expand) credit access is the unique threat posed by marketplace lenders. In this subsector of the FinTech sector, entities such as LendingClub, Prosper, and FundingCircle credit score and originate the loan. Critically, the loan is not funded until outside investors, either institutions or accredited investors, make a decision to purchase the loan. This method essentially puts the credit decision in the hands of thousands of individuals who bring their own sources of potential bias in deciding to fund a loan. Marketplace lenders derive income primarily from origination and service fees and are ultimately dependent on these investors for funding the loans.

Dugan and Demos (2016), writing in the *Wall Street Journal*, noted this potential pitfall of the platform while describing a widespread practice on the part of marketplace-lending investors of avoiding certain states like Nevada and Florida. The article focuses on LendingClub, which does not provide neighborhood-specific locational data for loans, limiting the extent to which individuals can engage in de facto redlining. Nevertheless, redlining is clearly the intent of the investors

identified in the article, as evidenced through investment advice articles specific to marketplace lending with titles such as, “The Joy of Redlining: Why I Never Lend Money to Florida” (Dugan and Demos, 2016). Notably, these investors have made it impossible for a marketplace lender to penetrate all areas of its service area and highlight the potential role CRA could serve in ensuring that borrowers in Florida or Nevada receive fair technology-enabled access to credit.

The incorporation of FinTech into CRA cannot work under the current paradigm of geographically defined assessment areas, as these nonterritorial entities seek the largest coverage possible. However, FinTech has the potential to liberate CRA-related spending by reaching borrowers that traditional banking structures cannot. Expanding the assessment area from its narrow historical boundaries to conform to the changing landscape of how financial services are offered is key to the liberation of CRA-related spending.

## How Assessment Areas Hurt Community Development

Alongside pressures on the assessment area stemming from FinTech is another issue related to the equity of spending spurred by CRA. One of the more problematic outcomes of CRA is that related activities fall in geographies where bank deposits are concentrated. Because the banking and financial services industry is concentrated in large urban areas, the major banks have assessment areas that overlap among and within major population centers, such as the Northeast corridor and California. The consequence is outsized demand for investments that may qualify for regulatory credit in those markets, whereas states in the Midwest and the Southeast rely on a smaller deposit base for equally meaningful community development needs.

This trend is particularly true of opportunities for investment credit, which is largely facilitated through purchase of tax credits, such as the Low Income Housing Tax Credit (LIHTC) and New Markets Tax Credit, and of mortgage-backed securities (MBS) that include home loans for low- and moderate-income borrowers. The LIHTC program in particular is one of the most liquid of all CRA-related investments, thanks to a process for generating equity for affordable housing development that has been refined in the 30 years since it was created in the Tax Reform Act<sup>8</sup> of 1986. As a result, the market and related pricing for LIHTCs provide the best measure of the geographic mismatch in CRA investments.

Cohn Reznick (2013) explored the geographic mismatch in LIHTC tax credit pricing due to CRA in detail, finding that 76 percent of tax credit properties are in areas where the top 20 U.S. commercial banks have CRA responsibility. Translated to tax credit pricing, this concentrated demand resulted in a 35- to 60-cent premium in the purchase price of each tax credit dollar if the project's location was in a favorable area for CRA. In the fall of 2016, the CRA yield premium was estimated to fall in the range of 1.25 to 1.50 percent (resulting in a higher tax credit price), according to industry observers (Garcia, 2016).

The consequence of this pricing discrepancy is that deserving projects outside of population centers where deposits are concentrated get less money. Cohn Reznick (2013) also noted this

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<sup>8</sup> Pub. L. 99-514, 100 Stat. 2085.

conclusion, arguing that geographic tax credit pricing gaps could be closed, and projects funded, by allowing for banks to invest in states and broader regions surrounding assessment areas.

For the purpose of this article, the question is not only how geography can be expanded, but also how other investments outside of the commonly used tax credit investments and MBS can become a more common part of the CRA toolbox, thanks to the specialization and the efficiencies gained through FinTech. One way to accelerate the integration of old and new financial services is to bring them into the same regulatory framework while reviewing each based on their furtherance of CRA's mandate to provide equitable access to financial services.

## **Comparative Advantage: A New Community Reinvestment Act Framework**

Fortunately, a framework for collaboration and alignment of incentives already exists, as two concurrent events—FinTech regulation and discussion of CRA reform—emerge. In early 2015, Lending Club and Citibank teamed up to arrange for a \$150 million credit facility that facilitated a third party's purchase of loans to low- and moderate-income neighborhoods and borrowers within Citi's assessment area (Lending Club, 2015). Critically, the arrangement has Citi providing credit to the third-party firm, rather than borrowers, and begs the question of why Citi did not directly engage with the population it had hoped to serve.

Nevertheless, the transaction provides an example of how the new and the old providers of financial services can build on their own comparative advantages to both meet regulatory requirements and produce better community-development outcomes. The former Lending Club CEO noted how this interaction is common when interfacing with traditional lenders.

We work with a lot of banks now and CRA often comes in conversation about something banks would like to more of. They are having trouble reaching these populations because they don't necessarily have branches in a particular area, so having an online lending platform is a way to reach them. (Banjo, 2015)

In this case, FinTech provided its ability to originate loans in difficult-to-reach populations, and a bank provided its access to capital. Unfortunately, this partnership did not expand CRA markets, as Citi's interest was in meeting the requirement of the existing regulatory framework.

One way to move beyond geographic mandates is to conceptualize CRA in an outcome-based framework that enables regulatory dollars to have the largest impact—wherever those dollars are needed most. In this framework, the power of big data harnessed for alternative credit metrics could also be applied to creating meaningful impact measures.

Pay for Success financing models, for example, provide a promising analogue for the outcome-based approach. In these models, loan payments are tied to outcomes, like reducing stormwater runoff volume or increasing the number of homeless individuals in stable housing. A typical CRA evaluation period spans 3 to 5 years and provides an appropriate timespan to measure the impact of community interventions tied to an institution's business model.

Aiding this potential framework is the large amount of data ready to be analyzed for CRA purposes. The U.S. Census Bureau, among other agencies, has application programming interfaces available for use in dynamic models, and the Federal Financial Institutions Examination Council publishes a number of CRA-related data sets that could be combined to understand where need exists but is not being met under current activities. Most promising, technology could enable community development technology to go where individual practitioners cannot by searching through regulator-authored CRA performance evaluation reports to identify local patterns and gaps—a desperately needed outcome as aggregated reporting on CRA-related community development lending and investments is scarce at a usable scale.

For on-the-ground practitioners of community development, this change would be welcome in all but a few markets. High-quality housing for low- and moderate-income populations may be as important to rural Mississippi as it is to cities on the Acela corridor, but it is often extremely difficult to attract any part of the \$87 billion in annual bank-related community-development lending to out-of-the-way places (FFIEC, 2016). Local banks may provide appropriate dispersion of loans and investment through their service areas, but they lack the scale of the 20 largest banks noted in the Cohn Reznick study.

In contrast, a small portion of one of the largest banks' CRA investment goals could go a long way toward increasing demand, and the amount of funding raised, for any number of important community objectives in markets that do not have oversubscription for qualifying projects.

Behind the compliance officer and regulator curtain, rumors abound that regulators expect to see CRA loan and investment targets in proportion to the amount of high-quality capital, such as U.S. Treasury bonds and deposits, known as Tier 1 capital, required by Dodd-Frank and Basel III. In reality, no formal targets exist within CRA, and the issue highlights the wide amount of discretion on the part of CRA examiners. An obvious alternative to the assessment area is to move from the map to the balance sheet and formalize the Tier 1 target (or others developed with stakeholder participation). Banks would then have the burden of proof to make the most meaningful investments within these capital targets.

FinTech can then help locate the most promising investments and loans to low- and moderate-income individuals. The potential for FinTech to aid CRA loans is already established in the Citibank-Lending Club partnership. Investments are an untested, but potentially critical, application of a new approach. A significant amount of activity related to meeting the investment criteria is concentrated in the purchase of qualifying secondary-market securities, like federally guaranteed MBS—hardly a good use of the CRA price premium.

It is not difficult to imagine an alternative wherein banks seek securities with better impact through FinTech start-ups like Neighborly or Point. The first of these is a municipal bond issuance platform that uses technology to gain efficiency in the issuance of municipal securities while opening the door to investments in small-scale infrastructure, like streetscapes and parks. The second is a platform to help owners monetize home equity by selling a fraction of their equity to Point, in turn, the owner avoids using a home equity loan and the start-up does not receive a return until the home sells or the owner buys back the equity.

As discussed previously, a price premium (note that a higher price means a lower yield and potentially a better rate for borrowers) for CRA spending clearly exists, which can provide additional financial incentive for FinTech to become involved in originating investment and loan opportunities. Meanwhile, FinTech will similarly be evaluated for its ability to reach populations in need, based on the appropriate macro outcome—origination, credit, and so on.

A symbiotic relationship between banks and FinTech around CRA could be one way to further the appropriately broad guidance given by the OCC in its framework for innovation in financial products.

The OCC may also issue guidance on its expectations related to products and services designed to address the needs of low-to moderate-income individuals and communities and may encourage innovative approaches to financial inclusion by promoting awareness of other activities that could qualify for Community Reinvestment Act consideration. (OCC, 2016)

Emerging practices in a data analysis can fuel this new framework by shedding light on the actual impact of dollars generated by regulatory requirements. FinTech participation is not the cure-all for better community investments, but it does represent a source of leverage to bring relative impact to the forefront of CRA spending.

Data-enabled guidance and regulatory approval on where banks and FinTech are going before they begin could build on early efforts at providing regulator-defined performance contexts and preapproval of CRA investments. Both of these approaches have anecdotally proven to be a success in facilitating higher quality and new types of activity (Choi and Dowling, 2014; Cisneros, 2015). Data, the fuel of FinTech, can help expedite these early and time-intensive efforts by reducing the risk of banks in considering new methods of CRA compliance.

A data-driven process would ease the time burden of regulators who would be required to evaluate a dispersed book of lending and investment that extends beyond their current geographic specializations. As always, enthusiasm for the elegance of data is tempered by the risk of spending in only those categories that are measurable, but it is one starting point for regulators to complement time-tested methods that have made CRA such an effective law.

Undoubtedly, we will see unimaginable changes in how financial services are provided in the next 40 years, but it is clear that the geographic basis of CRA is increasingly problematic. An outcome-based approach tied to the regulated entities' primary business plans, such as capital, loans originated, or whatever subspecialization emerges, is one method to ensure flexibility. This new framework would be only a start, but it would be critical in helping reallocate current spending related to CRA in a more equitable distribution for the benefit of all involved.

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