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The Basics of Fintech

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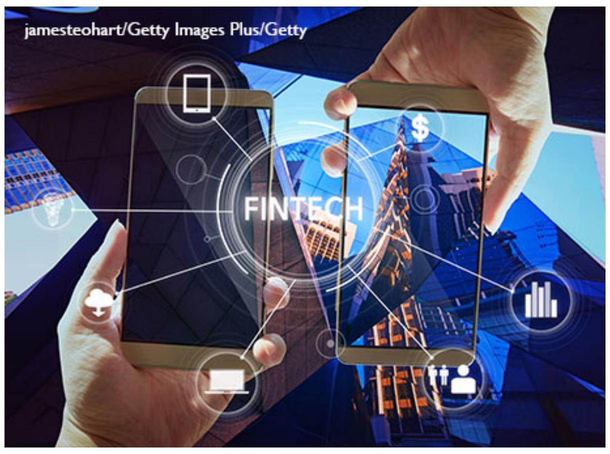
By Julie Stackhouse, Executive Vice President



This post is part of a series titled "Supervising Our Nation's Financial Institutions." The series, written by Julie Stackhouse, executive vice president and officer-in-charge of supervision at the St. Louis Federal Reserve, appears at least once each month.

Not that long ago, a number of financial sector prognosticators predicted that the virtual currency bitcoin would disrupt the traditional mechanisms for money transfer. Bitcoin was just the beginning, however, and its promise remains to be proven. It has been followed by other technologies that may change the future of financial services. These technologies, as a group, are called "financial technology," or "fintech" for short.

Evolution of Fintech

Just a few years ago, fintech startups boasted that they would replace banks. More recently, many fintech firms—including marketplace lenders, virtual currency exchanges and providers of digital wallets—have turned to banks as partners to hold their deposits, buy their loans or clear and settle the financial transactions they generated.

Other fintech firms have offered banks the option of buying or contracting for the underlying technology to offer new services to bank customers. And some banks have developed their own technology, like the digital wallet product Zelle.

Fintech Firms Becoming Banks

A limited number of fintech firms, such as Green Dot, have become banks. These firms have agreed to comply with all of the laws and regulations applicable to every U.S. bank, while they use their technology in a way that make them operate differently than traditional banks.

The decision to become banks has given these firms the ability to clear and settle financial transactions without relying on another bank. It also provides the firms with access to the federal safety net, which includes federal deposit insurance and the Federal Reserve discount window.

What's Next for Fintech?

Some fintech firms are now exploring ways to access clearing and settlement services without becoming banks. Two much debated alternatives for doing so are the Industrial Loan Company charter and the national bank special purpose fintech charter. I addressed the Industrial Loan Company charter in my October 2017 post.[1] The national bank fintech charter has not yet been used. The hope for direct access to direct clearing and settlement services creates the incentive for many more fintech companies to pursue these charters.

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We'll certainly hear more about fintech as the financial services industry evolves. In upcoming blog posts, I'll examine a number of uses for these technologies, including:

- Artificial intelligence/machine learning
- Machine-enabled lending
- Digital wallets
- Distributed ledgers

This list is by no means exhaustive, but a basic understanding of these core issues will be useful for understanding more sophisticated and emerging services.

Notes and References

[1] ILCs operate similarly to banks. However, their corporate owners are not subject to the limitations of bank holding companies with respect to activities, investments and shareholders.

Additional Resources

- *On the Economy*: Fintech Interest in Industrial Loan Company Charters: Spurring the Growth of a New Shadow Banking System?
- *On the Economy*: A Glimpse into Banking's Future by Looking at the Past
- Research: Cryptocurrencies and Fintech

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