

Fintech and Financial Inclusion (by Thomas Philippon)

David Dorn

University of Zurich and CEPR

June 2019

Context: Lack of Financial Inclusion

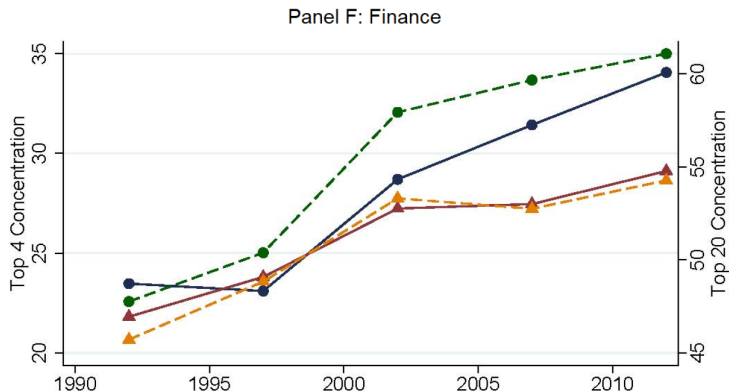
- **Two sources of lack of financial inclusion:**
 - Access to the best investment advice (or to investments in certain asset classes) is limited to **wealthy** investors
 - Specific **demographic** groups (e.g., racial minorities) face discrimination in access to financing

How Does Fintech Affect Access for the Less Wealthy?

- **This paper: Fintech improves access for less wealthy investors**
 - algorithm-based investment advice has a higher fixed cost than face-to-face advice
 - but variable per-client cost is lower
 - it becomes profitable for financial firms to offer high-quality investment advice also to less wealthy clients

Rising Market Concentration in US Financial Industries

- **Consumer gains partly offset by greater monopolistic power?**
 - a setting of high fixed cost / low variable cost is prone to raise market concentration
 - Autor, Dorn, Katz, Patterson, Van Reenen (2019): rapidly rising market concentration in financial industries



How Does Fintech Affect Group-Level Discrimination?

- **This paper: Fintech increases group-level discrimination**
 - banks observe individual-level signal on default risk
 - Fintech lenders observe (more precise) individual-level signal, and an additional group-level signal
 - by assumption, only fintech can discriminate between individuals that have the same individual-level signal, but belong to different groups
 - such greater discrimination by fintech trades off with greater efficiency, as fintech has more and better signals to predict the default risk

But Who Really Observes Group Identity?

- **Who observes the group-level signal?**

- the US Fair Housing Act (FHA) and Equal Credit Opportunity Act (ECOA) prohibit discrimination based on race, national origin, sex, or religion
- most of these characteristics are observed by a loan officer who meets a client face-to-face
- it is difficult for a loan officer to purge his knowledge of a client's race
- Fintech instead can feed an algorithm with information on a loan application that *excludes* information on race—this *avoids* group-level discrimination!

Effect of Removing Group-Level Signal Depends on Initial Conditions

- **If initial discrimination is statistical and efficient**
 - eliminates discrimination
 - improves access to financing for minority group, reduces access for majority group
- **If initial discrimination is taste-based**
 - eliminates discrimination
 - improves overall access to financing
- **If initial discrimination is statistical and inefficiently small**
 - eliminates discrimination
 - reduces access to financing for minority group

Inefficient Use of Group-Level Signal

- **Pope and Sydnor (2011): Peer-to-peer lending platform**
 - blacks get worse loan terms than whites, but still have higher default rates at every interest rate level
 - removal of racial identifier may *worsen* financing conditions for blacks here (as Behaghel, Crépon and Le Barbanchon (2015) found for hiring with anonymous resumé)

