

FUNDAMENTALS OF BANKING LAW:

REGULATION OF FINTECH

Fintech ecosystem
Operating authority
Operating obligations
Current environment

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FINTECH ECOSYSTEM

What Is “Fintech”? A Few Categorizations...

Customer

- Consumers – Venmo, Chime
- Small Business – Square, Mercury, Human Interest
- Large Business – Gusto, Blend, Anchorage Digital
- Government – Chainalysis

Product/Service

- Payments – Stripe, Remitly
- Credit (cards, loans) – Upgrade, Kabbage, Affirm
- Deposits – One, Current, Varo
- Savings – Even, Acorns
- Operations – TrueAccord, Ubiquity
- Compliance – Alloy, Hummingbird, Fairplay, ZenGRC
- Infrastructure – Plaid, Unit, Synapse

What Is “Fintech”? A Few Categorizations...

Function

- B2C (Business to Consumer/Customer) – ?
- B2B (Business to Business) – ?
- B2B2C (Business to Business to Consumer/Customer) – ?
- BaaS (Banking as a Service) – ?
- SaaS (Software as a Service) – ?

Regulatory cohort

- Banking
- Markets

True yet?

- “Every company will be a fintech company” – Angela Strange, a16z

OPERATING AUTHORITY

What Provides Fintechs Authority to Operate?

- First things first: You must be authorized to operate if you offer banking products or services directly to individuals
- How do fintechs offer banking products/services without a bank charter?
 - Authorization is through state licensure and bank partnerships
 - Fintechs must choose their path, similar to banks choosing their path
- Choice between direct supervision or less regulatory complexity
 - Notwithstanding, federal agencies focused on consumer protection (CFPB, FTC) may have jurisdiction

⇒ There is no such thing as a federal license to operate in the US.

State Licensure – Overview

- License types
 - Money transmitter licenses (requires federal MSB registration) – payments, crypto
 - Lending – brokering, origination (cards, small dollar loans, installment loans), servicing
 - Other – debt collection, credit repair
- Requirements
 - Background checks
 - Capital and bonds
 - Compliance program
 - Examinations
 - Reporting
- Contrasts...
 - Eligibility, application, supervision, enforcement

State Licensure Overview

- *50 states + DC*
- *100s of licenses*
- *State law (most rigorous state is floor) + CFPB*
- *States, CFPB, DOJ, FTC*

State Licensure – Potential Payments Alternative?

- Comptroller Tom Curry introduced Special Purpose Charter (Dec 2, 2016)
 - "We believe that companies that offer banking products and services should have the choice to become national banks if they wish to do so. Merely making a charter available, does not create a requirement to seek one. Nor does it displace the other choices a fintech company may have—for example, seeking a state bank charter in a state that makes one available or to continue operating outside the banking system."
- Acting Comptroller Brian Brooks proposed national payments charter (June 25, 2020)
 - V.1.0, a basic national MTL; V.2.0, adding direct access to Federal Reserve's payments system
 - "A national payments charter would align with the OCC's role, which is to create and support national financial services platforms. The proposed payments charter would bring entities that offer payment processing services, but do not take deposits or make loans, into the national banking system overseen by the OCC." (Consumer Finance Monitor, July 9, 2020)

State Licensure – Potential Payments Alternative?

- Acting Comptroller Michael Hsu suggested federal framework for payments regulation (Feb 21, 2024)
 - “First, most roads lead back to banks eventually, giving bank regulators some visibility and influence over nonbank activities.”
 - “Second, many nonbanks are subject to varying degrees of direct oversight by functional regulators.”
 - “Third, the law limits deposit taking to only banks.”
 - “Fourth, bank regulators’ licensing decisions can play a role.”
 - “[T]he U.S. lacks a federal money transmitter licensing standard and authority, in stark contrast to most peer countries.[] This fact has likely contributed to the explorations by fintechs for the specialized “bank-lite” charters noted previously. Rather than contort bank charters and blur banking and commerce (à la 1929), a better solution would be for Congress to create a federal framework for payments regulation, as recommended by the U.S. Treasury in its report on the future of finance.[] Doing so would provide a clearer path for innovation and growth in payments with less risk of blurring and to financial stability.”

Bank Partnerships – Overview

- Partnership types by product / service
 - Payments, credit cards, loans, deposits, savings
- Requirements
 - Appropriate leadership
 - Capital and liquidity
 - Compliance program
 - Information security
 - Monitoring
 - Reporting
 - Audits

Bank Partnerships Overview

- *Bank (one or more)*
- *For each bank: OCC, or state/FDIC v state/FRB*
- *State law (preemption sometimes) + CFPB*
- *Banks, states, CFPB, DOJ*

⇒ While fintechs may choose to contract with banks to operate, legally they are service providers to banks.

In practice, what does authorization look like?
Let's look at Affirm



OPERATING OBLIGATIONS

Obligations in Partnership Agreements

Legal

- Ownership of
 - Customers
 - Deposits
 - Data
- Privacy, data protection
- Liability, indemnification
- Right to audit

Compliance

- Underwriting models
- BSA/AML/OFAC
- Monitoring and testing
- Regulatory reporting
- Marketing and advertising



If a bank's oversight of its fintech clients' activities is insufficient, the bank risks enforcement action.

Operations

- Access to payments systems
- Account structure
- Issuance of
 - Routing numbers
 - Cards (debit, credit)
- Fraud management
- Customer support
- Tech stack

Obligations – Consumer Protection

FCRA +
Reg V

UDA(A)P

GLBA +
Reg P

FDCPA
+ Reg F

TISA +
Reg DD

EFTA +
Reg E

ECOA +
Reg B

TILA +
Reg Z

HMDA
+ Reg C

SAFE +
Reg G
Reg H

MAP +
Reg N

RESPA
+ Reg X

Data
Rights

Reg M



Obligations – BSA/AML/OFAC

- BSA Officer
- Customer Information Program (“CIP”)
Know Your Customer (“KYC”)
Identifying Beneficial Owners
Customer Due Diligence (“CDD”)
Enhanced Due Diligence (“EDD”)
Transaction Monitoring
- Suspicious Activity and Other Reporting
- Internal Controls (Policies / Procedures)
- Training
- Independent Testing
- OFAC Screening



Obligations – Privacy / Data Protection

- Federal law – Gramm-Leach Bliley Act (“GLBA”). a notice and opt-out regime
 - Draft legislation – American Privacy Rights Act of 2024
- State law – California, Colorado, Connecticut, Delaware, Indiana, Iowa, Kentucky, Maryland, Minnesota, Montana, Nebraska, New Hampshire, New Jersey, Oregon, Tennessee, Texas, Utah, Virginia, and more coming
- Contract – Bank partnership agreements
- International law – GDPR, PIPEDA



CURRENT ENVIRONMENT

Third-Party Risk Management – Overview

- A bank's obligations (compliance, operations, reporting, financial, etc.) expand when it agrees to a fintech partnership or engages in or with "Banking as a Service" (BaaS)
 - Not only is it responsible for itself in those areas, but it is responsible for each fintech it engages with
- This set of obligations is generally referred to as "third-party risk management" (TPRM)
- A bank's TPRM obligations become more challenging as the number and complexity of fintechs involved in a singular offering increases
- Not only is it difficult to execute on the obligations, but it is often even difficult to understand who provides what and is responsible to do what

Third-Party Risk Management – New Guidance

Regulators recently published their TPRM expectations in the form of comprehensive interagency guidance that contemplates such partnerships

- *Interagency Guidance on Third-Party Relationships: Risk Management* (June 2023)
 - Rescinds previous guidance from the Federal Reserve, OCC, and FDIC
 - Intended “to promote consistency in their [TPRM] guidance and to clearly articulate risk-based principles for [TPRM]”
 - Aims to help banks identify and manage risks in third-party relationships, which the agencies observe have increased in number and type, and comply with applicable laws and regulations
 - Principles-based, without imposing new requirements
- *Third-Party Risk Management: A Guide for Community Banks* (May 2024)
 - **“Engaging a third party does not diminish or remove a bank’s responsibility to operate in a safe and sound manner and to comply with applicable legal and regulatory requirements, including consumer protection laws and regulations, just as if the bank were to perform the service or activity itself”** (statement published with emphasis)

Additional Regulatory Guidance

Selected other risk management guidance

- *Banking with Third-Party Apps* (May 2024) – issued by FDIC for consumers
- *Conducting Due Diligence on Financial Technology Companies: A Guide for Community Banks* (Aug 2021) – Interagency
- *Conducting Business with Banks: A Guide for Fintechs and Third Parties* (Feb 2020) – issued by FDIC for third parties
- *Compliance Bulletin and Policy Guidance, Service Providers* (Oct 2016) – CFPB Bulletin 2016-02
- *Bank Use of Foreign-Based Third-Party Service Providers: Risk Management Guidance* (May 2002) – OCC Bulletin 2002-16
- *Interagency Guidelines Establishing Information Security Standards* (2001)
- *Interagency Guidelines Establishing Standards for Safety and Soundness* (1996)

Third-Party Risk Management – Concepts

Longstanding concepts in TPRM – “Third-Party Relationship Lifecycle”

- Planning
- Due Diligence and Third-Party Selection
 - *Strategies and Goals; Legal and Regulatory Guidance; Financial Condition; Business Experience; Qualifications and Backgrounds of Key Personnel and Other Human Resources Considerations; Risk Management; Information Security; Management of Information Systems; Operational Resilience; Incident Reporting and Management Processes; Physical Security; Reliance on Subcontractors; Insurance Coverage; Contractual Arrangements with Other Parties*
- Contract Negotiation
 - *Nature and Scope of Arrangement; Performance Measures or Benchmarks; Responsibilities for Providing, Receiving, and Retaining Information; The Right to Audit and Require Remediation; Responsibility for Compliance with Laws and Regulations; Costs and Compensation; Ownership and License; Confidentiality and Integrity; Operational Resilience and Business Continuity; Indemnification and Limits on Liability; Insurance; Dispute Resolution; Customer Complaints; Subcontracting; Foreign-Based Third Parties; Default and Termination; Regulatory Supervision*
- Ongoing Monitoring
- Termination

Third-Party Risk Management – Concepts

Longstanding concepts in TPRM – “Governance”

- Oversight and Accountability
 - Guidance sets forth responsibilities specific to Board and management
- Independent Review
 - Guidance lists factors that help assess the adequacy of third-party risk management processes
- Documentation and Reporting
 - Guidance provides examples of processes that support effective documentation and internal reporting

Banking as a Service – Then and Now

Earlier model – banks and fintechs worked together directly

- Direct agreement akin to the agreement described earlier
- Fintech would typically use the bank's tech platform, but could build their own
 - Using bank's platform was fast but limited flexibility in offerings
 - Building their own was complicated and time consuming, but enabled providing much more differentiated products

Current model – use of BaaS platforms / program managers / middleware to connect banks and fintechs (framework credit to Alex Johnson, *Fintech Takes*)

- Technology
 - Eg, “integrates disparate systems and data, providing dashboards, monitoring program performance and generating alerts, automatically testing compliance controls, tracking document exchanges, and facilitating marketing reviews”
- Managed services
 - Eg, account opening, BSA/AML/OFAC compliance, fraud management, Reg E disputes, and includes partner integrations
- Contracts and communication
 - Use of bi-party contracts, serving as an intermediary between client and bank
 - Use of tri-party contracts, requiring direct communication between client and bank

Enforcement Activity – Recent Actions

Enforcement activity related to bank partnerships has increased significantly over the past couple of years

Selected actions

- Blue Ridge Bank (OCC, Aug 2022)
- Cross River Bank (FDIC, Mar 2023)
- Metropolitan Commercial Bank (Federal Reserve, Oct 2023)
- First Fed Bank (FDIC, Nov 2023)
- Choice Financial Group (FDIC, Dec 2023)
- Blue Ridge Bank (OCC, Jan 2024)
- Sutton Bank (FDIC, Feb 2024)
- Piermont Bank (FDIC, Feb 2024)
- Evolve Bancorp and Evolve Bank & Trust (Federal Reserve, June 2024)
- And more to come...


Enforcement Activity – Provisions and Trends

Provisions and trends (credit to Jonah Crane, Klaros Group)

- Note the breadth of the most recent enforcement action

Recent Enforcement Actions: Topics Covered													
Bank	Board Governance	Consumer Compliance	CIS	BSA/SAFE	Internal Audit	TDIM / Oversight	Credit Risk	Interest Rate Risk	Operational Risk	Financial Risk Mgmt	Utility Risk	Strategic / Capital Planning Req	Restrictions on Business
Piermont Bank	Y	Y	Y	Y	Y	Y		Y		Y	Y	Y	Y
Sutton Bank				Y		Y							
Lineage Bank	Y			Y	Y	Y					Y	Y	Y
Blue Ridge Bank, NA (2024)	Y			Y	Y	Y			Y		Y	Y	Y
Choice Financial Group	Y			Y									
First Fed Bank	Y		Y			Y							Y
b2 Bank, NA	Y			Y		Y	Y			Y		Y	Y
Vast Bank, NA	Y							Y	Y	Y	Y	Y	Y
Metropolitan Comm. Bank	Y			Y		Y							
WEX Bank (2023)*	Y	Y	Y		Y								
Cross River Bank	Y	Y				Y			Y				Y
Evolve Bank & Trust	Y	Y		Y	Y	Y	Y	Y	Y	Y	Y	Y	Y

☐ Not included in enforcement ☒ Included in enforcement


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Enforcement Activity – Provisions and Trends

Additional provisions and trends

- Set up Board-level Compliance Committee with independent directors, which must submit regular progress reports
- Obtain “no supervisory objection” or “prior written approval” before engaging, offering, or setting up any new fintech, program manager, product, service, program, customer, subsidiary, or business line
- Provide criteria used to onboard end users, including fintech subpartners
- Ensure new accounts comply with BSA requirements, or cease onboarding
- Provide written plans for annual cash flow, capital preservation
- Develop plan for exiting and winding down fintech client relationships
- Develop plan for exiting and winding down fintech business strategy

Banking as a Service – Bankruptcy

Synapse Financial

- BaaS platform that filed for Chapter 11 bankruptcy in April 2024
- Bank partners – Evolve Bank, Lineage Bank, American Bank, AMG National Trust
- Clients – Mercury, Dave, Cleo, Copper, MainVest, Yotta, and many more
- Current estimated shortfall in customer funds is \$85 million
- Former FDIC Chair Jelena McWilliams appointed Chapter 11 Trustee

Full circle: Angela Strange led Series B funding round of \$19 million in 2019

See Jason Mikula's *Fintech Business Weekly* for detailed, real-time reporting

What solution would you propose for the challenges of BaaS?



QUESTIONS & DISCUSSION

Selected Resources:

- *Bank Reg Blog* (Substack)
- *Fintech Takes* by Alex Johnson
- *Fintech Brainfood* by Simon Taylor
- *Fintech Business Weekly* by Jason Mikula (Substack)
- Klaros Group posts (Konrad Alt, Michele Alt, Jonah Crane, Adam Shapiro, Brian Graham) (LinkedIn)