Surf's Up:

How to Ride the FinTech Wave Rather Than Be Swept Over

By Liz DeVos, Brad Rustin, and Randy Saunders; Nelson Mullins Riley & Scarborough, LLP

Any banker that has not felt the current building around personalized financial services has not read a newspaper, used a mobile phone, or turned on the television in the last five years. While initially, many traditional community, regional, and national banks pushed back and fought against the tide of FinTech; now, innovative and growing banks are embracing these companies, driving revenue growth, and building partnerships that retain customers, drive deposits, and lower costs. Traditional banks that viewed growth as a matter of acquiring others, building branches, or merging have now found new opportunities embracing FinTech. However, to ride this wave requires significant institutional knowledge and the right approach to risk management.

From 2010 to the third quarter of 2017, more than 3,330 new technology-based firms serving the financial services industry have been founded, 40% of which are focused on banking and capital markets.[1] The financing of these firms has been growing rapidly, reaching $22 billion globally in 2017, a thirteen-fold increase since 2010.[2] Lending by FinTechs now makes up 36% of all personal loans, from less than 1% in 2010.[3] Banks can either become part of this wave, or can be swept by and under.

These same FinTechs that are growing exponentially faster than traditional banks are faced with a daunting challenge—the federal and state regulations surrounding financial services. As their products grow, the FinTechs realize that the "Fin" of FinTech involves significant, sometimes decades-old financial regulations. Rather than spend millions of dollars from its limited capital to obtain licenses and registrations (or, presumably, an OCC Special Purpose National Bank Charter),[4] the FinTechs can bypass these issues by partnering with an existing bank.

Rather than viewing these groups as competitors, entrepreneurial community and regional banks now partner with these groups, serving as the regulated financial institution for the platform and letting the FinTech focus on the "Tech" portion of the equation. Telling, of the FORBES 10 Biggest FinTech Companies in

America, seven of the top ten use a bank as the basis of their platform or have pursued bank charters. Though participating in this space requires a great deal of knowledge on the part of the bank partner and a robust compliance department, the benefits to the bank can be unmatched.

As an example, WebBank (Avant, LendingClub, Prosper), as of the close of 2007, had 14 employees, $23 million in assets, no non-mortgage consumer loans, and $1 million in net income. Ten years later, WebBank has 82 employees (+19% annualized growth), $628 million in assets (+39% annualized growth), $173 million in non-mortgage consumer loans (+567% annualized growth), and $27.5 million in net income (+39% annualized growth).

Similarly, Cross River Bank (Affirm, CoinBase, Peerform, Upstart), as of the close of mid-2008 (earliest available) had 7 employees, $9 million in assets, no non-mortgage consumer loans, and -$651,000 in operating income. By the close of 2017, Cross River Bank had 142 employees (+35% annualized growth), $877 million in assets (+58% annualized growth), $330 million in non- mortgage consumer loans (+610% annualized growth), and $26 million in net operating income (+451% annualized growth). Cross River has now originated over $20bn in loans. However, with this growth also comes significant concentration concerns. Typical Peer Group 2 and 3 banks have 0.32% and 0.20% average loans held for sale as a percentage of assets.[5] Comparatively, WebBank has 49.7% loans held for sale and Cross River Bank has 14.92%.[6]

A bank exploring these opportunities must appreciate the significant strategic, operational, credit, compliance, and compliance risks associated with these types of collaborations. In addition to these broad categories of risk also comes model risk management, consumer protection concerns, BSA/AML/OFAC risks, consumer privacy concerns, and cybersecurity/data integrity risks.

By at least 2005, bank/non-bank partnerships had garnered the attention of regulators. In an interagency interpretive statement, the prudential regulators joined together to caution "banking organizations when providing banking services to money services businesses operating in the United States."[7] According to the regulators:[8]

[T]he minimum due diligence expectations associated with opening and maintaining accounts…are:

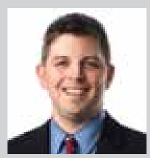
- Apply the banking organization's Customer Identification Program;
- Confirm FinCEN registration, if required;
- Confirm compliance with state or local licensing requirements, if applicable;
- Confirm agent status, if applicable; and
- Conduct a basic Bank Secrecy Act/Anti-Money Laundering risk assessment to determine the level of risk associated with the account and whether further due diligence is necessary.

Beginning in 2016, regulators began to focus their attention on bank/non-bank lender relationships. In 2016, the FDIC issued proposed guidance on third-party lending relationships (proposed FIL-50-2016).[9] Though these changes were never enacted, it provides guidance to banks exploring these relationships and provides an appropriate framework for how to work through the relationship and determine whether the relationship is appropriate for the bank. The theme that runs through this guidance is, in particular, the need to focus on due diligence and ongoing oversight. Similarly, in 2017, the OCC issued "Supplemental Examination Procedures for Risk Management of Third-Party Relationships."[10] All banks should view this guidance as forming a "checklist" of key considerations when entering into bank/non-bank lending partnerships.

Banks must appreciate that these types of relationships are extremely complex and require resources both within and outside the bank to adequately assess, quantify, and mitigate the risks associated with these types of FinTech partnerships. However, with the investment of time and resources can come significant financial rewards for community and regional banks looking for opportunities to grow outside of branch acquisition or the "acquire or be acquired" cycle.

These FinTech partnerships are a unique opportunity for banks to expand their customer base and product offerings without themselves taking all of the risk associated with offering the product. Through these models, the banks can use the FinTech to absorb a portion of the risk associated with expanding and offering new loans, payment systems, or technologies to its own customers.[11] As financial technology develops, bankers must realize that this is not competition, but an opportunity for significant growth for those banks willing to work in this space. ■

[1] U.S. Dept. of Treasury, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: NONBANK FINANCIALS, FINTECH, AND INNOVATION, July 2018, https://home.treasury.gov/sites/default/files/2018-08/A-Financial-System-that-Creates- Economic-Opportunities---Nonbank-Financials-Fintech-and-Innovation.pdf, p. 5.
[2] Id.
[3] Id.
[4] Depending on the exact product, a FinTech seeking multi-state money transmitter or lending licenses can be faced with greater than $750,000 in application fees and bond requirements, one or more years of delay, and up to $1,000,000 in legal fees
[5] BHCPR Peer Group Data, Dec. 31, 2017, Peer Groups 2 and 3.
[6] FFIED, Uniform Bank Performance Reports, as of December 31, 2017.
[7] FDIC, Interagency Interpretive Guidance on Providing Banking Services to Money Services Businesses Operating in the United States, FIL-32-2005, Apr. 26, 2005, https://www.fdic.gov/news/news/financial/2005/fil3205a.html.
[8] Id.
[9] Available at https://www.fdic.gov/news/news/financial/2016/fil16050a.pdf.
[10] Available at https://www.occ.gov/news-issuances/bulletins/2017/pub-third-party-exam-supplemental- procedures.pdf.
[11] For a discussion of the risks of expanded product offerings by banks, see OCC, New, Modified, or Expanded Bank Products and Services, Bulletin 2017-43 (Oct. 20, 2017), https://www.occ.treas.gov/news- issuances/bulletins/2017/bulletin-2017-43.html.



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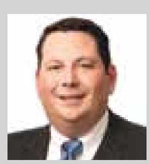

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