

Consumer Finance Monitor (Season 7, Episode 39): Insert Title

Speakers: Alan Kaplinsky, John Culhane and Ron Vaske

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services, what they mean for your business, your customers and the industry. This is a weekly show brought to you by the Consumer Financial Services Group at the Ballard Spahr law firm, and I'm your host, Alan Kaplinsky, the former practice group leader for 25 years, and now senior counsel of the Consumer Financial Services Group at Ballard Spahr. And I'm pleased to be moderating today's program. For those of you who want even more information, don't forget about our blog, consumerfinancemonitor.com. Yes, it goes by the same name as our podcast show. We've hosted our blog since 2011, and there is a lot of relevant industry content there, and particularly about the topic that we're going to be discussing today that I will mention to you in just a moment.

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Okay, well, let me give you a very short introduction to what we're going to be talking about today, and then I'm going to introduce our guests. So we're going to be talking about third party relationships that banks have with non-banks. While this seems to be an issue that has gotten particular attention in the fintech era, in the last, let's say five, six, seven years. It's been an issue that regulators have worried about, really going back to practically the beginning of banking. In fact, in my very lengthy career as a banking lawyer, we used to worry about third party relationships all the time with non-banks. But of course there was no fintech at that time.

So I decided I needed something really succinct to introduce the topic today, and I went to the FDIC Banker Resource Center. It has a lot of interesting information on it, by the way, and it says the following about third party relationships, "Third parties can help financial institutions attain strategic objectives, access expertise, or improve efficiency for a particular activity. The use of third parties does not diminish the responsibility to ensure that the activity is conducted in a safe and sound manner." Period. I would add to it, maybe, a safe, sound and lawful manner.

The FDIC then provides a lot of different documents that it's issued over the years. There probably are at least 10 documents issued by the FDIC itself, pertaining to third party relationships, and they are all in one very convenient location on the FDIC website. Now, of course, what we're going to be talking about today is something that all the prudential banking agencies are very focused on, as well as the CFPB. So you also need to look at what those other agencies have said about third party relationships.

Well, now, let me introduce our guests. I first want to introduce Ron Vaske. Ron is a consumer financial services partner in our firm's Minneapolis office. He co-leads the firm's fintech and payment solutions industry team, and his practice is primarily focused on matters involving consumer finance, banking, and payment systems. He has more than 27 years of experience, helping clients establish and administer bank sponsor arrangements for credit card lending and payment programs. He also counsels clients in product development, and preparation for CFPB, and banking agency exams. In collaboration with our firm's regulatory enforcement litigation team, Ron also assists in the defense of attorney general, banking agency and CFPB enforcement actions.

Also joining me on our show today is my longtime colleague John Culhane. John's a partner in our firm's Philadelphia office. He's a member of the firm's consumer financial services, bank regulatory and supervision, and higher education groups. His higher education practice emphasizes counseling clients on development, implementation and operation of student loan programs, tuition payment plans, and school payment card programs. His regulatory defense practice includes preparing

clients for banking agency, CFPB compliance exams, and assisting in the defense of attorney general investigations, and banking agencies, and CFPB enforcement actions.

So what we are going to do is... Well, let me just say one other thing. The genesis of deciding to do a podcast, on this podcast show at this particular time, is the fact that on July 25th, three of the banking prudential agencies, namely the FDIC, the Federal Reserve Board and the Comptroller of the Currency, combined together to issue a statement that deals with third-party relationships with non-banks. It's fairly lengthy statement that was issued by the three agencies together. And at the same time, they published an RFI, a request for information, to get more information about non-bank, third-party relationships. This is a very serious matter for the industry because usually when agencies do something like what the three agencies here have just done, they're not doing it simply to educate themselves. They're doing it because the intent is there to be some kind of follow-through, which will usually mean issuing additional guidance, maybe regulations, although I doubt they'll go down that road, but certainly enhanced supervision of relationships with non-bank third parties.

So this has been published in the Federal Register, the RFI, for a 60-day comment period. I don't think the comment period is quite up yet, and then it will be interesting to see where it goes. So before we jump into the questions that I have for both John and Ron, let me first invite them back to the program. Delighted John and Ron to have you join us today.

John Culhane:

Thanks, Alan.

Ron Vaske:

Thanks, Alan.

Alan Kaplinsky:

Okay, so we're going to start to build the foundation of what we're going to get into, and as I mentioned, we did a blog on this topic on July 30, a very brief blog, but today we're going to take a deeper dive, or the word I've been using lately is double-click on the topic. We're really going to dig into it, so you all will have a greater understanding of what this is all about. So the first question I have will be for you, Ron, and that's what types of bank-fintech arrangements are covered by this RFI.

Ron Vaske:

Thanks, Alan. Well, the RFI is really trying to be broad and cover just about every kind of relationship that a bank might have with a fintech company. I think there are two ways to categorize what they're focused on. First, the structural considerations, meaning the relationship between the bank and the fintech. And then after that, the specific products and activities.

On the structural side, there really are two ways that banks partner with fintechs in these relationships. One is directly, which is the old-fashioned model where a bank and a fintech or a non-bank financial company enter into an agreement and through that agreement, they create a joint venture that offers a financial product or service. The more modern or the newer approach that's used in different circumstances is an indirect approach through an intermediate platform providers, or that's what the RFI refers to them as. And that's often what you think of as banking as a service, where the bank will have a direct relationship with a fintech company that is really an intermediary for other fintech companies. And there may be 10, dozens, hundreds of fintech companies then that are supported by that third-party intermediary that has the direct relationship with the bank.

The types of products and services include deposit-taking activities, payment activities, that'd be ACH, wire, real-time payments, prepaid, prepaid cards, and then all types of lending, consumer, student lending, small business lending, including credit cards.

Alan Kaplinsky:

Yeah. Well, thank you Ron. And want to go to you, John, for the next question I have, and that is, what are the categories of risk that are a most concern to the agencies? And if you could tell us, for each category, John, what are the most significant concerns about each category?

John Culhane:

So in terms of categories of risk, the agencies talk about risk in particular ways, and they repeat those categories throughout the documentations that they use addressing risk. A key one is accountability, and I think this is the concern that we've seen going back almost to the start of bank-third-party relationships. There's a significant concern that banks will enter into third-party relationships and then wash their hands of all compliance and operational concerns. So the regulators routinely emphasize that the bank remains on the hook for compliance, and I think that the key concern here is, how do contracts allocate the division of labor between the bank and the fintech or fintechs, and how does that complicate the bank's ability to ensure compliance? Another focus of significant concern is end-user confusion. Fintechs are, I think, well-known for doing everything they can to make the operations as seamless as possible. And the downside of that seamless operation is there can be some confusion as to exactly what role, if any, the bank is playing in the process.

A particular area of concern in this section of risk is how the bank and the fintech deal with consumer complaints, how that process is managed, how the bank knows about the existence of the complaints, how the bank gets information from the fintech, and how those complaints are resolved and remediated. Another concern, I think endemic to this process, is regulators are always concerned about two things. One is phenomenal success, which I'm going to talk about now, that's rapid growth, and the other is dramatic and sudden failure. With rapid growth, the regulators are concerned really with appropriate scaling of risk on the part of a bank, and a topic that they point to regularly here is the potential for security vulnerabilities as the bank and the fintech are operating. The fintech may introduce avenues of access to the bank's systems that the bank isn't aware of, and that just has to be managed very carefully.

The flip side of rapid growth and phenomenal success is dramatic and sudden failure. And in this respect, the regulators look at concentration, how much the fintech is contributing to the operational success of the bank. That can be both with generating deposits for the bank to use in its operations and also generating revenue, both through the payment processing fees and through loan revenue. High concentrations impose risk, and the regulators here are concerned about adequate contingency planning and exit strategies so that, should there be a dramatic downturn, the bank's able to exit the relationship quickly, efficiently and safely. And then I think a routine aspect of bank-fintech operations, and one that the regulators focus on, is the use and ownership of data and customer information. Who actually owns the data, who has access to customer information? And that can be both on both sides of the relationship.

Obviously, the regulators are concerned that banks have access to data that resides with the fintech and that the fintech not be in a position to block any access to data. And then there's also a flip side to that, that the fintech may need access to data residing at the bank. So again, the areas of risk that the regulators focus on are accountability, end-user confusion, rapid growth, concentration and liquidity management, and then the use and ownership of data and customer information.

Alan Kaplinsky:

So John, the second significant area of concern that you identified is end-user confusion. And am I right that very recently the FDIC issued either new regulations or guidance about that topic, because of concern that a number of non-banks, in their advertising, were making it appear as if they were the bank, that they provided FDIC insurance? And obviously the FDIC didn't like that one bit.

John Culhane:

Yeah, there's new guidance on notification about FDIC insurance, but that's really the key here with end-user confusion is the understanding that, particularly with deposit accounts, that the deposit relationship is with the bank, that the bank is the place where FDIC insurance resides, that fintechs do not have any FDIC insurance.

Alan Kaplinsky:

Right, right. Thanks, John. So, Ron, let me go back to you and I'd like to find out what type and kinds of information are the agencies requesting?

Ron Vaske:

Thanks, Alan. Here again, it's pretty broad. They want to define the universe of what bank-fintech arrangements are. They went through and described a lot of different arrangements in the RFI itself, and so they want to confirm, did we describe the entirety of this industry? Is there anything that we missed? Also, the types of practices that banks engage in to monitor risk. What kind of information do they get? What are some of the things that they do to control the risk in these programs? How do you determine whether the end user is a customer of the bank or a customer of the fintech? The banks and the fintech's responsibilities, their legal obligations anyhow, are much different depending on whether or not the end user is their customer. Information about use of third parties, such as core service providers and other third parties in these arrangements, and how do they impact them and the risks to the bank?

Upfront costs and ongoing costs to the banks, and the revenue that the banks can typically expect to receive in these risk and risk management. Looking for information to define all of the risks that are involved in these programs, and then how do banks manage that risk broadly? Then, trends and financial stability, what are some of the things that the agencies should be looking at to monitor this industry and these relationships? Is there data, is there information that they should be looking at? But here, again, pretty broad in the types of information that they're seeking, and they really are hoping to get a better understanding of the industry, and what banks, and what fintechs are doing, and how that risk is being managed.

Alan Kaplinsky:

So let me ask a practical question, Ron, and that is, if you're counseling, let's say you're counsel to a bank that's recently entered into a special relationship within bank, and it's unique, and at least you're not aware of it having been done before, and why in the world would... And a client comes to you and says, "Ron, should we respond to this RFI?" CEO says, "Sounds to me like we're red-flagging an issue, or however you want to put it, putting our head possibly on the chopping block. If they don't like what we describe, they're going to come after us, so aren't we better just keeping a low profile?" Why is anybody going to respond to this?

Ron Vaske:

Yeah, I think that's a risk that is probably going to impair the quality of the information that the agencies receive. Of course, any bank that's involved in these relationships is subject to examination. So the information can be obtained by the agency, just by asking during the course of an exam, but to volunteer it, I suppose, there could be some hesitancy there. I think that you will see some responses and certainly the ABA, and the CBA, and some other industry groups have written and requested an extension of the deadline, but seem to be prepared to respond. And so I would expect that there will be more responses coming from industry groups, rather than specific banks or specific fintechs themselves. I expect also that we'll hear from consumer groups and probably some attorneys general or state banking agencies, and that sort of thing.

John Culhane:

If I could interject, Alan, I think it's possible that we may get some comments directly from banks, but ideally if you're a bank and you're thinking about commenting, you'd want to have just gone through an examination focusing on third-party relationships, and particular your fintech relationships, and really done very well in the exam, and maybe even had your regulator call out particular practices that you're engaging in as exemplary and worthy of duplication through the industry. That's, I think, the kind of bank or the situation in which a bank is likely to comment on this, as opposed to one that's entered into a new and maybe particularly challenging relationship.

Alan Kaplinsky:

Yeah, yeah. I'm just wondering from a... Is this a little bit of grandstanding by the agencies? Wouldn't have been more effective to gather this information very quietly in the course of conducting supervisory exams, rather than tossing this thing out to anybody who wants to respond? Because, yeah, you're going to hear about the wins, the successes, but maybe you'll hear from some consumer groups about obvious failures, but the obvious failures have been well covered in the press. So I guess, I just question the wisdom of doing it in this manner, but who am I to question three important government agencies? Let me go now to you, John. What would be some best practices that the agencies should identify from responses to the RFI?

John Culhane:

Well, I think some best practices we'd like to see the agencies identify would be ones that speak to the particular areas of risk that they've expressed concern about. Obviously, it would help if they provided some overall best practices for maintaining safety, and soundness, and compliance with applicable laws and regulations. But I think in that regard, they're just going to tell banks, "That's the accountability." They're just going to tell banks, "That's your responsibility." But some good guidance on how banks, and particularly smaller banks, should go through the process of entering into a relationship with a fintech, how they should negotiate contracts, what contractual provisions are particularly important in terms of allocating risk. And there are a number of questions about that, how they should conduct due diligence on a fintech, how they determine the attitude towards risk, the overall compliance, the financial stability of the fintech.

That would be very important overall. And then on these particular issues, how to best to address the risk of end-user confusion, whether there should be some suggested notices that should appear on fintech websites, maybe in bigger type than just in the small print at the bottom of the screen. How banks can appropriately plan to scale risk and compliance management systems to address rapid growth, which is obviously a concern, as I mentioned, the phenomenal success being a particular issue. I think there's some basic risks that the agencies are concerned about. Maybe they'll say more about percentages or levels of risk with deposits. There's the concern that there might be an over-dependence on deposits that are really a flight risk, that are just deposits from individuals seeking the highest possible rates. And then in terms of revenue, that there's an over-dependence on loan revenue or payment processing revenue. At what point does that become a concern? How much revenue would that have to amount to, to really be something that the banks should be extremely focused on? And then how banks ensure that disclosures are accurately and plainly communicated.

A lot of the concern the regulators have here is about the ability of banks, through fintechs, to make accurate and timely truth and lending disclosures, and truth and savings disclosures. That would be another area where we'd like to see some concrete and specific recommendations from the agencies.

Alan Kaplinsky:

Yeah. Hey, John, let me ask you a question that I commented on during my introduction, but wondering if you have any done any thinking about it. Do you share my view that agencies don't go through an exercise like this just for academic purposes, that they're leading up to something? Do you have any thoughts on what you think the next deliverable will be? Do you think it's just going to be more intense supervision of these relationships? Do you think they're going to issue further guidance? Where do you think they're headed?

John Culhane:

I think there are a number of things that are going to come out of this. I think there's going to be much closer scrutiny and more intense supervisory reviews of bank-fintech relationships. I certainly think that this is going to result in some specific recommendations. One of the things, looking at the questions about trends and developments, one of the things that I think we see here, with a nod to the CFPB, is that we may see some kind of notification requirements or some effort on the part of the regulators to require notifications of smaller banks or maybe all banks, so that regulators can identify and get data to assist them in monitoring developments and trends, since there's a lot of concern about how these relationships will evolve and whether they'll, in some respects, whether they will act as, the phrase the regulators used was, transmission mechanisms to amplify financial shocks in safety and soundness concerns. So those are some of the things that I expect we're going to see.

Alan Kaplinsky:

Do you think they might go so far as to require approval before entering into a third-party relationship? If they did something like that, the industry wouldn't like that, I'm sure.

John Culhane:

Yeah, I don't think we're at that stage, at this point. I welcome Ron's comments on that.

Alan Kaplinsky:

Yeah, what do you think, Ron?

Ron Vaske:

I agree on that. I don't think there's any way that we're going to be looking at prior approval of third-party relationships, and I think that would be hard to implement and define when that prior approval would be required. You do see, on a case-by-case basis, and we've seen it in enforcement actions in the past, that banks that are already engaged in these relationships, when they get into trouble, oftentimes that enforcement action will require prior approval of any new programs or any expansion of an existing program. But I don't think that we're going to see it upfront, with respect to any bank that's involved in these arrangements that they have to get prior approval.

Also, if I could interject just a little bit, I don't think I'm quite as cynical, Alan, as you are on the purpose for this. I think there's a lot going on and happening fast with these third-party relationships or these fintech relationships, and I think the agencies really do need to get their arms around it and figure out what is the whole industry and have a better understanding of it, because I think they don't fully understand it and what all of those risks are. And I think that this is, in the short term, not necessarily a positive development for banks and fintechs that are wanting to be involved in these arrangements, but hopefully in the long term, it will create a better understanding and better management of this, so that we don't have as many regulatory issues that come up by surprise.

Alan Kaplinsky:

Yeah. Well, let me ask you, you've identified a lot of risks that they're concerned about, but I don't think you said, and I may have missed it, but I don't think you said anything about reputational risk. And it made me think back, and this may be a good segue into the next question I'm going to ask you, Ron, about what led up to this, because I alluded to that at the beginning. But having practice in this area for decades, it's not very hard for all of us to remember how the agencies absolutely abhorred relationships with non-bank payday lenders, because part of the problem, a large part of the problem, was the triple digit APRs that were being charged on payday loans. And little by little, it didn't take very long for the Comptroller, the Fed and the OCC to essentially bar all banks, supervised by them, from engaging in payday lending with a non-bank.

They put enormous pressure on the banks that they supervise, to get out of that area, and the big thing they talked about was reputational risk. Very often they would come in and do examinations and everything was fine. Payday loans are a very simple product, right? In terms of lending disclosures, very simple. Consumers really do understand what they're doing, but a lot of the consumer groups didn't like the fact that banks were partnering with these non-banks that were in, what was considered, an unseemly business. So I'd like to ask both of you, is the concern about reputational risk gone away now that there isn't a great deal of payday lending going on? And I don't think any banks are actually engaged in payday lending.

Ron Vaske:

Yeah, certainly the concern about reputational risk has not gone away. I think what happened 20 years ago with respect to the payday lending partnerships, that was about reputational risk. I think there was probably more politics involved in it than actual reputational risk, but that's just my opinion, that the agencies probably were getting a lot of pressure from consumer groups and probably some people up on Capitol Hill, and they just got tired of it and took the position. Basically, that those kinds of relationships were unmanageable, that banks couldn't effectively manage their reputational risk in those. I hope that's not where we're going with respect to any kind of bank-fintech arrangement.

Alan Kaplinsky:

Yeah. John, do you have a reaction to that?

John Culhane:

Well, I think reputational risk is lurking behind some of these areas of concern. For example, maintaining safety, and soundness, and compliance, with applicable laws and regulations, that subsumes reputational risk. But a lot of the focus here,

in this RFI, is really on innovations and developing operations and systems to increase access to mainstream financial products and services, and to service underserved portions of the community. So the focus is a little different in this RFI than just on all of the bad things that might happen from being connected with a bad actor. Here, it's more on a good practice, and managing the relationship and the operations, to ensure that you get the results that you want from that practice.

Alan Kaplinsky:

One more observation I'm going to make, and then I want Ron for you to give us a little history lesson, and that is the agencies pay lip service, in my view, to the amount of revenues or profits that may be generated, or savings and expenses that there might be as a result of partnering with a non-bank. The banks will always focus on that, but if there are other things that are, not that the agency doesn't like, they're not going to care how much money the bank is making off of a particular product or activity. At least that's my, I guess, experience that I've had with the agencies. So, Ron, let's talk a little bit more about the history. What led up to this? Because there is a, I referred to it at the beginning when I counseled people to go to the FDIC banking resources webpage, but what can you tell us about that?

Ron Vaske:

Sure. Well, I think we've all seen over the past two or three years, a number of enforcement actions with banks that are engaged in these fintech arrangements. A lot of those have related to their anti-money laundering practices and risk management, but also with respect to their third-party risk management generally. In some cases, they had found some violations of consumer protection laws. In other cases, they really just focused on the bank's management of these relationships. I think also, if you recall back a few years when we had a number of crypto companies that were in bankruptcy, and this really came into focus then on the FDIC insurance aspect, and whether or not those fiat deposits were FDIC insured, and to what extent they were insured, and how customers understood that, and the implications then related to the crypto company's bankruptcy. That was a major area of focus for, particularly, the FDIC.

I think it's no coincidence that in May of this year, we had the Synapse failure. Synapse was what would be referred to here as an intermediate platform provider, providing the gateway or the relationship for a number of fintech companies with banks that would provide these services. Then when Synapse failed, there's about 200,000 customers that were unable to access their funds. There's still about \$85 million in discrepancy, as I understand it, according to the bankruptcy trustee, between what the records show customers are owed versus the amount that's on deposit in FBO accounts at the banks. And so there's some real money, some real financial concern on the line there, trying to deal with that. And then it probably shouldn't be a surprise, shortly before this RFA came out, we had some proposed changes to the brokered deposit rule, that the FDIC adopted just a few years back, now looking to really reverse itself on that and make changes that would bring in coverage of more of these bank-fintech arrangements. And the deposits that are generated through those would, in more cases, be subject to the brokered deposit rule. They would be brokered deposits.

Of course, as you mentioned at the beginning of this program, then we also had, concurrently with this RFI, the joint statement on banks arrangements with third parties to deliver bank deposit products and services that came out, just dealing specifically with these arrangements on the deposit side. And so there's been a lot leading up to this, and I can't say that I anticipated an RFI, but I certainly anticipated a lot of regulatory action and a lot of regulatory interest.

Alan Kaplinsky:

Yeah. I have a question for either one of you. Maybe, Ron, you may want to take the first crack at it. Why do you suppose they didn't invite the CFPB to the party here? They also are very wary of third-party relationships. I believe they've issued some guidance, from time to time, on it, or it's been part of consent orders that they've entered into with certain companies or banks. Why are they not part of this?

Ron Vaske:

Well, I am not sure. I'd speculate that their reasoning is that the primary thrust of this RFI is on safety and soundness issues, and practices for managing and these types of arrangements. Certainly, consumer protection issues are underlying all of that,

and they do talk about that quite a bit in the RFI. But really this is a safety and soundness issue. I don't know if, John, you might have some other insight on that.

John Culhane:

I agree. I think the CFPB isn't here because this really is largely a safety-and-soundness-oriented action. The concern here, I think, is the extent to which fintech-bank arrangements could affect the safe and sound operation of the bank. So that's not a CFPB issue. That's specifically a OCC, a FDIC, Federal Reserve Board issue, and I think that's why they're not present.

Alan Kaplinsky:

Yeah, and I guess you could also say, why isn't Treasury there or Department of Justice? They are worried about AML. That's mentioned in the statement that they made, and the banking agencies aren't the leading experts in the government on that topic. So that was another thing I was wondering. I guess, maybe they thought it would become just too unwieldy if they invited more people to the party. So, John, what do you think the future holds for bank-fintech arrangements?

John Culhane:

Well, I think what the future holds, I talked about this a little bit. I think the future holds closer scrutiny. I think that, although a lot of this is rhetorical, there clearly is support for innovation, and the delivery of products and services to customers that haven't had access to those products and services before. So I think that there's both support for growth, and support for development, and support for innovation, but the cost of all of that is much closer scrutiny and more interaction with the regulators, and for the fintechs, more scrutiny by the regulators of the fintechs.

Alan Kaplinsky:

Yeah. Let me ask a related question of you, Ron, and that is, what should banks who are thinking about getting into a fintech relationship be thinking about? I guess they need to first hire a lawyer, right, who knows something about the area?

Ron Vaske:

Yeah. They should first be thinking about hiring Ballard Spahr to help them prepare for that.

Alan Kaplinsky:

Well, of course that goes without saying, Ron.

Ron Vaske:

Yeah, I think, well, go in with your eyes wide open. Realize that we're at a time right now where there is going to be a lot of focus on these kinds of relationships. And so if you're going in new to this, make sure that you're prepared. You need to have the types of people, people with the types of experience that understand the risks here and understand how to manage these programs. It's probably something that you don't have internally right now. One thing that I have counseled banks to do in the past, that has been pretty effective, is to first develop your business plan, identify the risks with, say you have a program and specifically focus on the risks involved there, how you're going to manage it, and then talk to your regulator before you get into it.

I'm not asking for permission, but telling them, "This is what we're planning to do. Do you have any thoughts on how we're approaching this?" That has been effective for some of my clients in the past. Also, the one thing that it seems to me that bankers getting into this often don't fully appreciate at the outset, is how the customer relationship works. And it depends on the program, whether the bank has the direct customer relationship, or whether the fintech does, or whether there's some customer relationship between the two of them, or that each of them have. But when the bank has a direct customer relationship, that really changes the risk equation, and it's not good enough to say, "Well, we didn't do it. We didn't violate the law. Our contract says the fintech is responsible for that."

The contract doesn't matter. If it's the bank's customer, the bank is responsible for law. You may have recourse under the contract against the fintech partner, but the bank has legal liability and responsibility, and will be accountable to those customers and to its regulator. So understanding really what's all involved here, what the risks are, really going in with your eyes wide open and having a plan.

Alan Kaplinsky:

Yeah, and I guess, Ron, you need to do that at the beginning. What about monitoring the program as you go along, after you've got some experience with it? I take it, you need to do that, right? You can't rely, you don't want to wait until the regulator comes knocking on your door and tells you something that they saw that they don't like. If there is an issue, you want to know about it first and you want to remedy it. Am I right?

Ron Vaske:

Yeah. These are the arrangements that you don't want people in the bank looking at them just once in a while or at the time of contract renewal. These are the things that have to be managed on a daily basis. You're going to have staff in the bank that are going to be looking at reports that the fintech partner produces about complaints. You're going to be receiving all or at least certain types of complaints and making sure that their responses are appropriate. You're going to be monitoring for compliance with consumer protection laws. Best practice, and certainly something that I think just about every bank does, is goes through and approves all of the customer media. Anything that's an end-user facing, that the bank has to sign off on it before it goes out into the public domain. At least, if not each item bank signs off on, text that is acceptable for that media.

John Culhane:

I would just add to Ron's comment, that I think that RFI signals that to banks in these relationships, that this is a good time to basically do a mini compliance audit of all of your fintech relationships, to make sure that you understand all of the risks and that you're managing those risks appropriately.

Alan Kaplinsky:

Yeah, yeah, yeah. Yeah, and I know that our firm often gets asked to do that, to do, in a sense, a due diligence relationship that's already existing, as opposed to due diligence that you would do before entering into the relationship. And if you've got a law firm involved in that, I think important to get either in-house counsel or outside counsel involved, so you can try to protect the communications with attorney-client privilege, in case some things are identified that you don't really want to put in writing or red-flag for the supervisor.

Ron Vaske:

Yeah, and one more thing I could add, Alan. I think if I were a bank that were involved in these and looking at my processes, I would look at my existing contracts with these fintech partners. Some of these were negotiated years ago, and there's been a lot of evolution in this business since then, and a lot of things that we know now that we didn't know then, when these contracts come up for renewal. It's hard to renegotiate until renewal time, but as they come up for renewal, this would be a good time to look at those contracts and see if there are holes that we need to plug and things that we need to do, changes that we need to make to better protect the bank.

Alan Kaplinsky:

Yeah. Yeah, go ahead, Ron. I have a follow-up question for you, but finish your thought.

Ron Vaske:

Yeah, well, I was just saying that, oftentimes, they automatically renew, and if everything's going well, then you don't make any changes. But I think, with the signals we're getting from regulators, now would be a time that you would want to think about whether changes are necessary.

Alan Kaplinsky:

And don't you typically include, in these kinds of contracts, language that gives the bank an out or maybe even an ability to modify a contractual relationship before it's up for renewal, if there are safety and soundness or supervisory issues that have cropped up, that maybe you didn't know about at the time you entered into the contract?

Ron Vaske:

Those types of provisions are typical in these contracts. They're not unlimited in the bank's ability to make changes, though. Those types of things are easy to implement changes when, say an agency has identified issues, that they've told you are a problem, then it's pretty easy. Otherwise, it's an argument and with probably a good partner that you don't want to start an argument with. And also, you don't want to wait until the agency identifies the issue before you fix or address it.

Alan Kaplinsky:

Well, we're coming to the end of our program for today, but let me give both of you an opportunity. I know we've covered a lot of ground, but is there anything that you think we may have overlooked, that we ought to identify for our audience? And let me go to you first, John, and then, Ron, I'll give you the last say.

John Culhane:

Well, we haven't talked about what fintechs should be doing. And I think, in the same way that this is a signal to banks to look at their relationships, this is a signal to fintechs to look very carefully at the obligations that they've taken on under their relationships with their bank partners, and make sure that their practices will hold up to regulatory agency scrutiny, that they are operating in compliance with applicable law. And also, maybe even look at their stability and make sure that they shore up the underpinnings of the operation.

Alan Kaplinsky:

Yeah. Well, that raises a question, John, and that is, are these non-bank fintechs subject to supervision by the bank regulators? Do the bank regulators, and they treat them the same as if they're part of the bank, and go in and examine them, and request information?

John Culhane:

Well, I think that's a difficult question to answer generically, but yes, they could be deemed to be service providers to the banks, that would subject them to regulatory scrutiny. They could be considered institution-affiliated parties, which it would make them subject to enforcement actions. Really drilling down on the relationship would be important.

Alan Kaplinsky:

And I think that's something that's often overlooked by the non-bank fintechs. When they start talking to banks, what they're interested in is establishing the relationship because it's going to give them the ability to generate a lot of profits and to grow. But a lot of them, I don't think, realize that they're taking on a level of scrutiny and regulation supervision that they've never been subject to before. Many of them may not even be licensed under state law, right? Some are probably, but many of them are not.

John Culhane:

Well, clearly state law compliance is a focus here and something that the regulatory agencies have emphasized the bank should drill down on with the fintech.

Alan Kaplinsky:

Ron, let me ask you also, either to comment on anything that John just said, or do you have any other final wisdom that you'd like to share with our audience?

Ron Vaske:

Yeah, just commenting on what the fintechs should be thinking about is, as you mentioned, they've probably never been subject to this kind of regulatory scrutiny before. Typically, the banking agency, typically, isn't going to go directly to the fintech company and ask questions, but they're going to get their information from the bank, and they're going to expect the bank really to provide all the information from the fintech, and really expect the bank to monitor and control the fintech the way that the regulator controls the bank. So they're not directly supervised by the agency, but they are very much indirectly and they should think of themselves as subject to regulation as a bank, because they really are.

Alan Kaplinsky:

Right. Okay. Well, I want to thank you, John. Thank you, Ron. Really appreciate your sharing your thoughts with us today. And to make sure that you don't miss any of our future episodes, please subscribe to our show on your favorite podcast platform, Apple Podcasts, YouTube, Spotify, or whatever other platform you may use. And don't forget to check out our blog, consumerfinancemonitor.com, for daily insights on the consumer finance industry. If you have any questions or suggestions for our show, please email us at podcast@ballardspahr.com, that's singular, [@ballardspahr.com](https://twitter.com/ballardspahr), and stay tuned each Thursday for a new episode of our show. Thank you all for listening, and have a good day.