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BANKING AS A SERVICE

INSIGHTS

Bank Director
Strong Board. Strong Bank.

INSIGHTS

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Financial institutions that want to offer banking as a service must balance responsible innovation and robust third-party risk management. Vendor risk management policies and procedures should specifically address concerns about this business line, and banks must invest in personnel and compliance systems ahead of any partnerships.

KEY METRICS

50

Nearly 50 fintech partners working with at least 10 OCC-regulated banks

>$1B

Nearly 1/5 of BaaS banks have less than $1 billion in assets

Source: Acting Comptroller of the Currency Michael Hsu, September 2022 speech

KEY TAKEAWAYS

- Banking as a service can bring in deposits, greater payments transactions or increased loan volume.
- The bank houses the relationships and facilitates the transactions. It also takes the lead on compliance and oversight.
- Regulators want to see how banks manage the strategic, operational, transaction, credit, compliance and reputation risks that this business line can carry.
- Banks with less than $10 billion in assets have some advantages when it comes to banking as a service relationships.
- Selecting appropriate partners, engaging in third-party oversight, and frequent communication with partners and regulators are essential components of successful and compliant BaaS relationships.

Banking as a service can bring in more revenue, deposits and customers for community banks. But it can also increase compliance burdens and potential risk.

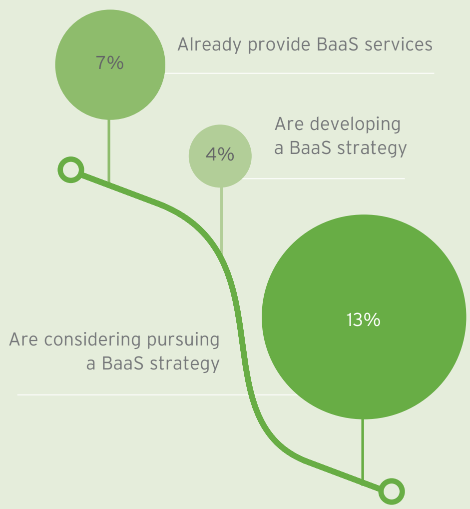
Banking as a service, or BaaS, is an indirect banking relationship where a financial institution provides the back-end servicing for a company that intermediates with retail customers. Today, most of these relationships occur online — the third party brings in customer deposits, payments transactions and loans in exchange for fees associated with the arrangement. In turn, the bank houses the relationship, facilitates the transactions, and takes the lead on compliance and oversight.

"Banks are outsourcing significant compliance duties to the third party, and they're taking on risks that are new and different from their direct business because they are providing their banking services indirectly," says James Stevens, a partner and co-leader of Troutman Pepper's financial services industry group.

Banking as a service isn't new, although technology has made it easier for institutions to build out this business line. Sioux Falls, South Dakota-based Pathward N.A., a subsidiary of $6.7 billion Pathward Financial, has been in this space for about two decades. The bank sees its legal and regulatory compliance management system as a "core strength" fueling its innovation with partners, says Lauren Brecht, senior vice president and managing counsel of credit and tax solutions at the bank.

That's because institutions interested in offering a BaaS business line must walk a fine line of responsible innovation and robust third-party risk management. Executives should understand that they can't outsource their oversight responsibilities. That's why it's so important that banks create robust, "top-down" third-party vendor risk management policies and procedures that specifically address BaaS concerns, Stevens says. He also recommends that

Banks on a BaaS Journey
Source: Cornerstone Advisors survey, Q4 2022



$25 billion

Estimated annual BaaS revenue in 2026

$85 million

BaaS revenue per sponsor bank
Source: Cornerstone Advisors' Banking as a Service report

banks invest in personnel and systems that can handle the oversight and compliance functions "way in advance" of any partnerships.

"Banks are always going to be the ones left holding the bag, from a regulatory and compliance standpoint," Stevens says. "It's incumbent upon them to not only do due diligence and establish a good contractual relationship with their partner, but to also have the capability to manage and oversee it over time to manage those risks."

Active Oversight

Regulators want to see that bank boards and executives are actively engaged in providing oversight for BaaS programs. The bank should have a grasp of how these partnerships could increase strategic, operational, transaction, credit, compliance and reputation risks, and how internal systems will monitor that. And the nature of the individual BaaS relationship will dictate more specific risks, Stevens says. A deposit program that includes debit cards will have Bank Secrecy Act concerns; lending could entail true lender risks around which partner owns the loan. Payment facilitation could include money transmission issues.

Who a bank chooses to partner with also matters. Brecht says Pathward is "strategic" about partnerships and provides appropriate compliance and oversight that consider a prospective partner's maturity and expectations. She says the bank is also mindful of reputational concerns and whether a partnership furthers the bank's mission to promote financial inclusion.

"We've got to make sure that we're monitoring our partners — not in a micromanaging way, but making sure that they're buttoned up," she says, adding that third-party oversight and frequent communication throughout different levels of the partnership are essential components of successful and compliant BaaS relationships.

Enhanced Scrutiny

The stakes for banks here are high. Financial regulators have flagged a number of risks that stem from layered, disintermediated banking relationships. Banks may encounter coordination, communication and disclosure challenges that can increase the potential for unfair or deceptive acts or practice violations; unclear partnership agreements could contribute to snafus, untimely resolutions or delivery failures. Community bank executives should be able to demonstrate to bank regulators that they are providing sufficient oversight and monitoring of partners, and making appropriate investments in their compliance offices to respond to the increased risk.

Getting a grasp on these risks is the first step toward launching a BaaS program. Interested institutions should reach out to risk consultants and attorneys who specialize in this space, and consider hiring employees with relevant experience. Banks may also need to bolster their risk management and compliance systems ahead of onboarding a BaaS partner.

"Success starts and ends with compliance," Brecht says, adding that sound legal and compliance practices allow Pathward to have confidence in their innovation and product creation. "We know that we're playing within the boundaries with our robust compliance management system."

Smaller banks do have some advantages when entering the BaaS space, Stevens says. A bank with less than $10 billion in assets receives more debit interchange income, which may be of interest to companies that want to issue debit cards. And a smaller bank may have the flexibility and focus to manage the relationship and risk of a partner, compared to larger institutions where a single relationship may be less meaningful.

Despite the risks, Stevens and Brecht are optimistic about the opportunities for community banks in this emerging space. If managed responsibly, banking as a service can make a big impact on revenue at community banks by growing deposits, loans or customers.

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