BankDirector

Breakout 3: Banking as a Service Regulatory and Compliance Update

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#BBTF23

Banking as a Service Regulatory & Compliance Update

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Agenda

- Banking as a Service (BAAS)
- Legal and compliance issues
- Key takeaways from the Bank Director BAAS Insights Report
- Questions and conclusion

What is Banking as a Service (BAAS)

- BAAS is an acronym for the term Banking as a Service. This is a business model in which banks offer banking services to nonbank fintech and other financial services providers or non-financial businesses so that those parties can in turn offer those banking products to their customers. An example of BAAS is when a merchant embeds access to a bank's credit products at the point of sale.
- We are focusing on consumer-facing partnerships.
- Implementation growing rapidly.

BAAS Partnership Examples

- Loan origination and facilitation
- Credit card issuing
- Prepaid and debt card issuing
- For benefit of (FBO) accounts
- Other deposit programs
- Check cashing

Key Legal Issues

- Risk management
  - Compliance
  - Concentration
  - Reputation
  - Transactional
  - Operational
  - Legal
- Third party vendor management
- Regulators have made it clear that these are board issues.

BAAS Partnership Issues

- **Third party vendor management guidance**
  - Applies in every deal because fintech is a third party vendor to the bank
  - Requires due diligence, monitoring, risk management and specific terms in agreements
- **Outsourcing compliance functions**
  - Bank remains responsible
  - Disclosures and agreements
  - Bank Secrecy Act/Anti-Money Laundering
  - Fair lending
  - Unfair, abusive and deceptive trade practices
  - Others specific to programs
- **Exclusivity/restrictive covenants**
- **Data ownership**
- **Privacy**

Interagency Guidance on Third Party Relationships

- June 2023 guidance put out by the Federal regulatory agencies refreshed and restated decades of prior guidance.
- While the agencies acknowledge that "[t]he use of third parties can offer banking organizations significant benefits, such as quicker and more efficient access to technologies, human capital, delivery channels, products, services, and markets," they caution that the use of third parties "does not remove the need for sound risk management."
- The guidance says that business relationships with third parties engaged in lending, payment, or deposit activities for the benefit of the bank or through the bank should be evaluated by banks using both the third party risk management guidance and the various risk management processes and rules that apply to traditional lending and deposit relationships.
- The focus is on managing risks associated with third party relationships.

Interagency Guidance on Third Party Relationships

- The use of third parties does not diminish or remove a bank's responsibility to perform all activities in a safe and sound manner, in compliance with applicable laws and regulations, including those related to consumer protection and security of customer information.
- Banks should consider these risks throughout the life cycle of the relationships, including when:
  - Planning
  - Conducting due diligence
  - Contract negotiation
  - Ongoing monitoring
  - Termination
- The guidance notes that sound third-party risk management takes into account the level of risk, complexity, and size of the bank, as well as the nature of the specific third-party relationship.

Highlights from Interagency Guidance on Third Party Relationships

- Emphasizes the importance of identifying and managing risks associated with third party relationships.
- Says banks should maintain an inventory of all third party relationships and periodically conducting risk assessments for each relationship.
- Requires that banks engage in more rigorous oversight of third party relationships that support “critical activities” such as those:
  - That cause a banking organization significant risk;
  - Have significant customer impact; or
  - Have a significant impact on the banking organization’s finances or operations.
- Advises banks to conduct periodic independent reviews to assess the adequacy of third party risk management processes.

Federal Reserve Release on Novel Activities

- In August, the Federal Reserve provided additional guidance on its Novel Activities Supervision Program to monitor novel activities in the banks it oversees.
- Novel activities are defined by the Fed to include:
  - technology-driven partnerships with non-banks to provide banking services to customers, and
  - activities involving crypto-assets and distributed ledger or “blockchain” technology.
- According to the Fed, “the Program will be risk-focused and complement existing supervisory processes, strengthening the oversight of novel activities conducted by supervised banking organizations.”
- The Fed will notify those banking organizations whose novel activities will be subject to examination in writing and will routinely monitor supervised banking organizations that are exploring novel activities.

Federal Reserve Release on Novel Activities

The Fed stated the Program will focus on the following activities:

- *Technology-driven partnerships with non-banks to provide banking services*.
    - This includes all manner of BAAS partnerships.
- *Crypto-asset related activities*. For example, activities such as crypto-asset custody, crypto-collateralized lending, facilitating crypto-asset trading, and engaging in stablecoin/dollar token issuance or distribution.
- *Projects that use* distributed ledger technology (DLT) *with the potential for significant impact on the financial system*. For example, the exploration or use of DLT for various use cases such as issuance of dollar tokens and tokenization of securities or other assets.
- *Concentrated provision of banking services to crypto-asset-related entities and fintechs*.
    - This includes providing normal deposit, lending and payments to firms concentrated within these industries.
    - For example, banking organizations concentrated in providing traditional banking activities to crypto-asset-related entities or fintechs.

Interagency Guidance on Due Diligence

- Business Experience and Qualifications
- Financial Condition
- Legal and Regulatory Compliance
- Risk Management and Control Processes
- Information Security
- Operational Resilience

Interagency Guidance on Vendor Contracts

Key provisions to include:

- Clear parameters for information access and use
- Data safeguards and controls
- Audit rights/ongoing due diligence/testing, QA, monitoring
- Compliance with laws & regulations
- Use of subcontractors and other vendors
- Customer complaint resolution
- Representations and warranties
- Indemnity
- Clear termination and wind-down provisions
- Limit of liability
- Dispute resolution
- Insurance coverage

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Regulatory Scrutiny of BAAS Partnerships

- Regulators have warned that bank partnerships could lead to increased risk for the banking industry.
- OCC has acknowledged that by partnering, banks can obtain tech innovations at a lower cost while fintechs and other bank partners gain access to long-standing customer bases and reputations of their banking partners.
- Comptroller Hsu has warned, however, that the benefits of these partnerships can be lost if the bank does not have an effective risk management framework, stating that bank information technology "concerns in the national banking system are elevated."
- He said regulatory concerns risk management, board oversight, governance, and internal controls currently constitute 25 percent of all cited supervisory concerns.

Regulatory Scrutiny of BAAS Partnerships

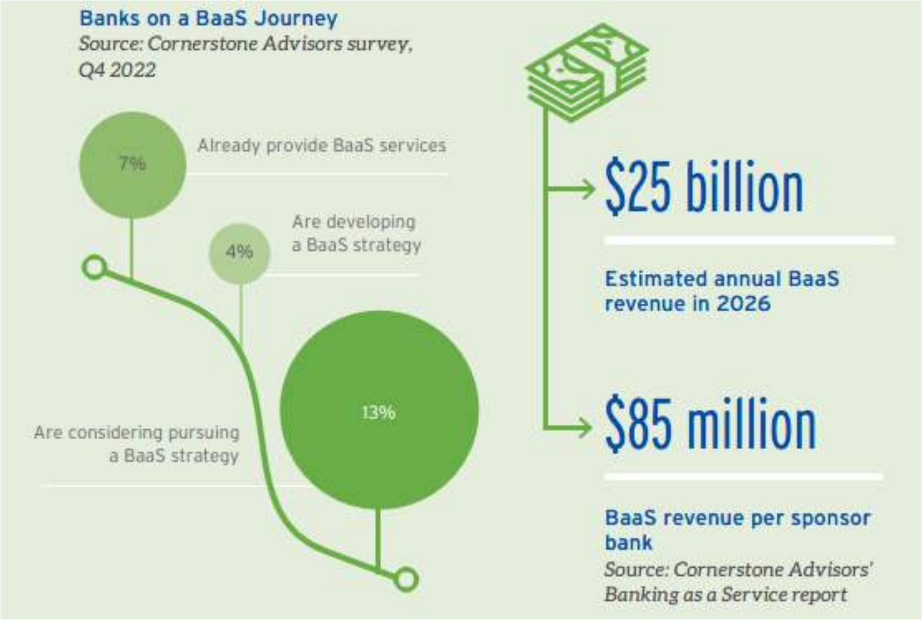
- The FDIC entered into a Consent Order with Cross River Bank in March 2023.
- The Order states that the FDIC determined that the bank engaged in unsafe or unsound banking practices related to the Bank's compliance with applicable fair lending laws and regulations by failing to establish and maintain (i) internal controls, (ii) information systems, and (iii) prudent credit underwriting practices.
- This order will definitely impact the future growth of the bank's offering of these programs and its operation of existing programs and contained the following substantive provisions:
  - Board Requirements: it requires the board to exercise greater exercise and control over these programs. Again, these are board issues.
  - New Credit Products and New Third Parties: the bank must seek regulatory non-objection before establishing new programs.
  - Information Systems: the bank has to make sure its systems allow it to properly manage and oversee the programs and fix any issues identified through that review.
  - Fair Lending Compliance Risk Management: the order requires the bank to conduct an assessment of its programs with applicable fair lending laws and regulations, submit that assessment for third party review and remediate any issues.
  - Third-Party Compliance Internal Controls: the bank must also submit to the FDIC its compliance internal controls for review and approval.

Regulatory Scrutiny of BAAS Partnerships

- This scrutiny follows other recent types of scrutiny on these partnerships, including:
  - FDICOCC order against Blue Ridge Bank related to BSA issues.
  - Crack down on crypto and fintech firms (and the banks that partner with them) related to misrepresentations. regarding whether funds are covered by federal deposit insurance.
  - Related actions against Chime and others by states claiming the fintechs are holding themselves out as banks
- The extent to which the Cross River order and these other enforcement actions will impact BAAS partnerships will depend on the extent to which the non-bank partners are complying with bank secrecy, fair lending and. other rules and regulations and how good a job the banks do with risk management
- The crackdown is clearly not a positive development for BAAS partnerships in general, but we believe that these BAAS programs will continue to grow, and that banks and non-bank partners that do them well should be able to withstand heightened regulatory expectations.
- It is also critical that banks that are partnering with BAAS providers under that this a corporate governance issue.

Key Takeaways from BAAS Insights Report

- In April 2023, Bank Director and Troutman Pepper released an Insights Report on The Secret to Success in Banking as a Service.



Key Takeaways from BAAS Insights Report

- “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.”
- “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.”

Bringing it All Together

- These programs are growing and will continue to grow.
- If you are going to do it, you must do it right and in compliance with relevant guidance by managing the risks and ensuring the program's compliance with applicable law.
- Must manage the risks and compliance from the top of the bank down.

Questions

Speaker Biography – James Stevens, Partner, Troutman Pepper

James is the co-leader of the Financial Services Industry Group at the firm. He provides corporate and regulatory advice to clients and has substantial experience in the representation of public and private companies, including banks, neobanks, marketplace lenders, payments companies, and other fintech and financial services providers and partners in connection with formation, licensing, banking as a service (BAAS) and other program agreements, mergers and acquisitions, securities offerings, and regulatory compliance.

In such capacity, James offers creative advice regarding how to structure and document business arrangements in line with regulatory requirements. He also advises clients regarding employment agreements and short and long term incentive arrangements for executives.

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Thank you!