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Bank relationships with fintechs

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Federal banking regulators continue to signal their attention to banks' relationships with third parties, and particularly with fintechs. We think that these developments should be of interest to larger banking organizations as well.

Background

The Federal Reserve published a paper titled *Community Bank Access to Innovation through Partnerships* (the Paper) on September 9, 2021. The Paper reflects discussions between Federal Reserve staff and representatives of over 40 U.S. community banks, fintechs, and other industry stakeholders.

The Paper posits that community banks[1] are increasingly using partnerships with fintechs to enhance their services to customers and leverage innovations that may otherwise be too costly or difficult for a community bank to develop on its own. The Federal Reserve begins the Paper by expressing support for "responsible innovation … while ensuring safety and soundness of the institution[] and the protection of consumers." The Paper expresses a positive view on this development, in "the right circumstances and with the appropriate guardrails." Officially, the Paper does not reflect the view of the Federal Reserve or its staff and is not new guidance or an interpretation of existing guidance. Nonetheless, the Paper provides clear Federal Reserve viewpoints that are helpful for all sizes of banking organizations.

The Paper illustrates the continuing attention paid by the Agencies to banks' third-party relationships, and particularly those involving fintechs. The Paper follows other recent publications by the Federal Reserve on related topics, namely (1) proposed interagency guidance on banking organizations' risk management of third-party relationships, which was jointly issued by the Federal Reserve, FDIC, and OCC (collectively, the Agencies) on July 13, 2021[2] and (2) *Conducting Due Diligence on Financial Technology Companies: A Guide for Community Banks*, which was jointly published by the Agencies on August 27, 2021. Davis Polk addressed each of those developments in recent client updates, which can be accessed here and here.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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[1] For purposes of the Paper, community banks are banks with less than $10 billion in assets.

[2] Comments concerning the Agencies' proposed guidance were initially due by September, 17, 2021, but following an extension of that deadline, are now due by October 18, 2021.

The Paper

Categories of Fintech Partnerships

- In operational technology partnerships, a community bank deploys third-party technology to its own processes or infrastructure to improve efficiency and effectiveness.
  - Examples of such partnerships include technology that automates aspects of the loan origination process, enhances fraud detection or provides more reliable customer authentication, or credit underwriting models developed by fintechs.
  - According to bankers that participated in outreach discussions, after a successful rollout of a third-party provider's products or services in support of a particular business process, a bank will often expand use of that solution to other workflows and departments.
  - Such partnerships may require technical training of bank staff or hiring new staff that already has technical expertise.
- In customer-oriented partnerships, a community bank engages a third party to enhance various customer-facing aspects of its business, and the bank continues to interact directly with its customers.
  - Examples of such partnerships include technological enhancements to online account opening tools and mobile deposit platforms.
  - These partnerships assist community banks in meeting and exceeding customer expectations. Bankers that participated in outreach discussions noted that the need for, and rate of adoption of, enhanced customer interfaces and other convenient means of digital interaction (such as video-based teller services) was elevated by the COVID-19 pandemic.
  - In addition, many community banks partnered with fintechs in customer-oriented partnerships around Paycheck Protection Program applications.
  - The ease with which a fintech's third-party solutions can be integrated into a bank's existing infrastructure and offerings without loss of functionality or convenience to customers is key to banks contemplating these relationships.
- In front-end fintech partnerships, a community bank's infrastructure is combined with technology developed by a fintech, with the fintech interacting directly with the end-customer in the delivery of banking products and services.
  - Such partnerships may involve key bank activities such as the acceptance of deposits, access to payment rails, extension of credit, or issuance of debit and credit cards.

    - The Federal Reserve notes that these partnerships, which reflect a business approach that has been referred to as "Banking-as-a-Service," are less common than operational technology partnerships and customer-oriented partnerships but offer the opportunity for banks to reach new customer segments not previously accessible by established channels.
    - Those who participated in outreach discussions noted that the nature of these relationships can raise heightened third-party and reputational risks because "the fintech partner essentially acts as an extension of the bank from the perspective of the end-consumer." The failure of a fintech with which a community bank enters into a front-end fintech partnership could require the bank to unwind client relationships.
    - The Paper also notes the difficulties that arise in front-end fintech partnerships from fintechs that are not used to being regulated and are not versed in bank regulation.
    - The Paper describes steps that community banks have taken to reduce the compliance risks associated with such partnerships, including through training and enhanced oversight of their fintech partners.

Considerations in establishing effective fintech partnerships

- **Commitment to innovation**: Participants in the outreach discussions noted the importance of having concrete goals (and related performance indicators) in mind when considering a potential fintech partnership, as well as having senior management and a board that has a long-term commitment to innovation.
    - Bankers emphasized employee-level commitment to innovation as well. For example, they noted the need to hire of technology-dedicated staff who are incorporated into the bank's strategy and broader teams, rather than operating in a silo. They also described efforts to ensure buy-in among staff as users of the technology.
- **Alignment in priorities and objectives**: Banks prefer to work with fintechs that share their priorities and strategic objectives.
    - In particular, community banks look to partner with fintechs that understand the role of a fiduciary and place an emphasis not only on acting as the bank's partner in business but also as the bank's partner with respect to compliance, risk management, and customer satisfaction. The ability to readily access a fintech's senior leadership to interface on these points was flagged as a key consideration by several bankers who spoke with the Federal Reserve's staff.
- **Thoughtful approach to connectivity**: The ease with which a third-party's technology integrates with a community bank's existing infrastructure is another key consideration.