

Fintech Strategy Roadmap for Community Banks

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TABLE OF CONTENTS

Executive Summary	3
Strategic Opportunity	4
Fintech’s Wide-Reaching Terrain	6
A Community Bank Advantage	8
Approaches to Fintech for Community Banks	9
Fintech Regulatory Environment	11
Risk Factors to Consider for a Community Bank	13
Conclusion	19
Appendix – Fintech Partnership/Joint Venture Checklist	20
About	21



FINTECH STRATEGY ROADMAP

EXECUTIVE SUMMARY

Community banks are, and always have been, innovators focused on the prosperity of the customers and local communities they serve. Community banks are not strangers to change. For more than 150 years, community banks have evolved in step with the technological changes occurring within the financial services industry. The Automated Teller Machine (ATM), mobile banking, and remote deposit capture are perfect examples of how community banks have collaborated with technology providers to meet the experiential and transactional demands of its customers.

With customer preferences changing at an expeditious rate and expectations from users for a seamless omni-channel experience on the rise, disruption is occurring within numerous industries including financial services. The latest wave of rapid transformation is bringing financial technology or fintech to the forefront of the financial services conversation.

Fintech is simply the intersection of financial services and technology. The innovation within this intersection is robust, and the positive impact to community banks is wide-reaching. Digital wallets and real-time transactions bring instant results to bank customers. New lending platforms offer streamlined experiences and faster credit decisions. Business intelligence solutions provide new ways for community banks to manage and anticipate customer activity, while transformed cloud infrastructures give banks more secure and efficient opportunities for data security and storage.

Today's community bankers understand that continued success is dependent upon the adaptation of banking practices to meet the evolving needs of the market. Fintech companies offer possible partnerships and collaborative relationships that can help community banks enhance the customer experience and promote mutually beneficial relationships.

Community banking is successfully built on a relationship-based business model. This Fintech Strategy Roadmap offers a look at various fintech approaches for community banks to consider when creating, collaborating, and investing in fintech. With a focus on how regulatory risk impacts a bank's actions, this roadmap outlines the necessary considerations to ensure these strategic decisions are successful for community banks.

STRATEGIC OPPORTUNITY

Amid the noise and disruption of fintech, one message is clear: Community banks are well-positioned to blend the strengths of their operations with fintech innovations. Community banks have historically enjoyed a strong lead in customer satisfaction over their larger counterparts. To maintain and build on this competitive edge, community banks are looking closely at fintech opportunities. In a 2017 ICBA Fintech Survey, community banker respondents noted the following benefits that fintech companies offer to community banks:

- **Increased Operational Efficiency and Scale:** Given their nimble nature, community banks are well-positioned to take advantage of the opportunities in the fintech landscape—opportunities that present potential gains in fee income, reductions in risk and fraud, increased efficiency, and improvements to the customer experience.
- **Increased Access to Customers with a Younger Age Demographic:** The baby boomer generation is winding down their earning and spending activity. Over the next 25 years, nearly 81 million US millennials (all of whom came of age after the digital revolution) will dominate the economy. Millennials demand financial services that focus on origination and sales, which are personalized and emphasize seamless/on-demand access to the service from the underlying product. Fintech companies are eager to meet millennials' preferences.
- **Increased Access to Loan Customers in New Markets:** Community banks can work with fintech lenders to provide critical banking services to underwrite consumer, mortgage and commercial loans. This can expand bank access into new markets where fintech companies have greater penetration. For example, marketplace lenders or “MPLs,” leverage data collection and technology to provide access to credit with little to no physical overhead or distribution network. Small and medium-size banks often partner with MPLs when they do not have the internal expertise or resources to execute an online lending business model.
- **Enhanced Brand Reputation:** Community banks partner with fintech companies to offer new, innovative services. To be successful, banks will need to work with fintech partners to develop marketing and financial branding strategies that carry forward the bank's brand. Customers may demand more universal banking automation and transformed branch experiences, all of which will need to be communicated through a community bank's brand messaging.
- **Enhanced Customer Experience:** Nearly 50 percent of responding community bankers noted the opportunity for enhanced customer experience as the greatest favorable benefit to capitalizing on new and emerging technologies. Community banks are looking to the fintech advancement as opportunity to strengthen customer and community relationships. Technology can act as the great equalizer to community banks successfully traversing the fintech scene given their ability to be nimbler in implementing change.

According to a PwC 2017 report¹, “Redrawing the Lines: Fintech's Growing Influence on Financial Services,” fintech is having a growing influence on financial services as the two are combining. The report notes that startups are seeking new customers to pair with capital funding. At the same time, traditional banks are looking to identify new approaches to drive change and a more innovative customer experience. The result of this increased partnership will be a broader ecosystem in the financial services landscape. Determining how to respond to these external fintech influencers and opportunities is quickly becoming a key strategic consideration for many community bank executives.



Fintech and financial services are competing less and coming together. **82 percent** expect to increase fintech partnerships in the next three to five years.

¹ PwC Global Fintech Report 2017, pwc.com/Fintechreport (PwC's survey included responses from 1,308 financial services company and Fintech executives).

STRATEGIC PLANNING

A bank's board of directors is responsible for, among other duties, overseeing the bank's strategic direction and providing senior management with risk parameters within which to exercise their business discretion. Fintech is no different. The board of directors should consider how fintech could complement and support the bank's overall strategic direction, and incorporate a discussion of fintech projects within the bank's strategic plan. A board of directors should also have a process for annually updating and approving their strategic plan, and for updating the plan on an ad-hoc basis between annual reviews. Those same processes should apply to fintech projects—if a fintech project rises to the level of business materiality that would generally require board approval and inclusion in the strategic plan, the fintech project should be approved by the board and incorporated into the strategic plan before material progress is made on that particular project.

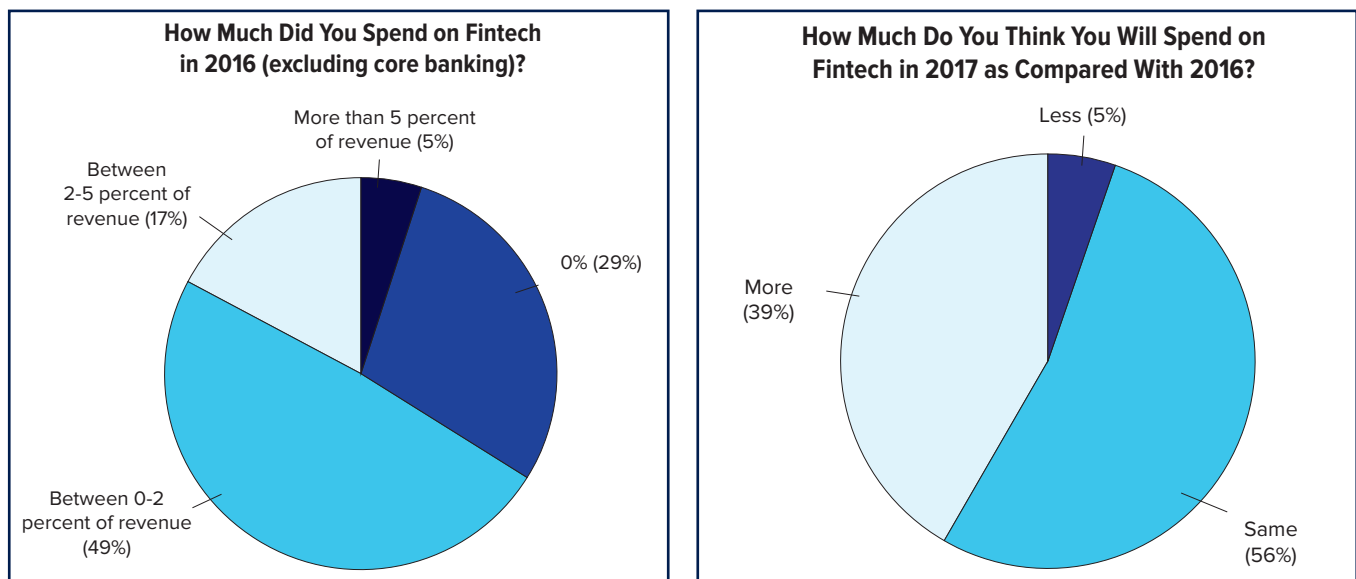
RETURN ON INVESTMENT AND COST

A bank's monetary return on investment ("ROI") for fintech related projects is difficult to predict with certainty. Experts believe returns to be incremental in nature and most financial institutions investing in fintech estimate an expected annual rate of return of approximately 20 percent globally.² The rising customer expectations for a streamlined, mobile, and innovative banking experience make investment in fintech a more prudent allocation of resources.

A major factor in the ROI for any bank is whether the fintech solution is aligned with the bank's overall business strategies. For ICBA member banks, the areas of mobile banking, payments and commerce, and cybersecurity rank as the top three fintech solutions that support current business strategies. ICBA Fintech Survey respondents also noted data and analytics, cloud infrastructure, and artificial intelligence as having potential alignment with community bank strategies.

It goes without saying that most efforts made to partner with, or invest in, fintech companies have a cost associated with them. Costs may be incurred in connection with capital investments in a fintech company, the acquisition of new systems to deliver products to customers, and any ongoing fees required to maintain the products and services.

In the 2017 ICBA Fintech Survey, the majority of community bank respondents indicated that between 0.1-2.0 percent of revenue was spent on fintech in 2016. This figure excludes expenditures on a bank's core processing system. Nearly 95 percent of the respondents indicated that they would spend either the same or more on fintech in 2017. Still in its early stages, the trend appears to support increased attention on the way banks are bringing fintech products and services to customers.



² Ibid.

FINTECH'S WIDE-REACHING TERRAIN

Based on a McKinsey & Company study³, the latitude of fintech products and services is extensive and wide-reaching. Fintech companies have made significant advancements in the MPL space, money transfers and payment applications through 2017. However, the fintech reach extends much farther into new and emerging areas including blockchain, roboadvisory, new account products, wealth management, security and more.

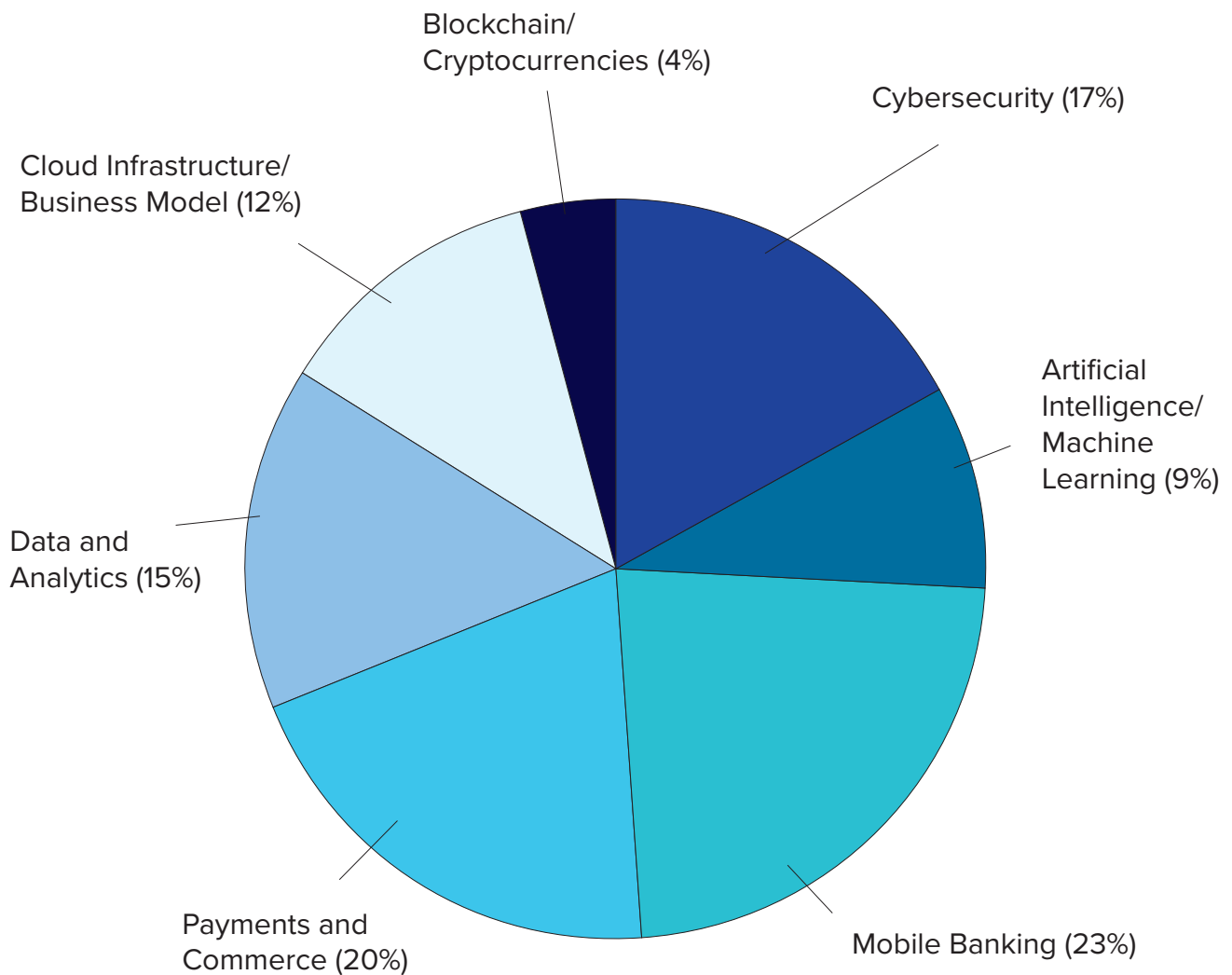
Fintech has evolved from startups that are looking to beat the traditional banks to a broad network of companies looking to leverage collaborative partnerships. In all of the following areas, technology stands to alter the way banking transactions have been historically conducted:

- **Lending:** Loan origination platforms, either direct or indirect, offer community banks an opportunity to access borrower data and make credit decisions in a more expeditious manner. These systems provide vast amounts of customer data to guide timely underwriting decisions and help to automate a consistent lending process.
- **Finance, Business Intelligence, and Liability Management:** Product pricing tools, profitability modeling, and report automation offer ways to operate more efficiently and improve net interest margins. Customer data acquired from transactional activities also provide community banks access to new behaviors and insights into account movements and patterns that allow for better predictive assessments.
- **Payments:** Digital wallets, real-time payments, global remittances, and digital currency movement all stand to enhance the practices customers use to move money from one place to another. The settlement practices have expanded the universe of merchants, customers, and financial institutions taking advantage of the new technologies.
- **Wealth Management and Personal Financial Management:** Technological advances and advanced analytics allow for more accurate, automated, and low-cost ways to manage funds and even offer investment advice. This appeal has moved beyond just the millennial base and is now part of the mainstream wealth management arena.
- **RegTech:** Technologies can offer banks opportunities to outsource regulatory maintenance, monitoring, data collection, and customer due diligence. RegTech looks to enhance all aspects of a bank's Compliance Management System including customer account alerts and monitoring, customer risk identification, and the fair application of lending practices.
- **Cloud Infrastructure and Open Application Programming Interface ("API") Business Model:** Data security and cost are the key advantages to these newer technologies. The ability to scale at a faster pace, and the opportunity to be more agile with account offerings, provide banks with evolving ways of doing business while keeping customer data secure.
- **Data and Analytics:** New data systems give banks the ability to improve fraud detection, provide real-time activity fees and proactive service alerts, and tailor offers to sell add-on products based on recent purchases. Data utilization also makes bank processes easier for the customer by prefilling forms, prequalifying for loans, and allowing for quicker user authentication and access.
- **Data and Cybersecurity:** Biometrics and identity management along with new methods to store data securely lead the ground in this area of fintech. The outcome is increased automated recognition of users (both internal and external to a bank) and greater surveillance of customer and transaction activity.
- **Marketing, Sales, and Customer and Channel Management:** Gaining access to customer activity and data provides for new cross-selling, customer acquisition, and targeted marketing opportunities. Increased access to data provides banks with an opportunity for more personalized marketing interactions at potentially lower costs.
- **Human Resources, Benefits, and Training:** Cloud-based systems are increasing efficiency in administering HR and benefit services to bank employees.

³ Panorama by McKinsey.

Fintech companies are also focusing on emerging technologies that will provide a renewed banking experience for customers.⁴ Emerging technologies like blockchain, cryptocurrencies, and artificial intelligence or machine learning are areas to keep an eye on. All three of these areas were identified as technologies in which large fintech companies would likely invest in over the next year.⁵

Emerging Fintech Technologies That You Think Best Fit Within Your Bank's Business Strategy



⁴ PwC Global Fintech Report 2017, pwc.com/Fintechreport (PwC's survey included responses from 1,308 financial services company and Fintech executives).

⁵ Ibid.



A COMMUNITY BANK ADVANTAGE

For years, community banks have offered a customer-centric banking tradition that puts customers first. This advantage rings loud and clear to the fintech companies that view community banks as a strong performer in the customer service space. But this isn't the only advantage community banks offer. The various gains of potential collaboration or partnership are intriguing to many fintech companies.

Community banks offer a fintech company a number of benefits: deposit insurance and liquidity, a sound customer base, credibility, and settlement and compliance services.

- **Deposit Insurance and Liquidity:** Fintech companies need the reliable access to liquidity that insured deposits provide. Seemingly every decade, markets are disrupted and there is a flight to reliable sources of liquidity. Absent bank funding, some fintech firms may not survive the inevitable ripple in the securitization market. Commercial lending relationships can be structured to fit the liquidity needs of a variety of fintech companies.
- **Sound Customer Base:** Fintech companies also have many advantages. They are not burdened with physical distribution costs and may have reduced overhead at least on a per loan basis, which provides cost advantages that banks can pass on to their customers. In addition, fintech's innovative data gathering tools can help banks find new ways to perform old tasks (like credit underwriting) and leverage existing infrastructure to create new products and tap unserved markets. But, to be successful, fintech companies need something banks already have a stable customer base. To that end, the advantage lies with the banks. As fintech players expand and garner market recognition, however, they have the potential to control the customer interface and then offer banks slimmer margins for the business developed. The rapid pace of change in fintech has another inherent disadvantage for banks—banks must constantly work to ensure that stability and profitability stay ahead of ever-evolving risks from their business partners and regulatory obstacles. That means a bank must ensure that its fintech company partner shares the bank's philosophies including the treatment of its customers—regardless of the model chosen by the bank.
- **Credibility:** Community banks, often long-established pillars of a local community, offer start-up fintech companies the institutional credibility that may help convince customers to utilize the fintech's services. In addition, community banks offer fintech customers deposit insurance coverage and expertise with the regulatory environment.
- **Settlement and Compliance Services:** Fintech companies in the payments space will require access to community banks' settlement infrastructure to process and settle payments. Fintech companies can leverage community banking's regulatory and compliance infrastructure to help meet compliance burdens.

APPROACHES TO FINTECH FOR COMMUNITY BANKS

Community banks are, and will remain, the keystone for providing consumer financial services. This is because they are responsible for maintaining the insured deposit accounts with which customers identify as the foundation of their primary financial relationship. Nonetheless, the way banks provide services will continue to change in the coming decades, due both to technological advances and in response to demographic shifts in the US population.

Once a bank has identified fintech projects to supplement and support its strategic plan, it should next consider how it will go about developing those projects. There are primarily three models a bank can use to pursue a fintech project:

- It can create the fintech product or service in-house;
- It can collaborate with a third-party, including another financial institution, or
- It can purchase a fintech product or service or invest in a fintech company.

Each model has its own associated risks and rewards.

CREATE IN-HOUSE

Some banks have elected to develop fintech products or services internally, either directly in the bank itself, or in an affiliate of the bank. Finding the right expertise to staff such projects can be a challenge, and the costs associated with an extended rollout of a new product or service can be cost prohibitive. On the other hand, a successful, internally developed product can be leveraged not only for the benefit of the bank's existing customers but can serve as a differentiator to attract new customers to the bank, or can generate new revenue through sales and/or leases to other banks or financial institutions.

For example, increases in computing power have led to an increase in the amount of data that can be stored, processed and analyzed. Recognizing the value of this data for business development, many banks have developed in-house "big data" fintech teams to manage customer data, develop new analytical methodologies and tools, and to leverage technology to provide more efficient financial services to bank customers.

COLLABORATE

Rather than creating a product in-house completely on its own, a bank could choose to collaborate with a third party to bring a new product to market. Potential partners may be sought out and identified by a bank itself, or a bank may find itself approached by potential partners with fintech business proposals. Collaboration has its own risks and rewards. One benefit of a partnership model is that the tasks associated with developing the product could be divided and allocated to the party best suited for such tasks. The bank could retain regulatory compliance, marketing, securing liquidity and access to settlement infrastructure while the bank's partner could be responsible for software development and other IT-related functions. Such a partnership could enable a bank to bring its idea to the market faster and with less cost than if the bank had tried to bring its idea to market by itself. Prior to entering into a partnership or joint venture with a fintech company, a community bank should consider several regulatory steps and conduct due diligence. Please refer to the **Appendix** for a checklist of important considerations. Collaboration generally takes three forms, as described below using marketplace lending as a fintech product example:

Business Partnerships. Business partnerships may involve the bank as the originator for loans on the fintech company's internet lending platform. Here, the bank can use its experience to outline underwriting criteria and run the back-end of the lending relationship, providing capital, determining the type of loans and managing risk levels. The fintech company works the front-end of the relationship, handling the market branding, customer relationship and data collection. For example, a Utah-based bank is a leader in developing business partnerships to structure and originate alternative financing products. The bank provides money to companies like LendingClub that arrange peer-to-peer loans. When a borrower applies for a loan with LendingClub, the bank issues the loan, and then, two business days later, LendingClub buys the loan and parcels it out to the investors who pledged to fund it. The bank's partnership allows it to collect interest on the money for that window and earn a fee from LendingClub.⁶

⁶ See "National Financing Programs – Alternative Payment Products," available at <http://www.webbank.com/financingprograms>. See also Noah Buhayar, Bloomberg Businessweek, "Where Peer-to-Peer Loans are Born," (Aug. 15, 2015), available at <https://www.bloomberg.com/news/articles/2015-04-16/webbank-where-peer-to-peer-loans-are-born>.

Investment Collaboration. Banks may also undertake debt and equity investments in the MPL arena or pursue a securitization model with respect to MPL originations. The debt and equity arms may provide a greater degree of control for the bank, but that comes with increased risk—and a big demand for capital up front. By contrast, securitization offers the bank a chance to spread the risk (subject to risk retention)—a fairly well-established practice familiar to many banks. New data technologies—including use of derivative data sets and APIs—enable banks and MPLs to create new methods of credit analysis and underwriting. This creates greater economies of scale and more efficient lending product delivery.

Generally, securitization requires limited upfront investment and can increase a bank’s ability to absorb increases in its loan book without proportionate increases in costs. However, regulators are quickly moving to a model where banks are required to apply the same level of due diligence on securitized loans as they would apply to a self-originated loan. That, in turn, raises the thorny issues of regulatory compliance and third-party risk management (addressed below), which may impact the profitability of the securitization model.

Technology Collaboration. The third method of MPL collaboration—technology partnership—allows banks to work with fintech partners that most closely align with the bank’s own customer base and risk tolerance. These partnerships are often win-win scenarios: banks receive access to new methods of lending and increased revenue; MPLs get access to a bank’s CMS, credibility, liquidity from its customer/depositor base and the bank’s institutional knowledge. These relationships can work in three broad ways:

REFERRAL SOURCES

The fintech company provides a referral service for bank customers, often using an algorithm to match the bank likely to be the best lender based on the customer’s information.

LENDING RELATIONSHIPS

The fintech company provides a bank with access to its technology platform and data-driven decision-making criteria. Lending platforms can be customized for different types of loans, including consumer, mortgage and commercial loans.

TECHNOLOGY PROVIDERS

When a bank does not have the internal resources to develop and/or staff its user interface and lending platform, the fintech provider can provide the lending application and integrate it into the bank’s core system. These often take the form of licensing partnerships.

A community bank headquartered in Boston is a good example of a bank thinking strategically about technology collaboration. With assets of just over \$1 billion, this bank partnered with LevelUp and Bottomline Technologies to provide lending services to customers. The bank’s customers can complete the entire loan application and approval process in just under six minutes. There is no need for a branch visit, hardcopy print out or mail-in application. Customers snap a picture of the barcode on the back of their driver’s license and the personal identification needed for the application is automatically populated on the form. The bank also has a partnership with the New York Currency Exchange (“NYCE”) shared deposit ATM network to allow customers to make deposits and withdrawals at non-proprietary ATMs across the U.S. with zero ATM fees. In addition, the bank offers a high-yield checking account (called “Hybrid”) through a partnership with on-line investment firm Aspiration, and personal loans between \$2,000 and \$35,000 through its partnership with the Prosper platform.

PURCHASE OR INVEST

HAS YOUR BANK MADE AN EQUITY INVESTMENT IN A FINTECH COMPANY?



YES (5%)



NO (95%)

A third option is for a bank to purchase an established product or invest in an established company. Purchasing an existing product is the fastest path to offering a new service to the bank's customers. Other banks have integrated off-the-shelf products—essentially, plug and play, out-of-the-box technology—to offer clients new fintech services like finance management and financial planning capabilities. By doing this, banks can leverage fintech to provide customized, highly self-directed services that have the potential to deepen relationships with digitally savvy customers with little effort.

However, a bank may have a limited ability to customize the product and may expose itself to vendor management risk if the bank is also purchasing ongoing services related to the use of the product. Acquiring an established company has many of the same benefits of creating a product in-house (e.g., potential for additional revenue streams) without some of the associated risk (e.g., that the product developed may not be viable). If a bank chooses to make an investment in a company, rather than acquire it, the potential risks and rewards resemble those associated with a collaboration business model.

FINTECH REGULATORY ENVIRONMENT

Similar to the banking world, the current regulatory environment for fintech is complex, varying from company to company. To determine which regulations apply to their business, fintech companies must ask three questions:

- What do we do?
- Where are we and our customers located?
- What lies ahead for fintech regulation?

The answers to these three questions will largely determine the regulatory regimes that apply to their business.

“What do we do?”

The financial products and services offered by a fintech company will determine which regulators, if any, have jurisdiction over the company when it participates with a bank:

- For broker-dealers, investment companies and registered investment advisors, the SEC, and perhaps FINRA.
- For money service businesses or money transmitters, the Financial Crimes Enforcement Network (or FinCEN) and one or more state regulators.
- For consumer lenders (but not a bank), possibly a state banking regulator.
- For partnerships with payment network (e.g., NACHA or MasterCard or Visa payment networks), the private membership rules established by that network.
- For nonbank fintech companies offering consumer financial products or services, the Consumer Financial Protection Bureau (the CFPB).

Fintech companies that partner with existing regulated entities (e.g., a bank or an SEC-registered investment advisor) may not have to directly comply with all of their partner's applicable regulations, but often must, by contract, agree to comply with certain regulations and a degree of regulatory oversight as a condition of the partnership.

Finally, all fintech companies located in America (and U.S. citizens operating overseas) must abide by the trade sanctions rules promulgated by the federal government. These rules are based on U.S. foreign policy and national security goals with respect to targeted foreign countries, terrorists and other threats to the United States. The Office of Foreign Assets Control ("OFAC") administers and enforces these rules.

"Where are we and our customers located?"

The location of a fintech company and its customers also shapes the company's regulatory environment. Each state has its own rules applying its regulatory regimes to companies located within the borders of the state. A state's regulatory regime will also, generally, govern all companies (regardless of their location) that provide consumer financial services to residents of their state. However, if a company operates with a federal banking license, at least some of these state rules may be preempted. Operating with a federal banking license can simplify the regulatory regime for fintech companies that operate in multiple states.

What lies ahead for fintech regulation?

Financial regulation tends to follow, not anticipate, changes in the financial services industry. The evolution of fintech, therefore, will play a large role in shaping its own future regulatory environment. Four additional factors may impact changes in the fintech regulatory environment:

First, functional regulation, that is assigning a company a regulatory regime based on the functions or services the company provides, has been the dominant financial regulatory model for some time (since Gramm-Leach-Bliley). Therefore, to this point, the evolution of fintech regulation has consisted of existing regulators' declaring that particular fintech business lines provide functional services that fall within their jurisdiction, and then applying established regulations for these functions to those fintech companies. This trend will likely continue, at least in the near future.

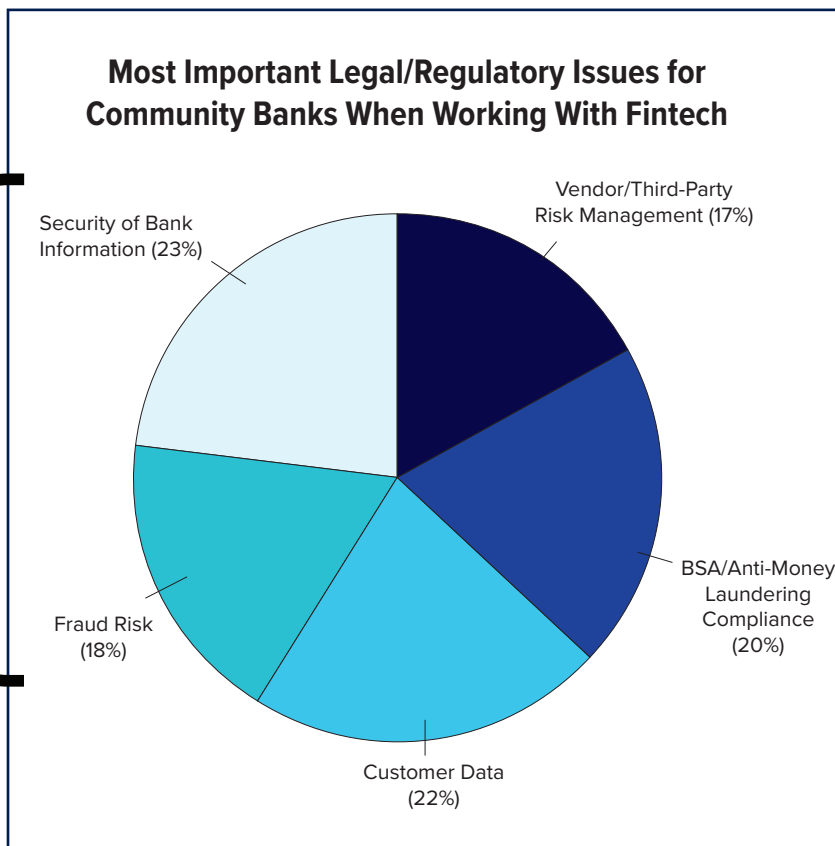
Second, the evolving concept of what constitutes "money," as well as the increasing integration of financial markets has impacted how (and the degree to which) the Federal Reserve can control the money supply and exercise monetary policy. To the extent that fintech products and services are within expansive definitions of the money supply, the more likely it is that those products or services would be brought under the Federal Reserve's jurisdiction or otherwise be subjected to bank-like regulation.

Third, the evolving nature of transaction settlement services (e.g., blockchain technologies) will likely have a dramatic impact on the financial industry. The changes could make settlement faster, safer, more efficient and less costly. It could also decouple the provision of settlement services and the provision of other financial services. If a fintech company achieves significant scale with a settlement service, it is possible that they could be regulated by the Federal Reserve as a designated financial market utility or a systemically important financial institution.

Fourth, the global competition for fintech innovation has driven some jurisdictions to amend their regulatory framework in order to attract capital and people. This trend will continue, but holes in regulation could lead to detrimental economic consequences, which in turn could reverse deregulation trends.

RISK FACTORS TO CONSIDER FOR A COMMUNITY BANK

To no surprise, emerging from this fintech movement are several risk factors and areas for consideration for any community bank. In the 2017 ICBA Fintech Survey, **23 percent** of respondents noted the security of bank information as their top fintech risk management concern while data privacy, BSA/AML compliance, fraud risk, and vendor management followed closely behind.



DUE DILIGENCE – KEY RISK CONSIDERATIONS

Due diligence is key to assessing whether a third-party vendor can meet its regulatory expectations. Banks need to conduct a thorough due diligence review to understand how the fintech company intends to provide services and products to bank customers. Fintech projects need to be assessed within the same risk framework that the bank applies to other products and services. Generally, this means assessing the project's impact on strategic, credit, interest rate, liquidity, price, operational, compliance, and reputational risks. Different fintech projects have different risk profiles, but most fintech projects present medium to high levels of operational and compliance risk. This is due to the technologically innovative nature of fintech projects and the uncertainties that often surround the application of compliance laws to new fintech products and modes of service. To mitigate these risks, it is critical that banks that are considering a strategic plan that includes a material level of fintech projects invest in the right people and processes to mitigate these risks. A strong chief technology officer and a strong chief compliance officer will greatly help reduce risks and build credibility and goodwill with regulators.



Financial institutions themselves are responsible for providing innovative financial services safely...While 'run fast and break things' may be a popular mantra in the technology space, it is ill-suited to an arena that depends on trust and confidence... There are more serious and lasting consequences for a consumer who gets, for instance, an unsustainable loan on his or her smartphone than for a consumer who downloads the wrong movie or listens to a bad podcast.⁷

⁷ Federal Reserve Board Governor Lael Brainard, Speech: The Opportunities and Challenges of Fintech (December 2, 2016).

Banks must continually assess and manage risks associated with third-party relationships—fintech companies are no exception. After onboarding, the bank must implement a comprehensive monitoring process. This can involve many aspects, but the crucial points are:

- Ongoing monitoring of the fintech company’s activities and performance;
- Preparing contingency plans for terminating the fintech relationship in a manner beneficial to the bank;
- Developing clear roles and responsibilities for overseeing and managing the relationship and risk management process with the fintech company;
- Reporting lines that facilitate oversight and accountability, and
- Conducting independent audits so that bank management can determine whether the fintech relationship aligns with its strategy.

The best way to meet these points is to make sure they are set out in a written contract (discussed in more detail below). Lastly, all due diligence activities and third-party risk assessments must be documented in a consistent, uniform and easy-to-understand manner. This will benefit the bank’s internal processes and make compliance examinations easier to manage.

UMBRELLA RISK ASSESSMENT – CURRENT ORGANIZATIONAL INVENTORY

As part of their risk assessment and due diligence of fintech projects, banks should also consider the project’s targeted customers, how they will staff the project internally, and what internal systems will be necessary to support the project. The bank may want to consider test running the project with a smaller subset of customers before making it more widely available, and should ensure that the marketing plan for the project reflects the profile of the target customer. As the bank progresses through the life-cycle of a new fintech project, the bank may need to adjust the project’s staffing needs. For example, more technology and compliance resources at the beginning of the project lifecycle, and a switch to more business line resources will likely occur as the project matures, automation occurs, and economies of scale begin to kick in.

HOW TO MITIGATE THIRD-PARTY RISK

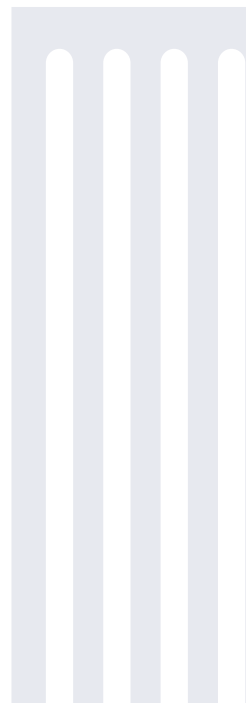
Managing fintech collaborations and partnerships as third-party relationships is the key to working with fintech companies. Third-party relationships are an outgrowth of the bank. Particularly where a third-party relationship with a fintech company involves bank-critical functions (e.g., payments, clearing, settlements, custody) or shared services (e.g., information technology), banks need to evaluate the extent to which a failure of that relationship entails significant risk to the bank or the bank’s customers. For that reason, regulators expect banks to promote high standards of compliance and vendor management when using third parties to provide services and products directly to consumers. At the outset, banks must develop and implement a vigorous compliance management system (CMS) to mitigate third-party risk and address regulatory obligations. In the context of third-party risk in a fintech relationship, a good CMS will address nine pillars:

1. Board oversight (how the fintech relationship fits into the bank’s strategic plan, outlining the inherent risks, objectives, cost-benefit analysis and other considerations);
2. Policies and procedures (the internal rules governing the use of the fintech solution);
3. Risk assessment (operational, compliance, reputation, strategic, credit and contractual risk associated with the fintech solution);
4. Due diligence (a full-scope evaluation of the fintech solution);
5. Compliance officer (how the bank will execute the compliance framework with respect to the fintech solution);
6. Training (up-to-date and tailored training specific to the fintech solution);
7. Contract provisions and considerations (how the bank frames its legal expectations for the fintech solution);
8. Monitoring (measuring performance metrics of the fintech solution), and
9. Complaint management (the unofficial pillar of CMS).

⁸ FDIC Examination Guidance for Third-Party Lending (July 29, 2016).



An institution’s board of directors and senior management are ultimately responsible for managing activities conducted through third-party relationships, including lending relationships, and for identifying and controlling the risks arising from such relationships as if the activity were handled within the institution.⁸



In particular, the FDIC, the Federal Reserve and the OCC all have issued guidance regarding third-party risk and vendor management. A key consideration for banks is the level of due diligence information available from newly established fintech startups. If unable to receive in-depth information from the fintech company, banks need to develop alternative ways to analyze such relationships—particularly when the relationship with the fintech company supports a bank-critical activity.⁹ Another key consideration is whether the potential fintech partner utilizes any other third-party vendor to offer its product and services. If the answer is yes, the bank will need to assess to what extent due diligence is required to be comfortable with those derivative third-party relationships.

These guidance expectations equally apply to banks' relationships with fintech companies and should be incorporated in their CMS. Moreover, banks will want to make sure their fintech partners have equally effective CMS in place. As explained in more detail below, a good CMS is the first line of defense against consumer and regulatory concerns.

COMPLIANCE

Banks bear a heavy burden: a legal duty to balance the pace of fintech utilization against the risks to consumers involved with financial services. That isn't something that banks can simply pass on to others—regulatory authorities will ultimately hold banks responsible for legal compliance. It is vital that banks put compliance and regulatory issues at the forefront of their fintech deployment—regardless of whether they buy, build or collaborate to engage with fintech. In particular, banks need to evaluate fintech companies as they would any other third-party relationship, considering legal compliance themes as well as operational compliance themes. Depending on the sophistication of the fintech company and the comfort level the bank has with its risk analysis, the depth of compliance may be tailored to the relationship.

LEGAL COMPLIANCE THEMES

- **CRA Impact—Will it change my bank's footprint or CRA assessment area?**

Because they do not take deposits and do not receive depository insurance from the FDIC, fintech companies are arguably not subject to the Community Reinvestment Act of 1977 (CRA). In addition, because fintech companies do not have traditional brick-and-mortar storefronts operating out of a defined neighborhood, measurement against a distinct CRA assessment area may prove to be difficult. For these reasons, bank collaboration with fintech companies is not, in the near term, likely to change the bank's CRA assessment area. Nonetheless, fintech partnerships can influence CRA ratings. Regulators—in particular the OCC—have stated that they would like to see the evolving fintech environment meet the CRA's goals.¹⁰ Namely, fintech companies—and the banks that partner with them—should expect regulators to ask for documentation as to how the product or service is being implemented in a safe and sound manner and how it meets the CRA's goals of financial inclusion, fair access, and fair treatment.

- **Federal Trade Commission Act, the Consumer Financial Protection Bureau, UDAAP and Other Consumer Concerns**

Unfair, deceptive and abusive acts and practices (UDAAP) remain a central consumer protection issue for bank regulatory agencies as well as other state and federal regulators (e.g., the Federal Trade Commission, the CFPB and state attorneys general). Although UDAAP concerns often seem to be a nebulous catch-all for consumer compliance issues, heightened areas of compliance risk permeate banks' third-party relationships—in particular those in the fintech space. Many fintech companies providing services to bank customers will directly interface with those customers without real-time bank oversight. Payments and mobile banking services may implicate, among other things, the Electronic Funds Transfer Act and Regulation E. Remittance rules impose significant duties on service providers (including banks involved in the transaction) and trigger pre-transaction disclosure requirements that explain the permissible fees, error resolution procedures and consumer rights. Understanding which rules apply to which transactions and what compliance responsibilities may be passed on from the bank to the fintech vendor is critical.¹¹

⁹ OCC Bulletin 2017-21, Frequently Asked Questions on Third Party Relationships, FAQ 1 (June 7, 2017).

¹⁰ See Remarks by Thomas J. Curry, Comptroller of the Currency, regarding Special Purpose National Bank Charters for Fintech Companies, p. 6 (Dec. 2, 2016).

¹¹ For example, Section 1073 of the Dodd-Frank Act provides an accommodation with respect to consumer disclosures for remittance transfer providers (or "RTPs") that are insured depository institutions and insured credit unions (the "Temporary Exception"). The Temporary Exception allows for estimates of exchange rates and fees assessed by entities with whom the RTP does not have a direct correspondent relationship. While the Temporary Exception has proved useful to banks and credit unions, the CFPB will phase it out by July 21, 2020. Banks and credit unions that provide remittance transfers need to evaluate their relationships before that sunset date. See generally Gimbert & Chang, BANKING & FINANCIAL SERVICES POLICY REPORT, Remittance Transfers: Policy, Practicalities, and Innovation (August 2017).

- **BSA/AML**

Every fintech product and service implicate Bank Secrecy Act and anti-money laundering (BSA/AML) issues. The consequences of a BSA/AML violation can seriously impair a bank's ability to operate (as well as its market reputation) and cut across all service segments and accounts. Illicit actors are constantly pressing the edges of legality to conceal the sources and uses of funds from regulatory scrutiny. This is particularly true in the payments, mobile banking and remittances areas—where creative electronic transactions, multiple relay points and digital currencies are used. In many cases, fintech vendors may not be as sophisticated or experienced as internal bank staff. Furthermore, because banks are subject to new and heightened obligations to know and understand the beneficial owners and control persons of their fintech vendors, banks need to work with their fintech vendors (as well as monitor them) to meet BSA/AML compliance goals. That means rigorous due diligence, a comprehensive onboarding process and continued, active surveillance of the fintech relationship.

OPERATIONAL COMPLIANCE THEMES

- **Audit Structures/Controls**

The bank will need to establish (or if existing, enhance) its ability to audit both the fintech partner as well as its own compliance and enterprise risk management systems, to include policies, procedures and staffing levels to address, facilitate and operate the venture. Regular documented reviews of this system must occur at both the bank and the fintech partner. If necessary, the bank may need to employ specialized staff in this regard and insist that the fintech company do the same.

- **Contract Concerns**

Probably the most important single item in the fintech relationship is the contract between the bank and fintech company. This should never be a take-it-or-leave-it form. The contract sets forth which party has control over what and when in the relationship. Banks should have legal counsel closely review fintech contracts to make sure bank compliance needs and regulatory concerns are met. Even though some fintech services have standard default rules for banks and customers built in to the platform (e.g., card networks, the NACHA rules, etc.), a well-drafted contract will provide more detail with respect to legal and regulatory compliance and the parties' obligations. Banks can also expand the obligations imposed on the fintech company, which can reinforce, and potentially alleviate, the bank's compliance burden. Perhaps most importantly, the contract can address concerns not contemplated by regulatory schemes so that the bank's obligations and rights are uniform and clear across the entire relationship.

- **Intellectual Property Concerns**

Fintech is driven by innovative technology that optimizes, expands and replaces existing service capacity. To that end, successful fintech companies invest large amounts of time and money to develop proprietary intellectual property—including sophisticated algorithms and complex software that must be closely guarded to prevent competitors from eroding the value of that investment. Whether banks decide to buy, build or partner with fintech companies, there are several types of legal protection that can be employed to maintain a competitive edge for that technology. Identifying the proprietary intellectual property at issue and how to protect it is important, particularly for banks entering into agreements or licenses with fintech companies to co-develop, market or distribute cutting-edge products and services. Legal counsel can help banks address many of these concerns in the written contract with the fintech company or through ancillary agreements, such as nondisclosure agreements and noncompete/nonsolicitation agreements.

- **Technology/Data impact**

Fintech services implement new technologies, including artificial intelligence, machine learning and other data-analytic innovations. These technologies generate enormous amounts of data, ranging from highly sensitive to nonconfidential, and business critical to irrelevant. The biggest and as-of-yet-unresolved issue is ownership of the data. Much of the customer-specific data is legally the property of the bank or its customer. But what about the data created from that data? Control over that data has enormous implications for fintech. Knowing how to sort through the data and which laws and regulations are implicated when obtaining, using, sharing and storing data is crucially important.

- **Data Security, Privacy and Technology-Systems Impact**

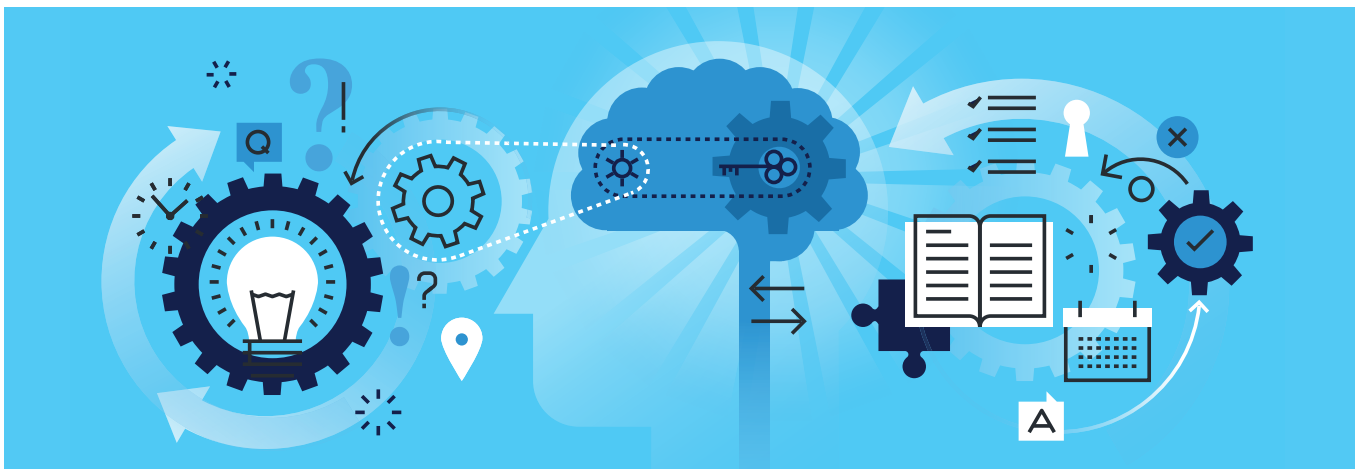
Cybersecurity is also of paramount importance. Depending on the scope, a single data breach has the potential to cause the greatest amount of damage to a bank. For that reason, regulators expect banks to have in place effective measures to counter cybersecurity breaches, including security monitoring, enterprise-wide risk assessments and third-party cyber risk. Furthermore, it's not just that the bank or the fintech company could lose the data regarding a discrete set of customers who elected to use the service. The fintech company can itself be the conduit for a data breach intended to strike at the bank's entire customer database, which gives rise to second- and third-order effects that may be even worse.

As banks know, many fintech products run APIs, which support critical bank functions connected to consumer deposit and account data access, payment systems, credit origination, and compliance management. Governor Brainard of the Federal Reserve has recently highlighted safety and soundness issues with respect to aggregation of consumer financial data by APIs.¹² In her opinion, because banks are more tightly regulated than fintech companies, consumer protection and safety and soundness are greater concerns than cutting edge innovation. In particular, data security and control over third party service providers are essential for banks to meet their safety and soundness obligations.

Governor Brainard also noted that regulators in the United Kingdom and continental Europe are moving forward to outline new approaches to facilitate connectivity in financial services, while attempting to mitigate the associated risks. Nine of the UK's largest banks were required to create open APIs to share non-sensitive, non-consumer-specific information, like pricing, fees, terms, and conditions as well as branch and automated teller machine locations. This initial limited sharing of information has started communication and collaboration across the industry on areas like data standards and organizational governance, which will facilitate work on more contentious questions. Beginning in 2018, EU member states will be required to implement revised Payment Services Directive (PSD2). Among other elements, PSD2 has created licensing regimes for third parties that access bank accounts for purposes of initiating payment orders or consolidating information with consumers' consent. PSD2 mandates that banks allow these licensed third parties to access their consumer accounts (with consumer permission) without premising such access on contractual agreements with the banks.

- **Core System and Other Infrastructure Considerations**

A community bank's core system remains a top infrastructure element, and as such, drives many opportunities and challenges for community banks. With core integration playing a key role in whether community banks consider potential fintech partnerships, over 60 percent of ICBA's Fintech Survey respondents noted they rely on their core providers for fintech opportunities. Of those same respondents, 44 percent of them consider their core service provider an obstacle to partnering with a fintech provider. This data would seem to indicate that while the core may present itself as a reasonable fintech connector, some community banks are looking outside their core for solutions. For those community banks that are working with or considering working with their core providers on new fintech projects, cost, integration fees, ongoing subscriptions, and implementation time appear to be the greatest hurdles to entry.



¹² Federal Reserve Board Governor Lael Brainard, Speech: Where to Banks Fit in the Fintech Stack? (April 28, 2017).

- **Other Infrastructure Considerations**

For community banks the focus is, and always has been, on the customer. Today, changing customer preferences and demands for a modern banking experience are influencing the products and delivery methods community banks offer. The same drivers are persuading banks to initiate partnerships with fintech vendors to offer new services. How a bank delivers its brand value and vision to its customers is likely to be impacted by the confluence of fintech and a bank. New marketing and financial branding strategies may be necessary. Customers may demand more universal banking automation and transformed branch experiences, which will all need to be communicated through a bank’s messaging.

A bank’s staff, culture, and overall strategic plan will play a considerable role in how effective fintech efforts will be at an institution. Banks with nimble, customer-focused staff will generally fare better than institutions with more hesitant operations. Success has also been linked to overt use and knowledge of the new products and services by staff. This activity is often driven by an organization whose passion for innovation and advancement begins at the top with senior management and is disseminated throughout its organization’s culture.

It is important to note that community banks believe nearly 22 percent of the fintech challenges facing banks today hinge on the customer impact, qualified staffing, and the cultural fit to an organization. In confronting these challenges, banks need to invest in rigorous self-examination. What measures does the bank have in place to protect its data from a breach? What remedies are available to the bank with respect to the fintech company’s management of the breach? Does the bank have cyberinsurance? Will the fintech company be able to indemnify the bank for its losses? How will the bank meet its regulatory obligations? These and other questions need to be answered before the fintech relationship starts.





CONCLUSION

Just like any other aspect of a bank's strategy, the foray into fintech should be developed through a bank's strategic plan, with multiple iterations through its risk management and compliance framework before implementation. Below are some key questions to think through as any community bank develops its plan:

- What is the community bank's largest competitive concern?
- In what area of the bank can fintech help achieve the highest returns? Attempt a cost-benefit analysis if there are competing considerations.
- Does the bank have sufficient compliance staff to oversee a significant third-party relationship?
- What will be the regulatory response?
- Is the chosen path consistent with the bank's strategic plan?

Fintech began as a process of experimentation in efficient ways to use technology to deliver customer services. Initially, banks looked to fintech to upgrade their potential to serve a built-in customer base—think of the evolution of credits cards, ATM machines, automated telephone services, electronic bank records, online account access, remote deposit capture, Interactive Teller Machines (ITMs) and more. This history of smart evolution has proven very successful for the community banking industry.

Today, fintech is at a tipping point—companies are not simply focused on enhancing customer experiences—they want to radically change and improve the way banking services are offered in the digital economy. Community banks that wisely engage with fintech will have an opportunity to do just that.

APPENDIX

FINTECH PARTNERSHIP/JOINT VENTURE CHECKLIST

Prior to entering into a partnership or joint venture with a fintech company, a community bank should consider the following regulatory steps and conduct due diligence:

- Conduct due diligence of fintech company, its customer agreements, marketing materials, scripts, compliance management systems and internal controls (and any other third party related to the fintech company);
- Prepare profitability analysis (or, if under an administrative action, whatever other analysis is required of the bank);
- Prepare and review the bank's business plan to reflect the new activities;
- Prepare supplemental policies specific to the activity/relationship (to the extent not already addressed in the bank's existing policies) and prepare procedures to backstop these policies;
- Draft new third-party risk management policy if the bank's existing policy does not speak to risk assessments, monitoring, contract negotiation, etc.;
- Prepare descriptions in detail of the experience of the personnel who will manage the activity as well as board reporting/controls/Management Information System ("MIS") related to the activity;
- Establish board-approved levels of the activity in terms of transaction volume (which may be driven by the risk assessment and could be customer based), etc.;
- Describe how existing IT systems and BSA/AML, Know-Your-Customer, cybersecurity and privacy policies address risks associated with the activity/relationship (or if not, enhance the systems), along with controls to mitigate the risks;
- Revise the bank's strategic plan, enterprise risk management plan, and capital plan to reflect the change in business plan and address the increased risk profile and potential capital needs of the bank.
- Additional corporate actions if forming a separate entity (for example, a limited liability company ("LLC")):
 - Prepare an operating agreement for the LLC;
 - Prepare a service agreement to be entered into between the operating subsidiary and the bank to govern the services provided by the bank on behalf of the operating subsidiary as it relates to the LLC;
 - Form the operating subsidiary as an LLC; and
 - Perform testing on the LLC as it ramps up over time.

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 Peter Weinstock, Partner
Heather Archer Eastep, Partner
Carlton Goss, Associate
Zayne Tweed, Associate

 www.hunton.com
 214-979-3000 (Dallas)
 202-955-1500 (Washington, DC)

 Kevin Tweddle,
Group Executive Vice President,
Innovation & Financial Technology

 www.icba.org
 kevin.tweddle@icba.org
 202-821-4419 (Washington, DC)

 Lindsay LaNore,
Group Executive Vice President,
Community Banker University

 www.icba.org/education
 lindsay.lanore@icba.org
 800-422-7285 (Sauk Centre, MN)

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