REGULATORY INTELLIGENCE BRIEFING — ISSUE 5, 2018

EXPLORING PARTNERSHIPS IN FINTECH

Capco Center of Regulatory Intelligence

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IN THIS ISSUE

EDITORIAL NOTE FROM THE MANAGING PRINCIPAL, CENTER OF REGULATORY INTELLIGENCE

PETER D. DUGAS
MANAGING PRINCIPAL, CENTER OF REGULATORY INTELLIGENCE

Peter has more than 16 years of government and consulting experience in advising clients on supervisory matters before the U.S. government and in the implementation of enterprise risk management programs. He is a thought leader in government affairs and regulatory strategies in support of banks' and financial institutions' compliance with the Dodd-Frank Act and Basel Accords. Prior to joining Capco, he served as a director of government relations at Clark Hill and in senior government positions, including serving as a deputy assistant secretary at the United States Department of the Treasury.

In today's financial landscape, utilizing financial technologies is essential for firms who want to be cutting-edge and stay competitive. But as the financial services industry becomes increasingly technology-focused, it has become clear that there are differences in the way stakeholders want to utilize innovation to move the industry forward. Traditional financial institutions, fintech firms and even regulators and legislators are trying to find solutions, but many times, the parties do not act in unison.

This month's Regulatory Intelligence Briefing (RIB) focuses on how these parties can create cohesion moving forward, and particularly provides advice for traditional institutions and fintech firms on creating beneficial partnerships or discovering the best options for your firm's fintech needs.

Our main article begins with background on how the fintech landscape currently stands, providing an understanding of how regulators and legislators are trying to manage this technology-driven field, and where the trends may be heading for regulation and enforcement. With this background, we consider how firms can protect themselves and most effectively work together when moving into innovative business solutions or product offerings.

Our Congressional Activity Summary delves into some of the implications of the recently repealed guidance on indirect auto lending guidance and compliance with the Equal Credit Opportunity Act (ECOA). On May 21, 2018, President Donald Trump signed S.J. Res. 57 and repealed the Bulletin the Consumer Financial Protection Bureau (CFPB) had put forth in 2013 on indirect auto lending.

Capco Center for Regulatory Intelligence (CRI) has been monitoring this activity since the beginning of 2017, when the guidance came into question under the Congressional Review Act (CRA). Last month's RIB focused on the procedural aspects of S.J. Res. 57, and now that we have a concrete answer to the indirect auto lending guidance's permissibility, we consider what the consequences of these legislative actions may be. We will continue to monitor the rescission's aftermath and keep your institution informed of any developments regarding both indirect auto lending and the CRA.

As always, we will continue to monitor changes and provide any updates. With Congress passing a major regulatory reform bill and the Financial Stability Oversight Council at full occupancy, we are expecting a range of regulatory activity over the coming months. ❖

REGULATORY ROUNDUP

Regulatory and Compliance Alerts

FFIEC Issues New CDD and Beneficial Ownership Examination Procedures

On May 11, 2018, the Federal Financial Institutions Examination Council (FFIEC) issued new examination procedures on FinCEN's Customer Due Diligence Requirements for Financial Institutions (CDD Rule). These examination procedures apply to banks, savings and loan associations, savings associations, credit unions and branches, agencies and representative offices of foreign banks.

OCC Releases Publication on Bank Collaborations with Minority Depository Institutions

On May 22, 2018, the Office of the Comptroller of the Currency (OCC) published the latest edition of its *Community Development Investments* newsletter entitled, "Profitable Partnerships: Collaborating with Minority Depository Institutions." The publication discusses how executives working for minority-owned depository banks can collaborate with large and midsize banks in ways that are profitable and beneficial for all involved parties.

Homeland Security Unveils Strategy to Guide Cybersecurity Efforts

On May 15, 2018, the Department of Homeland Security (DHS) released a strategy outlining the department's approach to identifying and managing national cybersecurity risk. The DHS strategy details a department-wide approach to address the evolving threats to cyber and critical infrastructure security, including a core guiding principle of collaboration.

Trump Signs Economic Growth, Regulatory Relief, and Consumer Protection Act

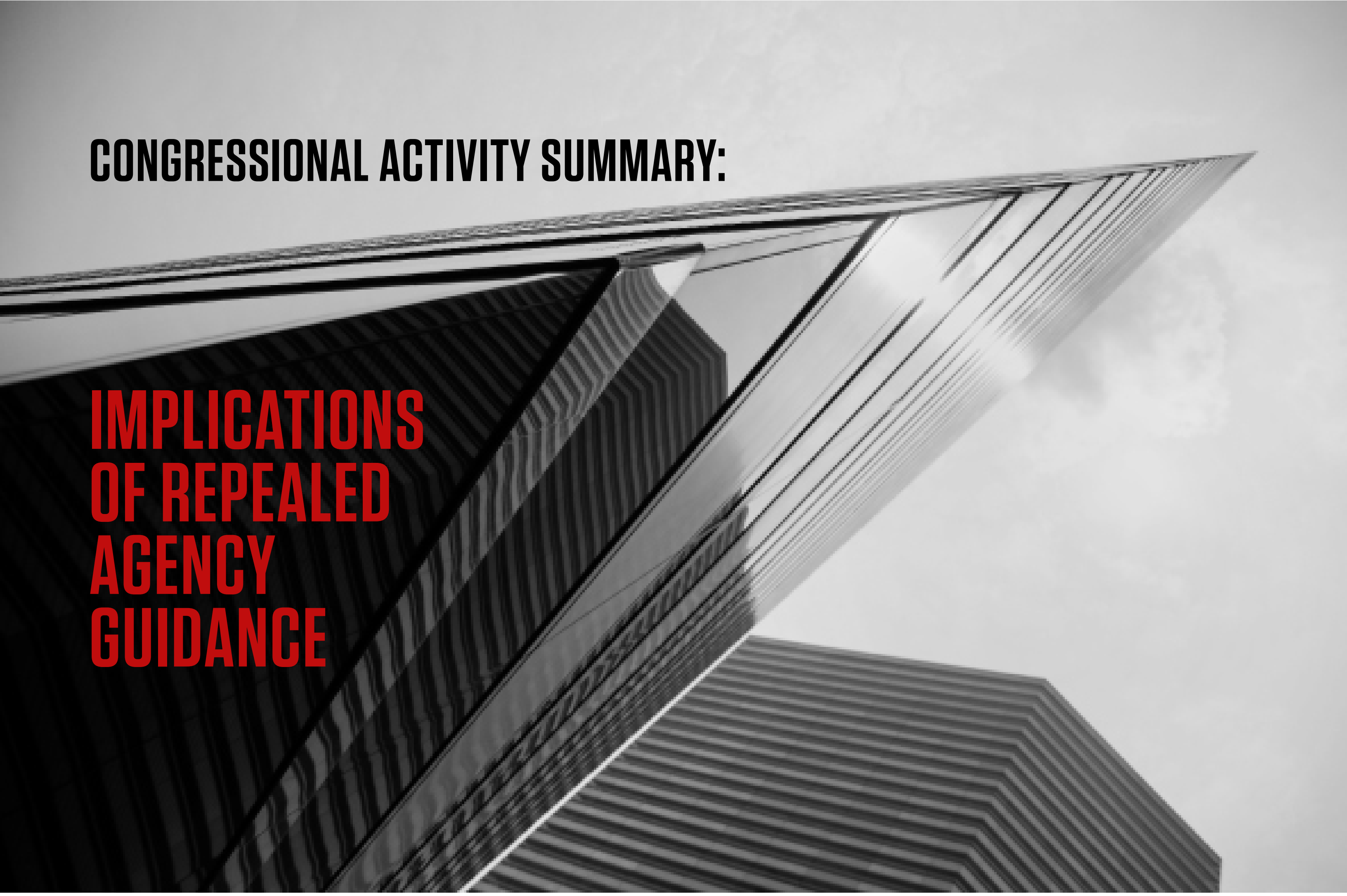
On May 24, 2018, President Donald Trump signed a bill that will make significant reform for financial institutions, and is intended to promote economic growth, provide tailored regulatory relief and enhance consumer protections. Among other things, the bill makes changes to mortgage lending, regulatory thresholds, capital markets, student lending and consumer and veteran protections.

CFPB Releases Complaint Snapshot on Debt Collection

On May 31, 2018, the Consumer Financial Protection Bureau (CFPB) published a Complaint Snapshot on debt collection. The report also includes a high-level overview of trends in consumer complaints and supplements the Consumer Response Annual Report with more recent information about monthly changes in complaint volume.

SEC Issues Final Rule to Eliminate Provision of Certain Personally Identifiable Information in Certain Forms

On May 14, 2018, the Securities and Exchange Commission (SEC) issued a final rule to eliminate the portion of certain forms that request filers to furnish certain personally identifiable information of natural persons, including Social Security numbers. **The final rule is effective May 14, 2018.**



CONGRESSIONAL ACTIVITY SUMMARY:

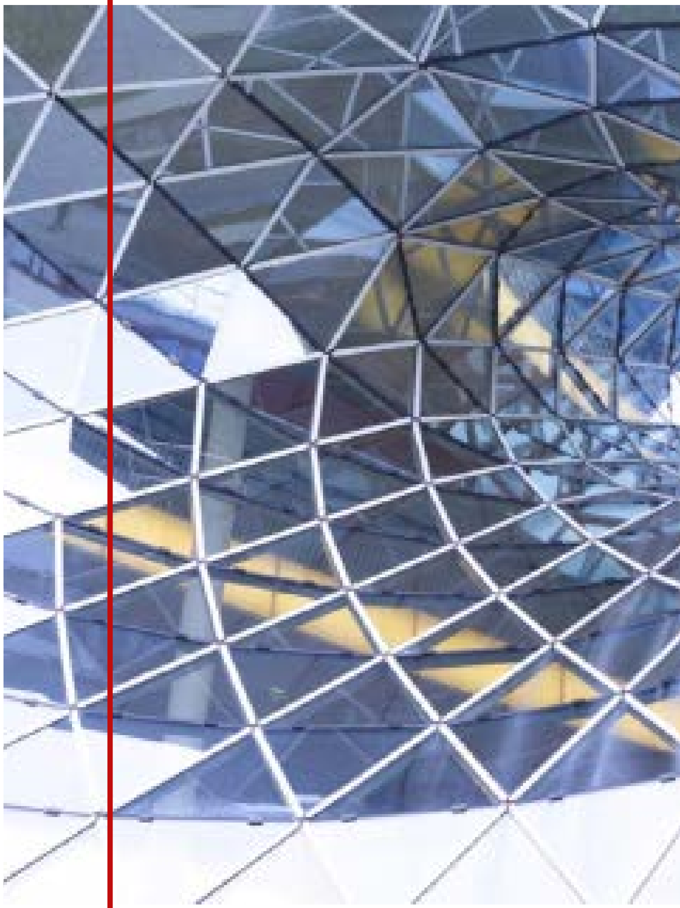
IMPLICATIONS OF REPEALED AGENCY GUIDANCE

On May 21, 2018, President Donald Trump signed S.J.Res. 57, repealing the Consumer Financial Protection Bureau (CFPB) Bulletin issued on indirect auto lending guidance and compliance with the Equal Credit Opportunity Act (ECOA) and its implementing regulations (Regulation B), as applied to dealer markup and compensation policies. The guidance, which had been in effect since 2013, became the focus of the joint resolution of disapproval following a determination by the Government Accountability Office (GAO) in December 2017. The GAO determined that the Bulletin was a "general statement of policy" designed to assist indirect auto lenders in complying with ECOA, and thus, was a "rule" subject to repeal under the Congressional Review Act (CRA). This article focuses on the implications of the guidance's rescission; for a deeper, procedural analysis of the CRA, please see Issue 4 of the RIB.

CFPB Bulletin 2013-02 on Indirect Auto Lending and Compliance with ECOA

Although the Dodd-Frank Act gave the CFPB regulatory authority over ECOA, the CFPB does not have supervisory oversight of auto dealers. Therefore, the primary purpose of Bulletin 2013-02, dated March 21, 2013, was to inform indirect auto lenders of the liability under ECOA for practices that permit dealers to increase consumer interest rates and that compensate dealers with a share of the increased interest revenues.

The Bulletin begins with a discussion of a common policy that allows the dealer to "markup" the interest rate above the indirect auto lender's "buy rate," which is the minimum interest rate at which the lender is willing to purchase the retail installment sales contract. Typically, the dealer is compensated through a "reserve" (or interest revenues) based on the difference between the buy rate and the actual note rate charged to the consumer (after the markup is added) in the retail installment contract executed with the dealer. As such, the CFPB stated that there is a significant risk that this policy will result in pricing disparities on the basis of race and national origin.



Indirect Auto Lenders Considered 'Creditors' under ECOA

The CFPB indicates in the Bulletin that under ECOA, an indirect auto lender is likely a "creditor" when it evaluates an applicant's information, establishes a buy rate and then communicates that buy rate to the dealer. ECOA defines a "creditor" as any person who regularly extends, renews or continues credit, and any assignee who participates in the decision. Regulation B further defines a "creditor" as a person who regularly participates in the credit decision, including an assignee. As such, the CFPB stated that an indirect auto lender is a "creditor" under ECOA and Regulation B if, in the ordinary course of business, it regularly participates in credit decisions. The CFPB recognized that while credit transactions in indirect auto lending may take many forms, the information the agency gathered suggests that the standard practices of indirect auto lenders likely constitute "participation in a credit decision" under ECOA and Regulation B.

Liability of Indirect Auto Lenders for Discrimination Resulting from Pricing Disparities

According to the CFPB Bulletin, indirect auto lenders may be liable for disparities that exist within the lender's portfolio under the legal doctrines of both disparate treatment and disparate impact. The CFPB further stated that an indirect auto lender's policies for dealer markup and compensation may be sufficient to trigger liability under ECOA. To determine if disparities in dealer markup existed in indirect auto loans — "disparate impact analysis" — the CFPB assigned race and national origin probabilities — "the proxy methodology" — that combines geography-based and name-based probabilities based on public data from the U.S. Census Bureau. The CFPB made its interpretation of "liability of indirect auto lenders" apparent through enforcement actions the agency issued against indirect auto lenders for pricing disparities based on dealer markup and compensation. The CFPB also stated that to avoid being cited for a discrimination violation and referral to the Department of Justice (DOJ), indirect auto lenders should either eliminate dealer discretion to markup buy rates or charge a flat fee per transaction. The table below illustrates three of the indirect auto discrimination cases for pricing disparities resulting from dealer markup:

Enforcement Action	Prohibited Basis Groups	Restitution
Consent Order 12/19/13	African-American Hispanic Asian	$80 million
Consent Order 7/14/15	African-American Hispanic Asian	$24 million
Consent Order 9/28/15	African-American Hispanic	$18 million

GAO Letter (B-329129) on Applicability of the CRA to Bulletin

On December 5, 2017, in a response letter to Senator Pat Toomey (R-PA), the GAO determined that the CFPB's Bulletin 2013-02 was a "rule" and subject to the requirements of the CRA. Although the GAO agrees with the CFPB that the Bulletin is a non-binding document that offers clarity and guidance on the CFPB's discretionary enforcement approach for indirect auto lending and ECOA, the GAO also opined that the CRA requirements apply to "general statements of policy" which are not legally binding. According to the GAO, "The Bulletin provides information on the manner in which CFPB plans to exercise its discretionary enforcement power. It expresses the agency's views that certain indirect auto lending activities may trigger liability under ECOA." Therefore, the GAO determined the Bulletin was considered a "rule" and was subject to the CRA. This determination was what allowed Congress to review and eventually disapprove the Bulletin, as the Bulletin was never properly submitted to Congress and the GAO, as the CRA requires.

Potential Impact of the Repeal

The repeal of the CFPB's rule as applied to dealer markup and compensation policies in indirect auto lending opens the topic to new interpretations. While we cannot foresee the direction of any new technical guidance that may be forthcoming from the CFPB, we can be fairly certain there will be changes in the agency's approach to indirect auto lending oversight in the months ahead. The rule's repeal will restrict the CFPB's regulatory authority to cite indirect auto lenders for discrimination under ECOA for pricing disparities related to dealer markup practices. Given that auto financing is the third largest category of consumer debt, and indirect auto lending is the most prevalent type of vehicle financing, the industry eagerly awaits answers to a number of key questions this repeal raises.

1. While the Dodd-Frank Act expressly prohibits the CFPB from regulating auto dealerships, critics of the agency suggested the CFPB circumvented this prohibition by targeting indirect auto lenders that collaborate with auto dealerships. This controversial activity generated over $162 million in settlements of enforcement actions against indirect auto lenders for pricing disparities resulting from dealer markups over the past five years.

Was the repeal of the CFPB's guidance to indirect auto lenders for guarding against pricing disparities in dealer markups a pivotal move to weaken the CFPB's ability to take enforcement action against indirect auto lenders for liability under ECOA?

2. Section 1029 of the Dodd-Frank Act granted auto dealers protection from the CFPB, stating explicitly "the Bureau may not exercise any rulemaking, supervisory, enforcement or any other authority, including any authority to order assessments, over a motor vehicle dealer that is predominantly engaged in the sale and servicing of motor vehicles." Further, pursuant to the CRA, the overturned rule "may not be reissued in substantially the same form, and a new rule that is substantially the same as such a rule may not be issued, unless the reissued or new rule is specifically authorized by a law enacted after the date of the joint resolution disapproving the original rule." The effect is to stifle future attempts at a similar regulatory provision.

Looking forward, because the CRA prohibits any new rule that is "substantially the same," will auto dealers operate unchecked in a market where dealer markup practices are discretionary, based on non-credit bearing factors?

3. Under the March 2013 Bulletin, indirect auto lenders were subject to increased scrutiny for liability under ECOA for practices that permit dealers to markup consumer interest rates and thereby enhance dealer compensation. This increased oversight caused some indirect lenders to change their business revenue models, or perhaps even exit the market due to competitive disadvantage.

If no longer deemed a "creditor" for ECOA liability purposes, indirect lenders may now have reduced incentive to perform periodic fair lending audits, including disparate impact analysis. Will other regulators, both at the federal and state level, step in and require new or enhanced fair lending requirements including the maintenance of prudent dealer markup and compensation policies? Will this repeal change the need for indirect auto lenders and dealers to manage fair lending risk by monitoring their portfolios, conducting training, and establishing other best practices to mitigate the risk of disparate treatment or disparate impact discrimination?

Capco will continue to closely monitor regulatory activity on this topic not only at the CFPB, but also across other federal agencies and at the state level. For more information on the indirect auto lending guidance's rescission, reach out to Capco FRC's Consumer Finance and Fair Banking team at Robert.Cardwell@Capco.com. ❖

FOCUS EXPLORING PARTNERSHIPS IN FINTECH

While traditional financial institutions and fintech firms are both eager to explore new technology-driven opportunities, there is not always cohesion in the way these types of businesses try to advance the industry. In this article, we present ideas to both sides on creating beneficial partnerships and discovering the best options for your firm's fintech solutions.

The relationship between traditional financial institutions and fintech firms is not what it was five years ago and probably is not reflective of what it will be five years from now. When the fintech boom hit the financial services landscape, many traditional institutions and their stakeholders feared the potential effects these innovative firms could have on business. Banks were used to contending with other banks, who faced the same regulatory restrictions (with limited exceptions, such as the Dodd-Frank Act). Fintech firms, however, seemed to be sliding through the cracks of legal and regulatory barriers.

Industry participants urged regulators to more clearly define fintech firms' accountability and legal requirements. Some of this push came from consumers and lobbyists who wanted to ensure consumer protections, but some also came from traditional financial services businesses, and community banks in particular, who wanted to level the playing field.

With regulators beginning to issue options for and opinions on fintech regulation, it has become clear that much of the confusion comes from the rapid pace of change and newness of the types of products fintech firms are introducing to the market. In many cases, the argument could be made that a single fintech firm — or product — could fall under the jurisdiction of several different federal agencies, not to mention the state-specific or international regulatory bodies that could also claim some oversight authority.

However, using regulatory and statutory roadblocks to stunt fintech growth also impedes innovation and the novel products consumers in our increasingly technology-driven world demand. Furthermore, while traditional financial institutions have come to realize the necessity of using technology to deliver competitive product offerings, fintech firms have found that partnering with established institutions can not only help get their products and initiatives to the market, but can also provide some protection from the uncertainty of legal demands.

In many ways, the era of fear and competition between traditional financial services institutions and fintech firms has given way to a modern era of partnership and collaboration. There are new headlines every week of high-profile partnerships, and it is easy to get swept up in trying to join the wave. And while this is often a valid and beneficial option for both traditional financial institutions and fintech firms, there are certain considerations both entities must keep in mind.

In this article, we will review related regulatory and legal developments and then look at the concept of collaboration from the points of view of both traditional financial institutions and fintech firms. We will provide informed suggestions on how to create solid, advantageous partnerships while mitigating risks for both parties and the consumers they serve.

THE REGULATORY RESPONSE

As with any other type of product offered in the financial services industry, it is of utmost importance that products in the fintech field balance a company's fiscal and growth goals with the benefits for and safety of consumers. Regulators, therefore, have been keeping a close eye on these types of products.

Potential Regulatory Solutions

The growth of fintech and the challenges that accompany this growth are not confined to the U.S. In many other countries around the world, financial regulators and government legislators have created solutions to mitigate uncertainty and support safe innovation. One of the top international trends is the regulatory sandbox, which certain European and Latin American countries have been implementing. The U.K.'s Financial Conduct Authority (FCA) launched the first fintech sandbox in 2015.

WHAT IS A 'SANDBOX'?

The concept of regulatory sandboxes in the financial sector is to create space for companies to experiment with innovative products, providing grounds for a test period in which companies may operate new products or services for a limited time and under specific, limiting rules such as the number of users, when the product can be offered or transactional monetary amounts. Firms are therefore able to test original products, services and solutions, while working closely with supervisors to ensure some type of regulation and monitoring.

It is important to note that sandboxes are not for new firms specifically, but for new ideas. They are governed by a set of policies and procedures to allow new, existing or already regulated companies the ability to explore technological advances in different segments of the financial sector while in a controlled and secure test environment. This includes solutions such as online or mobile lending and alternative finance, artificial intelligence-supported portfolio management or consulting, virtual currency and blockchain technology, regtech, insurance, digital banking and remittance and payment systems.

With countries across the globe implementing their own versions of these sandboxes, and with the FCA's announcement that it is in the blueprint stages for a "global fintech sandbox," regulators and legislators in the U.S. have brought up similar proposals in a variety of contexts. One of the main challenges, however, is the sheer number of jurisdictions that have regulatory authority in the country's broad fintech landscape.

While it is possible that regulators could come together to find a common solution, or that legislators could attempt to provide for such cohesion, this has not happened yet. The U.S. has thus far taken an approach more progressionally linked to the current established system. Specifically, individual regulatory agencies have developed their own solutions and policies.

Some Regulatory Responses

OCC

The Office of the Comptroller of the Currency (OCC) has been at the forefront of the fintech conversation in recent years, mostly for its proposed special purpose fintech charter. In March 2017, the agency released a draft supplement to its Comptroller's Manual, describing the reasoning behind, and process by which, the agency might begin chartering fintech companies. The proposed charter has had a long history, marked by opposition and legal battles. However, across various directorships, from former Comptroller of the Currency Thomas Curry to current Comptroller Joseph Otting, the agency has stood by its opinion that offering more options may benefit the market overall.

It also turns out the OCC may be considering more than just fintech charters. Interestingly, in January 2018, the OCC's Chief Innovation Officer Beth Knickerbocker published an article in which she stated the agency is considering developing a "bank pilots" program to further understand "innovative products, services, processes, or technologies." The pilots "may accomplish the same goals as what others call 'sandboxes,' and allow the OCC to foster responsible innovation by OCC-supervised banks and enable participants to obtain OCC feedback early in the development process."

Knickerbocker explained that "Information gathered in the pilots could also inform OCC policies and ensure that we are ready to supervise the new activity when implemented on a larger scale." As is the case with most regulators in the U.S., however, Knickerbocker was quick to refute any assumption that companies would be free of compliance responsibilities, stating that the pilots "do not provide a safe harbor."

CFTC

The Commodity Futures Trading Commission (CFTC) has also been active recently in fintech regulation. The agency has allowed bitcoin futures trading to begin, and has taken a stand that it wants to support technological change and innovation, while still maintaining the right to intervene when necessary and update requirements as the agency sees fit.

One way in which the CFTC hopes to support innovation is through its "LabCFTC" program, which provides a forum for CFTC experts and fintech firms to discuss new products and ideas. It also serves as an avenue for CFTC educational efforts to keep market participants up-to-date on fintech developments.

LabCFTC, announced in May 2017, offers GuidePoint, a dedicated point of contact between fintech innovators and the CFTC. The program not only aims to support the fintech community, but also to leverage fintech innovation "to make the CFTC more efficient and effective as a regulator." Through this initiative, the CFTC holds events and office hours, releases primers and other educational materials and creates fintech cooperation agreements. The program does not shield participants from regulatory enforcement actions, however.

CFPB

The Consumer Financial Protection Bureau (CFPB) operates and manages "Project Catalyst," a program with the stated mission "to encourage consumer-friendly innovation in markets for consumer financial products and services." The program aims to help the agency:

- Engage with the innovator community
- Participate in initiatives that inform policy work
- Monitor emerging trends to remain a forward-looking organization

The agency was among the first federal regulators to begin offering unique supervisory programs for new and innovative products, with Project Catalyst going into effect in November 2012. In addition, in February 2016, the CFPB announced the introduction of its no-action letter (NAL) policy, which allows companies to apply for a CFPB statement to reduce regulatory uncertainty surrounding new products or services that might offer consumer-friendly innovation.

In September 2017, the CFPB issued its first NAL within Project Catalyst, to a fintech company that uses alternative data to make credit and pricing decisions. The NAL requires the company to report lending and compliance information to mitigate consumer risk, and aid CFPB's understanding of the impact of using alternative data for lending decision-making. While the letter may signify a need for more intensive regulation, it is still more cost-effective than fines and restitution payments that companies operating in this space fear.

US STATES

Some states are taking the initiative to create their own sandboxes:

ARIZONA

In March, Arizona became the first state to enact a law that allows for establishing a fintech regulatory sandbox program.

- Arizona hopes that the relief from state licensing requirements will foster more "innovation," which the law defines as, "the use or incorporation of new or emerging technology or the reimagination of uses for existing technology to address a problem, provide a benefit or otherwise offer a product, service, business model or delivery mechanism that is not known by the Attorney General to have a comparable widespread offering in this state."
- Arizona's Office of Attorney General will administer the state's sandbox, which will open for applications in late July.
- Eligible companies include those that offer products that would normally require licensing from Arizona's Department of Financial Institutions, such as money transmitters, consumer lenders, debt management companies, mortgage brokers and deferred presentment companies.
- There will be certain limitations on the programs that are designed to test their efficacy in the market, evaluate implications for Arizona residents and effectively manage levels of risk.
- Participants are not exempt from federal consumer financial services laws, but the new Arizona legislature deems participants to "possess an appropriate license under the laws of this state for purposes of any provision of federal law requiring state licensure or authorization." Thus, the terms of Arizona state law satisfy federal provisions that make it illegal to operate without a required state money transmitter license.

ILLINOIS

Illinois has also proposed a sandbox program. If it passes, the Illinois law would go into effect on January 1, 2019, but it differs slightly from the Arizona law. Particularly, the Illinois bill assigns program administration to the Illinois Secretary of Financial and Professional Regulation. Compared to Arizona's provisions, there would also be shorter test periods for the programs and a lower cap on the number of users.

NEW ENGLAND

Lastly, in the Northeast, six states are attempting to create a multi-state sandbox called "The New England FinTech Sandbox." This regional cooperation initiative would not require a legislative fix, but a number of the states involved in the conversation are considering legislative action.

Comparing developments across the board, it seems that U.S. state-level "fixes" are more on trend with what we are seeing internationally for fintech regulation. Though some federal regulators are attempting to create their own policies to explore solutions, there appears to be reticence to remove certain aspects of compliance requirements for products that qualify for mandated regulatory oversight — especially when it is unclear which mandates apply to these novel products.

Congress's Response

As traditional financial institutions, start-ups, established fintech firms and regulators have all come forward to urge a common response, Congress has begun exploring ways they can help in the fintech sector. On January 30, 2018, the House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit held a hearing titled "Examining Opportunities and Challenges in the [Fintech] Marketplace."

Hearing witness Brian Knight, from George Mason University's Mercatus Center, provided three suggestions for ways in which Congress might help:

1. Clarifying existing regulation, including but not limited to issues around the validity of a loan made by a depository institution in conjunction with a fintech lender partner so that consumers can benefit from more efficient and competitive credit markets

2. Modernizing regulation to eliminate unnecessary or unjustified barriers to competition from new firms, including but not limited to fintech lenders and money transmitters being subject to state-by-state licensing and limitations while their bank competitors enjoy broad uniformity granted by federal law

3. Enabling regulators to provide the necessary and appropriate regulatory environment where companies can experiment with innovative services while ensuring appropriate consumer protection

The first suggestion refers to a series of lawsuits that highlighted confusion over the "valid-when-made" doctrine (which provides a loan that is valid at inception cannot become usurious upon subsequent transfer to another person or company) and the "true lender" theory (determining which party in a partnership or third-party relationship agreement has the predominant economic interest in a transaction). Many stakeholders in the financial services industry have been eagerly awaiting a clear, definitive solution to this, and while there has been proposed legislation attempting to offer solutions, including H.R. 4439, H.R. 3299 and S. 1642, none seem close to approval and passage.

Why the Lack of Legislation May Be Hindering Regulators

The fact that there is not a confirmed legal answer to this confusion affects not only the institutions and firms involved in these types of transactions, but also the regulators charged with compliance oversight. Essentially, regulators' efforts themselves become stymied, as they cannot accurately define and implement the safety nets necessary for full-fledged fintech exploration and instead seem to be fitting new offerings into out-of-date policies.

HOW TO PROCEED AS A MARKET PARTICIPANT: TRADITIONAL INSTITUTIONS

With a large variety of fintech product types in the market or in development, it can be challenging for financial institutions to know where to start once they decide to utilize certain fintech solutions. And with the fear of negative repercussions for mistakes or risks, it is prudent for institutions to carefully consider each decision and document these considerations.

A "decision tree" approach may best fit many types of institutions hoping to delve into the fintech realm. This means that for each decision, a team should record all factors they take into consideration, including the benefits and detriments. Each "decision" not only includes the active steps the institution decides to take, but also the opportunities it decides to forgo. For the next decision the institution considers, the previous decisions (and their benefits and drawbacks) should come into play.

The Decisions

Your financial institution's decision tree should start with determining what types of fintech products or solutions best fit your firm's strategic plans. Prioritize opportunities that best serve your customer base and fit within your institution's short- and long-term goals. This could include real-time payments, digital delivery, data analytics or artificial intelligence.

Then, if applicable, share these determinations with your core processors. For community banks, core processing systems are a critical infrastructure element. A core processor, therefore, can inform important decisions, and many are already involved in the fintech space. Open conversations on new or next-generation capabilities, technologies and systems can impact a core vendor's investment choices.

WHY DOCUMENTING DECISIONS MATTERS

If a bank decides to partner with a third-party remittance solutions provider, the bank will have to document many aspects of the third party's business, and the bank's own outlooks for advantages and disadvantages of the partnership. Because the bank is concerned about money laundering risks, it decides it wants to receive reports every other week on the third party's Know Your Customer (KYC) efforts. After two years, the third party asks if it may make the reports less frequent, as the firm would like to cut costs. The bank looks back at the initial partnership decision and notices it was expecting the third party to be working with a higher percentage of legal entity customers, which require higher levels of due diligence, and according to the reports, these types of customers are not as common as initially projected. After re-reviewing these criteria and their relevance to the nature of the partnership, the bank decides to oblige with the third party's request, since the bank can rely on their reasoning behind a previous decision to inform this decision.

Next, choose a model for fostering your fintech projects. The primary choices are:

- Building a solution in-house
- Collaborating and contracting with a third party to build a solution
- Creating a "white label partnership," where your institution does most of the client-facing tasks, but uses a third party's technology
- Forming "referral partnerships," in which you refer customers to an outside vendor if the customer requires products or services you do not offer, or if the customer is not eligible for participation in a product or service at your institution
- Working with a third-party intermediary to manage fintech collaborations
- Purchasing a financial technology solution

If your institution does not have enough information to decide on the best model, you may consider issuing a request for information to obtain more information on a technology or capability for a system, product or service. Subsequently, you may issue a request for proposals to formally request details and pricing from the market.

When deciding on what model best fits your institution, consider time, short- and long-term goals and the particular importance of the product or service for reaching the firm's goals. Fintech collaboration should follow the same process as working with any new third-party vendor, but should also consider the risks associated with the fintech product or solution. Considerations may be broad or specific such as:

- Fraud risk
- Data encryption standards
- KYC concerns
- Firm's operating history
- Firm's capital
- Firm's investors
- What types of customers will be included

It is essential to confirm throughout the selection process that any potential partner can meet regulatory expectations. Because regulatory uncertainty still exists across the industry, it is best practice to fully review each product or service individually for regulatory compliance. Oftentimes, the onus of finding the right balance between fintech innovation and consumer risk falls on the traditional institution utilizing the innovation. Regardless of the method of partnership or collaboration, and especially for in-house solutions, your institution must prioritize compliance and regulatory considerations.

Lastly, flexibility is important. Do not lock your institution into positions that will be difficult to pivot from; strict long-term deals, for example, may not be the best option. It is essential to keep the conversation going with your core processor, especially if the desired solution is enabled through a third-party fintech provider and could impact systems and processes with the core processor. While it may be necessary to make an investment to move ahead in the fintech space, in order to stay competitive, you should remember that your firm may want to be a part of the next big innovation.

RISKS TO ASSESS WHEN ENTERING A MARKETPLACE LENDING RELATIONSHIP

A common example of a partnership in the fintech sphere is when a traditional institution partners with a third-party online marketplace lender. Though specific to the field of lending, some of the best practices associated with this type of partnership can be translated into other fields as well. These best practices include:

Contemplate making all consumer financial protection policies of the marketplace lender joint policies of the bank.

Consider whether to require ongoing compliance monitoring and testing of the marketplace lender's origination and servicing processes match the bank's own internal monitoring and testing.

Become familiar with the marketplace lender's compliance training and consider involving the bank in the review and approval stages for training.

Evaluate the marketplace lender's vendor risk management program.

Explore different required testing scenarios, including an annual independent audit of the marketplace lender's compliance management system, including risk-based transaction testing.

Do not overlook call monitoring of origination and servicing call centers, as applicable.

Continually review the marketplace lender's website to ensure timely updates are completed.

Consider having the bank receive and review all customer complaints to the marketplace lender.

Establish a suspicious activity capture and referral process before any loans are funded to enable the bank to file timely, accurate and complete SARs, as necessary.

Create a separate oversight program within the bank's CMS for managing compliance risk from strategic partnerships with marketplace lenders.

A previous issue of the FDIC's Supervisory Insights *highlights further risks and advice for mitigating those risks.*

HOW TO PROCEED AS A MARKET PARTICIPANT: FINTECH FIRMS

For a fintech firm, a similar "decision tree" approach is necessary for your own due diligence purposes, especially in the early stages of development before deciding whether to operate independently or to partner. Since it is not always obvious what rules apply, it is critical to not only thoughtfully consider each decision in the product development process, but also to understand what constitutes a "decision," determine what factors you are taking into consideration, be able to clearly support each conclusion and document each step of the way and the aftermath of each decision.

Since current regulatory trends show regulators are trying to fit innovative products into preexisting definitions, it is critical to explore what different regulators may consider your product or service to "be." For example,

- The Financial Crimes Enforcement Network (FinCEN) found "administrators" and "exchangers" of virtual currencies likely need to be registered as money services businesses (MSBs), unless certain exceptions in the definition of an MSB apply.
- The IRS found virtual currencies should be treated as "properties" for U.S. federal tax purposes.
- The CFTC considers virtual currencies "commodities," so that the agency has jurisdiction over virtual currencies when they are used in a derivative contract, or if there is fraud or manipulation involving virtual currencies traded in interstate commerce.

Then, you might consider licensure options, depending on the products or services your firm offers. For example, according to the OCC, there are certain activities that are "core banking functions": taking deposits, paying checks or lending money. Companies that engage in all three of these types of services may be required to be licensed as a "bank," but there are sometimes other options.

ILC LICENSES

One of the options for non-banks hoping to move into deposit-taking is an Industrial Loan Company (ILC) license, which the FDIC offers, but which has not been utilized recently. However, FDIC Chair Jelena McWilliams said in a hearing before the Senate Banking Committee on January 23, 2018, that "the law of the land is that the ILCs exist — it's a statutory mandate — and the job of the FDIC is to give each ILC application due consideration and, if appropriate, proceed with the approval." She further stated that she is willing to look into "where the holdup has been in the approval process" for ILC licenses. McWilliams was confirmed into the position on May 23, 2018, and Capco CRI will monitor any developments in this area.

Regulators are likely to enforce laws under what their agency considers your products to be and what licensing they think you should have. It is therefore critical to show that you have put thought into what you consider your products and why you feel a certain licensing option best fits your firm. If there ends up being a question of legality, you have documentation to show thoughtful, informed decisions and not simply decision by indecision.

Letting a decision get away from your firm can cause more headaches in the long run. Your institution's bottom line, reputation and level of compliance can be boiled down to one key principle: if your firm offers something that is associated with established rules and regulations, your firm needs to follow those rules, or be able to prove why the rules don't apply. Doing your due diligence from the beginning can benefit your institution regardless of what operational model you decide to use to bring your product or service to market.

For fintech firms that decide to operate independently, heightened attention toward decision making can help mitigate institutional risks. For firms that decide to partner, properly recording decisions can establish a more successful and rewarding partnership, since you will be able to quell a potential partner's uncertainties with documentation of research and good-faith effort.

TOP LEGAL CONCERNS FOR FINTECHS:

- Understanding regulatory requirements
- Lack of all-inclusive standards
- Traditional regulation for non-traditional innovation
- Government monopolies on currency
- Data privacy and cybersecurity concerns
- Intellectual property infringements
- Partnership and collaboration mistakes with any associated exit clauses
- Funding sources

TIPS FOR A SUCCESSFUL PARTNERSHIP FROM BOTH SIDES

Once a financial institution and a fintech firm decide to partner, there are some things to keep in mind for a successful partnership that is advantageous for all parties involved.

1. **Create a realistic timeline:** Understand that it takes time to not only build a detailed and operational strategic plan, but to also build a relationship.There are bound to be differences in the ways two companies operate, and putting an effective partnership into place almost always takes longer than initial expectations.

2. **Define roles:** Designate a point person or team leader on each side who has a track record of transparency and proven strong communication skills. Creating clear roles and management positions will ensure each side is kept abreast of each decision and update.

3. **Communicate:** Meet face-to-face and switch off between home bases to balance the power and create trust. If it is not within the budget, use a video conferencing service. Placing faces to names is vital to creating relationships; seeing how a company works and what their corporate environment feels like can be very informative and will help mitigate culture clashes.

4. **Manage risk:** Talk about risk mitigation from both sides, and talk about it early on and often. Ensure that both sides understand what risks exist for all stakeholders, including customers, the financial institution and the fintech firm. ❖

ABOUT CAPCO

Capco is a global business and technology consultancy dedicated to the financial services industry, plus a dedicated energy division. Capco delivers innovative solutions in Banking & Payments, Capital Markets and Wealth & Asset Management, designed to withstand market forces, continual regulatory change and increasing consumer demand.

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CONTACT US

Capco Center of Regulatory Intelligence
1101 Pennsylvania Ave., NW Suite 300
Washington, DC 20004
E: capco.cri@capco.com
P: 202.756.2263

@CAPCO

WWW.CAPCO.COM

CAPCO