Recent BaaS Enforcement Actions

Lessons For Effective BaaS Risk Management

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Agenda

1. Definitions
2. Regulatory Environment
3. Business Environment
4. The Future of BaaS

Definitions

What We Talk About When We Talk About BaaS

There are no standard definitions of Banking as a Service ("BaaS") terminology. To avoid confusion, for the purposes of today's session

- **BaaS** is the provision of banking products and services through third-party distributors under the powers granted by the bank's license. The respective roles and responsibilities of the bank and the third party can vary widely:
  - **'Traditional' Sponsor Banking** - The Bank's role consists primarily of providing a banking license, payments system connectivity, and oversight of the third party. *Example - Chime.*
  - **Embedded Finance** - The Bank also supports operations for the partnership, with the third party role primarily consisting of managing marketing and embedding the customer interface into its user experience. *Example - Apple Card.*
- Some, but not all, BaaS banks use **BaaS platforms** or other **technology service providers** to interface with third-party distributors. Both provide software that allows the bank to connect to third parties and manage their BaaS business. Platforms may also perform other functions, including sourcing of clients, provision of operations, and (in a fast-dwindling number of cases) intermediating the relationship.
- BaaS overlaps with, but is **<u>not</u>** the same as:
  - **Providing banking services to fintechs** - Many fintechs operate under their own licenses or do not need licenses to conduct their activity. *Example - PayPal.*
  - **Application program interface ("API") Banking -** BaaS banks often uses APIs to connect to third parties, but this is not the only way to conduct BaaS. And many technology-enabled firms use APIs for other banking needs.

Regulatory Environment

Agency Action Overview - By the Numbers

Since 2021, federal banking regulators and the CFPB have taken a wide range of actions specifically targeting or materially impacting bank-fintech partnerships

17 Proposed or final regulations and guidance documents

2 "Novel Activities" supervision programs

39 Public enforcement actions

BaaS Regulatory Prospects/Rules

Date	Action	Description	Agency	Stage
9/17/2024	NPR: Custodial Deposit Accounts and Pass-Through Insurance	Would require banks that offer certain custodial accounts (e.g., FBOs) to conduct daily reconciliation, have continuous access to end user account data, and take other steps to ensure compliance with pass-through requirements. .	FDIC	Proposed / Request
7/31/2024	RFI: Bank-Fintech Partnerships	Solicits input on the nature of bank-fintech arrangements, effective risk management practices regarding bank-fintech arrangements, and their implications.	Interagency	Proposed / Request
7/30/2024	NPR: Brokered Deposits	Would undo 2020 modernization, recharacterizing virtually all fintech deposits as "brokered."	FDIC	Proposed / Request
7/25/2024	Guidance: Joint Statement on Banks' Arrangements with Third Parties to Deliver Bank Deposit Products and Services	Highlights potential risks inherent in deposit-focused fintech partnerships and provides examples of effective risk management practices.	Interagency	Final
7/1/2024	Planned NPR: Consent to Engage in Certain Covered Activities	Would establish filing requirements for FDIC-supervised banks that seek to engage in certain covered activities, including fintech partnerships.	FDIC	Planned
7/1/2024	Planned NPR: Notifications and Recordkeeping Under BSCA	Would require banks to provide notification of certain third-party relationships under the BSCA, and create an ongoing requirement to periodically update the information.	Interagency	Planned
5/3/2024	Interagency Guidance: Third-Party Risk Management - A Guide for Community Banks	Useful guide highlighting risks, regulatory expectations, and effective practices for community banks that want to engage in partner banking.	Interagency	Final
4/30/2024	Updates to Liquidity Exam Manual	Updated Section 6.1 of the Risk Management Manual of Exam Policies ("Liquidity and Funds Management") to state that "deposits obtained through programs marketed by third parties (such as a broker-dealer, financial technology firm, reciprocal network, or other third party)" are considered "wholesale funds."	FDIC	Final
11/17/2023	NPR: Larger Participants in Payments Rule	Would subject consumer-focused payments apps to CFPB supervision under its "larger participants" rule if they process at least 5 million transactions annually.	CFPB	Proposed / Request
10/11/2023	NPR: Corporate Governance and Risk Management Guidelines for Banks >$10 billion	Would establish large bank-like heightened standards for banks with $10bn+ in assets, and reserves right to apply to banks with operations that "present heightened risk."	FDIC	Proposed / Request
6/9/2023	Interagency Guidance: Third-Party Risk Management	Unified federal agency guidance regarding bank's use of third parties, including fintechs and other nonbank distribution partners.	Interagency	Final

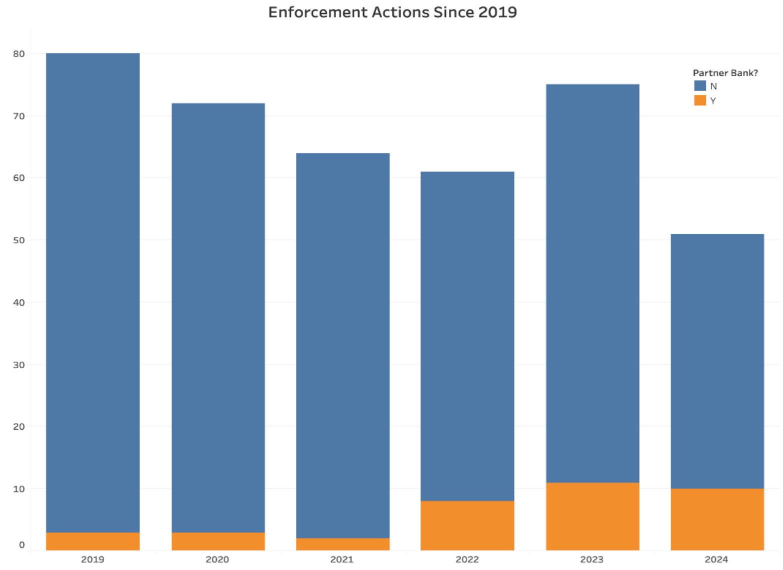
BaaS Regulatory Prospects/Rules

	2021				2022				2023				2024		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Agency															
OCC										Updates to liquidity handbook Novel Bank Supervision Program					
FRB			Guidance on bank-fintech partnerships								Novel Activities Supervision Program				
FDIC												NPR on corporate governance and risk mgmt.	Deposit insurance advertising rule	Update to liquidity exam manual	NPRs covering brokered deposits, FBO accounts, ILCs, and filing requirements
CFPB												Larger participant rule for payments companies		Registry of nonbanks under orders BNPL rule	NPR on FCRA
OCC, FRB, FDIC			Guidance on due diligence of fintechs							Updated Interagency TPRM guidance				TPRM guidance for community banks	RFI on partnerships Deposit partnership Joint Statement NPR on BSCA recordkeeping

Proposed | Final

BaaS Enforcement Actions

Enforcement actions against partner banks are climbing, with much of the recent activity driven by BSA/AML issues.



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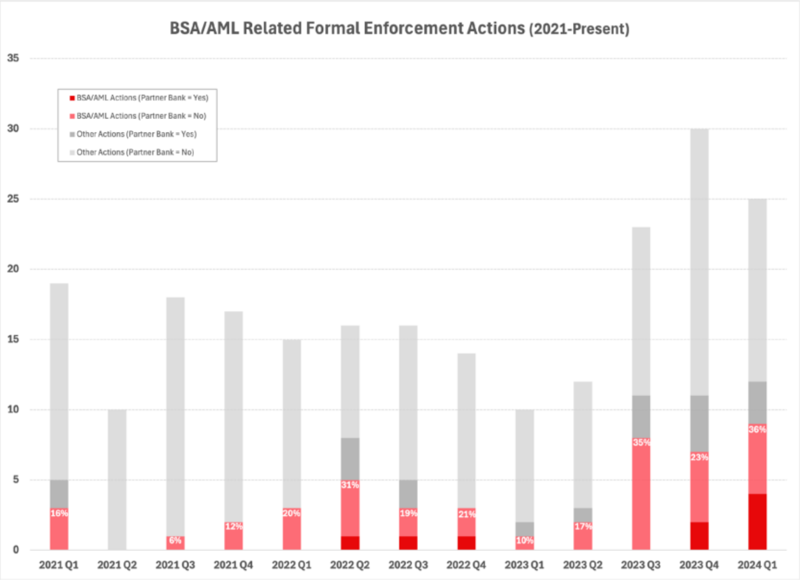


Recent Enforcement Actions: Inventory

Bank	Regulator	City	State	Total Assets ($000)	Order Type	Issued Date
Customers Bank	FED	Malvern	PA	20,956,641	Written Agreement	August 5, 2024
Green Dot	FED	Provo	UT	4,644,087	Cease & Desist, Civil Money Penalty	July 19, 2024
Thread Bank	FDIC	Rogersville	TN	709,471	Cease & Desist	May 21, 2024
Evolve Bank & Trust	FED	West Memphis	AK	1,679,658	Cease & Desist	June 11, 2024
Piermont Bank	FDIC	New York	NY	551,321	Cease & Desist	February 27, 2024
Sutton Bank	FDIC	Attica	OH	2,162,075	Cease & Desist	February 1, 2024
Lineage Bank	FDIC	Franklin	TN	271,411	Cease & Desist	January 30, 2024
Blue Ridge Bank, NA	OCC	Martinsville	VA	2,913,225	Cease & Desist	January 24, 2024
Choice Financial Group	FDIC	Fargo	ND	4,935,807	Cease & Desist	December 18, 2023
First Fed Bank	FDIC	Port Angeles	WA	2,205,162	Cease & Desist	November 21, 2023
b2 Bank, NA	OCC	Mountain Iron	MN	83,981	Formal Agreement	November 14, 2023
Vast Bank, NA	OCC	Tulsa	OK	602,837	Cease & Desist	October 23, 2023
Metropolitan Commercial Bank	FED	New York	NY	7,264,517	Cease & Desist	October 16, 2023
WEX Bank	FDIC	Sandy	UT	7,597,943	Cease & Desist	September 20, 2023
Cross River Bank	FDIC	Fort Lee	NJ	8,815,206	Cease & Desist	March 8, 2023
Blue Ridge Bank, NA	OCC	Martinsville	VA	2,913,225	Formal Agreement	October 29, 2022

Recent Enforcement Actions: Topics Covered

Bank	Board Governance	Consumer Compliance	CMS	BSA/AML	Internal Audit	TPRM / Oversight	Credit Risk	Interest Rate Risk	Operational Risk	Financial Risk Mgmt	Liquidity Risk	Strategic / Capital Planning Req	Restrictions on Business
Customers Bank	Y			Y					Y				Y
Green Dot	Y	Y	Y	Y									
Thread Bank	Y			Y		Y				Y	Y	Y	
Evolve Bank & Trust	Y	Y		Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
Piermont Bank	Y	Y	Y	Y	Y	Y		Y		Y	Y	Y	Y
Sutton Bank				Y		Y							
Lineage Bank	Y			Y	Y	Y					Y	Y	Y
Blue Ridge Bank, NA (2024)	Y			Y	Y	Y			Y		Y	Y	Y
Choice Financial Group	Y			Y									
First Fed Bank	Y		Y			Y							Y
b2 Bank, NA	Y			Y		Y	Y			Y		Y	Y
Vast Bank, NA	Y							Y	Y	Y	Y	Y	Y
Metropolitan Comm. Bank	Y			Y		Y							
WEX Bank	Y	Y	Y		Y								
Cross River Bank	Y	Y				Y			Y				Y
Blue Ridge Bank, NA (2022)	Y			Y	Y	Y			Y				Y

CONFIDENTIAL

Not included in enforcement

Included in enforcement

Some Notable Actions

Despite the evolving regulatory landscape, the past is prologue when it comes to regulatory oversight of partner banks. Institutions involved in or considering entering partner banking should learn the lessons of these partner banks and why they ended up in the regulatory penalty box. We highlight several noteworthy examples below and focus on what went wrong.

Example	What Went Wrong	Description
Piermont Bank (Feb. 2024)	**Inadequate oversight, risk management, and data and systems for BaaS business**	The FDIC's February 2024 order found the bank lacked adequate internal controls (particularly BSA/AML and consumer compliance), information systems, and oversight for its BaaS program. The order also raised concerns about senior management expertise and compliance/risk resources. The order requires enhancements to Board oversight, third-party risk management (TPRM), BSA/AML and consumer compliance, and data and systems, and look-backs of potentially suspicious activity and disputes.
Lineage Bank (Jan. 2024)	**Inadequate oversight and risk management practices concerning the bank's fintech partners**	The FDIC's January 2024 order on the bank's BaaS program cited issues with board oversight, TPRM, BSA/AML, liquidity risk, and contingency planning. The order required a capital plan, strategic plan, growth plan, budget and profit plan, funding concentration reduction plan, and contingency plan for winding down "significant third-party FinTech partners."
Cross River Bank (Mar. 2023)	**Inadequate oversight of fair lending risks related to its fintech partners**	The FDIC consent order found deficiencies with BaaS program internal controls, information systems, and fair lending compliance. The order required the bank to obtain FDIC non-objection prior to offering new credit products or entering new credit partnerships.
Blue Ridge Bank (Aug. 2022 and Jan. 2024)	**Inadequate oversight of fintech partners in its BaaS portfolio**	The OCC's 2022 consent order found deficiencies in the BaaS program, including TPRM, BSA/AML compliance, and IT control and risk governance. The order required the bank to obtain OCC non-objection before contracting with any new fintech partners or offering new products for existing partners. In a subsequent 2024 order, the OCC found the bank to be in troubled condition and cited deficiencies including "systemic" BSA/AML control "breakdowns" and failure to correct regulatory issues. This order required TPRM and BSA/AML remediation, a look-back review, and refreshed strategic and capital plans, and increased the bank's minimum capital requirements.

*See Appendix for an inventory of BaaS-related enforcement actions and the topics covered therein.

Common Risk Management Enhancements

Partner banks are responding to increased regulatory scrutiny. Common themes include:

- Strengthened ledgering and reconciliation capabilities
- Deeper initial diligence and ongoing oversight
- Enhancements to partners' contractual obligations
- Clearer articulation of the Bank's risk, compliance and control expectations of partners
- In-sourcing of key controls, especially those related to BSA/AML transaction monitoring and, for credit programs, fair lending testing
- Strengthened business continuity and contingency planning in relation to partner programs
- Development of bank-run risk- and compliance as a service offerings to support embedded finance options with lower third-party risk
- Greater collection and standardization of partner data, in order to inform bank reporting and controls
- Upgraded risk and compliance staffing
- Reassessment of risk tolerances and review of existing programs to identify and exit those with poor risk/reward trade offs
- Lower use of 'BaaS Platforms' as intermediaries and more use of them as bank-controlled software patterns

In the short term, this work increases partner bank costs. However, partner banks are also getting more pricing power and the banks that enhance well will have a greater 'moat'

A Strong Business Supports Strong Controls

Strong partner banking controls don't happen in isolation. Business, operations, and technology have a critical role to play in developing a well-controlled partner banking business. Successful partner banks have:

- Differentiated business capabilities and niche expertise, allowing the bank to attract top-tier programs within its key verticals
- A common understanding of the types of businesses the bank wants to serve and what their value proposition is to end-customers (and the ability to explain that to regulators in language they understand
- Robust data collection and management capabilities, with best practices involving a data lake which a common data taxonomy allowing for effective controls and customized reporting
- Strong ability to integrate with third-party service providers, such that control functions can take advantage of leading-edge regtech products that support partner risk management
  - Better to be the bank able quickly to deploy 'Grammarly for Marketing Material Review' to your clients!
- Strong risk-based pricing

Notably, quite a few partner banks with enforcement actions did not build out strong business or operational functions. It is no surprise that those banks ended up with many of the weakest partners.

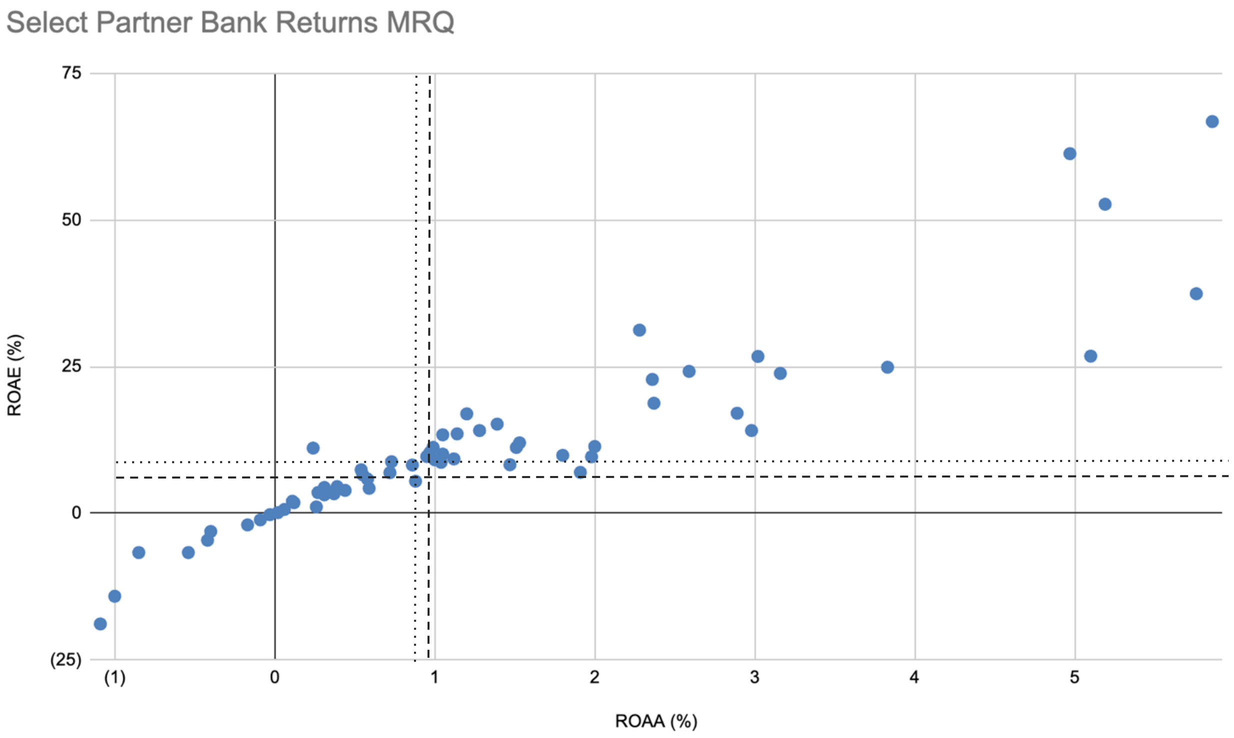
Business Environment

Competitive Dynamics

There are structural reasons why BaaS presents competitive opportunities to smaller banks

- **Durbin-Exempt Interchange.** Debit interchange revenue for banks under $10bn is more than double that of larger banks, and the Fed's proposed changes to Reg II would make that difference even larger
  - Any program materially reliant on debit interchange effectively has to work with a smaller bank
  - The business is scalable, since excess deposits can be 'Intrafied' and excess assets can be sold back to partners
- **Fewer Competitive Concerns.** Most partner programs have a national footprint. Working with smaller banks that don't compete nationally helps avoid conflicts of interest.
  - Smaller banks can also be nimbler about pursuing targeted opportunities with favorable risk/reward trade offs
- **Scale Business -** Building the technology, operational and control infrastructure necessary to do partner banking right involves significant upfront costs
  - Returns come when the business scales, both in terms of the number and size of programs - this takes time
  - As a rule of thumb, many successful banks look to make a small marginal profit through monthly minimums on programs not yet at scale, with the programs at scale making the business profitable
  - The time it takes suits those small banks with the ability and patience to invest for the longer term
- **Flexibility to make smart risk/reward decisions.** Smaller management teams find it easier to align on risk tolerance. In larger banks, many business leaders fight BaaS initiatives through fear of 'collateral damage'

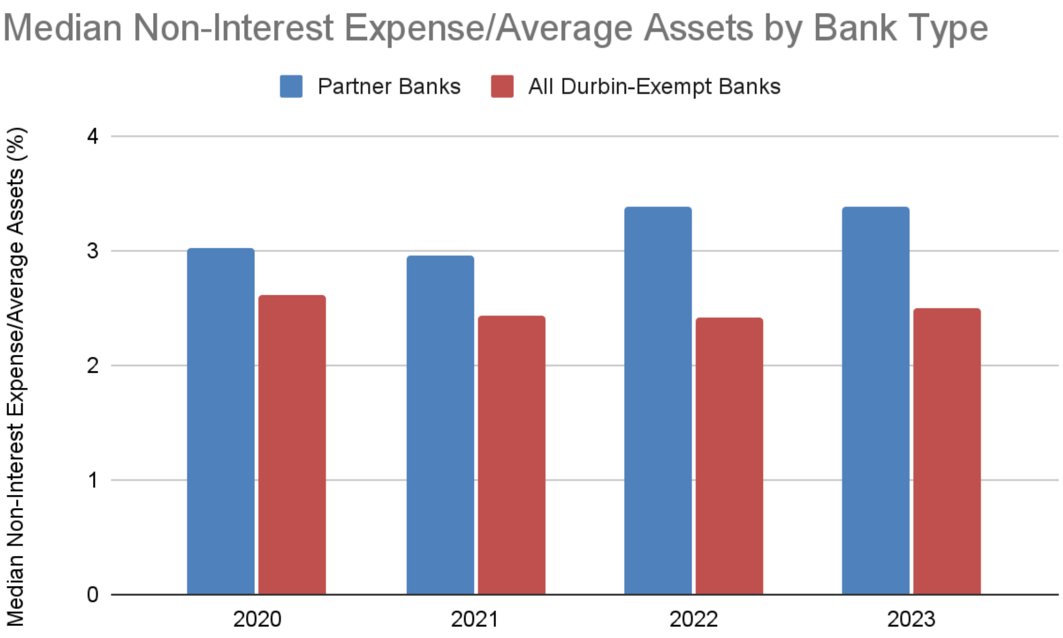
Select Partner Bank Returns



	Partner Banks	All Durbin-Exempt Banks
Median ROAA	0.98	0.96
Median ROAE	8.97	10.42

Partner Banking - a Scale Business

The fixed costs involved in partner banking are relatively high compared to traditional community banking, so having one or two programs is not a stable long-term solution.



Differentiated Business Model

A crucial question partner banks must answer is how they will differentiate themselves from the other ~130 partner banks in the United States. Here are eight potential strategies, none of which require in-house build of cutting edge technology

- Build Risk and Compliance as a Service offerings that will appeal to embedded finance clients
- Develop strong data connectivity that allows for more automated client oversight
- Find one or more specialist market niches. For example, becoming the go-to partner bank for cashflow lending to the 1099 economy or SME inventory finance
- For banks with excess deposits, accompany loan sponsorship with provision of balance sheet capacity in the form of retained loans or warehouse capacity
- Develop playbooks, client standards, and processes that demystify the onboarding process for new clients and provide predictable operational performance to existing clients
- Develop expertise in non-standard customer onboarding. For example, there is huge demand for low-limit USD accounts for non-U.S. residents
- Expose existing bank products or services as embedded finance offerings
- Demonstrate ability to build custom products and services for larger and high-margin clients

The Future of BaaS

Gazing Into The BaaS Crystal Ball

- Approximately half of the ~125 current partner Banks will exit the business line in the next three years
- But a significant number of other banks will enter BaaS. Those that invest smartly in technology, operations, risk, and compliance will do well - at least two of the top-ten partner banks in five years time will be banks not thought of as partner banks today
- Sponsor banking and embedded finance will become more clearly distinct
  - Larger bank entrants will target (non-debit card) embedded finance
  - Service providers will develop embedded banking solutions that smaller banks can use
  - In response to more realistic sponsor bank pricing, more fintechs will find ways to launch using embedded finance solutions
- Lending-as-a-Service will increase in prominence, especially in relation to lending to small and micro businesses.
- Regulatory enforcement will continue, but:
  - The BaaS business model will survive. Regulators will coalesce around Mike Hsu's position of "This is the future, so let's do the future right"
  - Heightened regulatory standards will, over time, provide an increasing competitive advantage to those with strong controls and regulatory relationships

Questions

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