Fintech: Friend or Foe of Banks?

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It seems as if everyone wants to get on the fintech bandwagon — even the banking regulators. The Office of the Comptroller of the Currency recently announced that in the fall of 2017 it will be opening an "Innovation Office" to allow financial institutions the opportunity to explore new technology-based banking products and services while still supporting applicable law and regulation, including consumer protection. Similarly, the Consumer Financial Protection Bureau has a "Project Catalyst" to promote the use of technology in financial services. The Comptroller has gone so far as to say it is exploring a special limited-purpose national bank charter for fintech companies.

Such measures are refreshing given that the regulation of banks in part gave rise to the innovators and "disrupters" that have brought us bitcoin, blockchain, robo advisors, payment innovations and alternative lending, most notably simpler, speedier and more convenient loans made over the internet, called "marketplace lending." Given the flurry of activity in this arena, is there a place for banks and, if so, what role can banks play?

Given that marketplace lending is the most developed form of fintech today, it can be analyzed to see how banks do play important roles and employ different strategies dealing with this emerging market segment. Marketplace lending arose in part because many banks stopped making small consumer and business loans allowing entrepreneurs to fill the void. But banks have been a necessary part of this cottage industry. Many of the large marketplace lending platforms enter into program agreements with banks that actually make and fund the internet-originated loans through a marketing website operated and branded by the platform operator.

Having a bank make the loan allows for a more uniform and national program to be conducted because of federal preemption and the ability of banks to export the rates and fees of their home state nationwide. Banks already play an important role in marketplace lending, serving as originating banks that make these loans. While most of the market focuses on shorter-term, smaller-dollar, unsecured consumer installment loans and small-business loans, there are also marketplace programs for auto, home equity, real estate and larger commercial loans.

Like most financial products, marketplace lending has raised some legal issues. Because the original idea of matching individuals wanting to make loans to other individuals wanting to borrow money, referred to as "P-to-P lending," raised significant issues regarding compliance with securities laws and regulations, including the registration of notes involved in the programs, most marketplace lending is now done on a whole-loan basis, where the marketing platforms and/or institutional investors purchase the marketplace loans. In fact, many banks have purchased for their own portfolio marketplace loans. It is yet another role that banks play in the fintech world.

Where the platform both markets and purchases the loans, often also servicing the loans, legal challenges have arisen

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claiming that the platform, not the funding bank, is the "true lender" for the loan. This raises questions of state licensing and adherence to state usury and fee caps that are otherwise preempted by federally insured banks. In addition, last year, a New York federal appeals court decision ruled that where a bank sells or transfers a loan to a non-bank entity (in that case to a debt collector) and no longer has any interest in the loan, the non-bank entity is not entitled to collect the rates and fees that the bank was able to charge.

While this case only applies to three states on the East Coast, its ramifications, if followed elsewhere, would go far beyond marketplace lending and impact any sales of loans to non bank parties. The case was appealed to the U.S. Supreme Court, which declined to hear the matter. But the Solicitor General of the United States in a brief filed with the court stated that the case was wrongly decided and violated the long-standing legal principle that a loan is "valid when made" and therefore an assignee can enforce the contract of its assignor.

Other banks have found other niches to fill within the marketplace lending sector. Some banks provide loans to platforms and marketplace lenders, providing the liquidity necessary to make or purchase the loans. These can be in the nature of forward-flow agreements, warehouse lines of credit or secured credit facilities. Because many marketplace loans have short maturities, averaging around three years, there are potential short-term funding opportunities for banks. Other banks assist in the securitization of marketplace loans serving in various capacities including trustees of securitization trusts.

Some banks recognize that fintech is here to stay and seek to find ways that business relationships with marketplace lenders can help serve their own customers, without creating undue operational or regulatory risk for the institution. Some banks have entered into arrangements where the bank refers customers to platforms, which offer products that the bank does not offer in return for a referral fee. Other banks have entered into programs with marketplace lenders where the bank will use the platform's technology to make consumer or small-business loans that it retains on its own books but relies on the platform to originate and sometimes service the loans. Some banks see that as an option to provide a product they normally do not have available, yet being able to retain and control the customer relationship. Other banks may choose a co-branding approach that highlights the involvement of both the bank and the platform. Any of these bilateral arrangements raise vendor management and structuring issues that need to be addressed from both a legal and compliance perspective.

Of course, some institutions view the innovators and disrupters as competitors and seek to stay ahead of their customers' needs by providing the bank's own products and services on the internet, through mobile banking or smartphone applications in a more speedy, convenient and simplified manner. Finally, there are banks that may wish to buy or invest in fintech companies, either purchasing discrete applications or even entire companies or platforms to augment and grow the institution's innovative products and services.

In reality, the roles that banks can and play in the fintech space are varied and many depend on how the bank wishes to approach these opportunities. It is not unfair to say that fintech would not be where it is today without the involvement of banks. The more developed marketplace lending arena proves that banks are a necessary part of innovation. Banks need to develop a strategy and approach to adapt and integrate innovation and technology into the institution consistent with its risk profile and then structure relationships to protect the bank that ensure compliance with applicable law and regulation. An exciting future awaits! IB

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