Testing the Strength of the FinTech-Bank Partnership Model

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Online lenders and other FinTech companies have increasingly shifted their focus from disrupting the banking industry to partnering with it. A July 11, 2018 report by the New York Department of Financial Services ("DFS") suggests, however, that FinTech-Bank partnerships may soon face additional scrutiny in the state.[1] And by signaling a more aggressive state enforcement posture (and suggesting that new regulations may be coming), the report calls into question the viability of these partnerships in New York.

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The DFS report complicates an already uncertain regulatory environment for FinTech firms—just as the Office of the Comptroller of the Currency ("OCC") is set to reveal details on the proposed special purpose FinTech charter.[2]

In this client update, we discuss these developments and what they may mean for the future of the FinTech-Bank partnership model.

The Bank Partnership Landscape. The trend within FinTech, from disruption to collaboration, has been unmistakable in recent years. In New York, the share of collaborative versus competitive FinTech investments rose from 33% to 56% between 2010 and 2015.[3] Since 2012, the top ten U.S. banks by total assets have participated in 81 deals with FinTech startups, seven totaling $4.1B in disclosed funding.[4]

This is largely a consumer-driven phenomenon, as both startups and banks realize that neither segment is likely to dislodge the other—and that customer demand is best served by working together. A recent PwC report found that 30% of consumers plan to increase their usage of nontraditional financial services providers, while only 39% plan

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1 NEW YORK STATE DEPARTMENT OF FINANCIAL SERVICES, ONLINE LENDING REPORT 30 (2018), *available at* https://www.dfs.ny.gov/reportpub/online_lending_survey_rpt_07112018.pdf.

2 *U.S. Regulator to Publish FinTech Charter Position in Next Few Months*, REUTERS (Apr. 9, 2018), https://www.reuters.com/article/us-usa-occ-otting/u-s-regulator-to-publish-fintech-charter-position-in-next-few-months-idUSKBN1HG2FA.

3 *Fintech's Golden Age: Accenture and Partnership Fund analysis of CB Insights data*, ACCENTURE 4 (Jul. 24, 2016), https://www.accenture.com/us-en/insight-fintech-golden-age-competition-collaboration.

4 *Where Top US Banks are Betting On Fintech*, CB INSIGHTS (Feb. 1, 2018), https://www.cbinsights.com/research/fintech-investments-top-us-banks/.

to continue using legacy institutions only.[5] Perhaps reflecting this trend, another survey found that 82% of commercial banks in the U.S. plan to increase FinTech investments over the next three years, and 86% of bank executives are currently looking to boost FinTech funding.[6]

In the consumer lending space, a common model for FinTech-Bank partnerships involves an online marketplace lender teaming with a traditional FDIC-insured bank. The bank originates and funds loans that the online lender then purchases, either to hold in its own portfolio or to sell to downstream investors. This arrangement generally permits the online lender to take advantage of federal preemption through origination by an FDIC-insured bank.

Although common, this model poses challenges for both federal and state banking agencies.[7] As nonbank lenders, these online firms fall within the traditional purview of state licensure and supervision, but the hybrid FinTech-Bank partnership introduces new complexity—and uncertainty. The overlapping jurisdiction and regulatory jostling that results can be difficult to navigate even under the best of circumstances.

The DFS Report. The July 11th DFS report is likely to complicate this dynamic even further. It suggests that, in the agency's view, online lenders charge higher interest rates than traditional lenders—and that the increased access to credit they provide is accompanied by correspondingly higher risks for predatory lending.

Accordingly, the DFS report includes findings that could portend a more aggressive posture toward FinTech-Bank partnerships than the agency has pursued to date and concludes with recommendations that take direct aim at basic principles of federal preemption. Specifically, DFS recommends that:

- New York State consumer protection laws and regulations should apply to all consumer and small business lending that occurs in the state;
- State usury laws should apply to all loans made to New York consumers and businesses and that structures designed to "bypass this sound regulatory structure"

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5 PwC, GLOBAL FINTECH REPORT 2017: REDRAWING THE LINES: FINTECH'S GROWING INFLUENCE ON FINANCIAL SERVICES 5 (2017).

6 Penny Crossman, *Where fintech dollars will go in 2018*, AMERICAN BANKER (Dec. 26, 2017), https://www.americanbanker.com/news/bank-fintech-investment-will-focus-on-blockchain-and-ai.

7 OCC, Exploring Special Purpose National Bank Charters for FinTech Companies (2016), *available at* https://www.occ.gov/topics/responsible-innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf; FDIC, Proposed Examination Guidance for Third Party Lending (July 29, 2016) *available at* https://www.fdic.gov/news/news/financial/2008/fil08044a.pdf.

undermine principles of free markets and a fair playing field and hurt both economic development and consumer protection; and

- Direct supervision of online lenders by DFS is "the only way to ensure that New York's consumers and small business owners receive the same protections irrespective of the channel of delivery, and that all lenders operate their businesses and conduct their activities in a safe and sound manner."

DFS's concerns about the federal regulatory architecture are, of course, not new. Just in the past two years, the agency has sued the OCC over its plan to grant special purpose charters to FinTech companies and challenged a foreign banking organization's ability to switch a state to a national charter.[8] Whether the July 11th report is merely another front in these battles or something more significant remains to be seen. There can be no question, however, that the FinTech-Bank model appears less secure in New York than it did just weeks ago.

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Please do not hesitate to contact us with any questions.

NEW YORK

Courtney M. Dankworth
cmdankworth@debevoise.com

Gregory J. Lyons
gjlyons@debevoise.com

David G. Sewell
dsewell@debevoise.com

WASHINGTON, D.C.

Naeha Prakash
nprakash@debevoise.com

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[8] *NY Regulator Sues U.S. OCC over National Charters for Online Lenders*, REUTERS (May 12, 2017), https://www.reuters.com/article/us-new-york-occ-fintech/ny-regulator-sues-u-s-occ-over-national-charters-for-online-lenders-idUSKBN1882QO; . *New York Battles `Invalid' Regulator Switch by Tokyo Bank*, BLOOMBERG (Jan. 31, 2018), https://www.bloomberg.com/news/articles/2018-02-01/bank-of-tokyo-mitsubishi-accused-of-unlawful-u-s-regulator-swap.