Treasury and Trade Solutions

Fintechs Are on the Cusp of a New Era... *and Bank Relationships Will Be Key*

Over the past decade and a half, fintechs have dramatically reshaped finance. Their value proposition lies in their agility, entrepreneurial spirit, and innovative use of technology. Compared to banks, fintechs are smaller, less hierarchical, and more nimble, often focusing on niche areas within the financial sector. As the landscape evolved, fintechs thrived.

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Following the financial crisis, banks were preoccupied with complying with new rules and regulations, which demanded significant investments in systems and risk management capabilities. This focus on regulatory compliance created an opportunity for fintechs to step in. They identified unmet needs, such as improving cross-border payments, and concentrated on enhancing the consumer experience rather than simply meeting regulatory requirements.

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Fintechs excelled at solving specific problems, quickly becoming leaders in their respective niches. In the process, they developed deep, symbiotic relationships with banks. For instance, many fintechs rely on banks' payment infrastructure, while working closely with a bank offers a fast track to market and rapid growth. They can leverage the bank's position as a trusted adviser and its deep, long-standing relationships with corporate finance and treasury departments.

Likewise, banks ally with fintechs to adapt and grow, meeting clients' needs more swiftly than they could through in-house solution development. Some banks chose to associate with banking-as-a-service (BaaS) platform vendors or develop in-house BaaS divisions to collaborate with fintechs.

As fintechs have grown and saturated their niches, some have sought to expand their services to offer more bank-like functions. Over the last decade, many fintechs have evolved from specializing in one area to providing a wider range of services (such as collections), expanding into new markets, offering wallet services, and even selling these services to other fintechs.

In essence, some fintechs have begun to operate like banks, without actually being licensed as such. Now, there are indications that an inflection point has been reached from a regulatory perspective, potentially paving the way not only for an evolution in fintechs' business models but also for a transformation in their relationships with banks.

Blurring the boundaries creates risks

Speaking at the Exchequer Club in July, Acting Comptroller of the Currency Michael Hsu addressed the increasing complexity of relationships between banks and nonbanks, particularly fintechs, which is leading to greater interdependencies and blurring the lines between banking and commerce.[1] His key points included:

- **Evolution of banking relationships:** Traditionally, banking involved direct relationships between customers, merchants, and banks. However, this is changing as nonbank entities, especially fintechs, increasingly provide financial services.
- **Disintermediation and shadow banking:** The 1990s saw the rise of capital markets and money market funds, which began to disintermediate banks' traditional roles in lending and deposit-taking. This shift contributed to the growth of shadow banking, a key factor in the 2008 financial crisis.
- **Transformation in payments:** Similar changes are now occurring in payments, driven by technological advancements and the rise of online and mobile commerce. Fintech companies are increasingly providing services like payments, lending, and deposits. Fintechs associate with banks to execute these services through intermediaries or middleware firms, and banks rely on non-bank service providers and cloud services.
- **Banking supply chains:** The result is a complex, interdependent banking supply chain that resembles global manufacturing supply chains. This complexity can lead to distributed risks and blurred lines, making it difficult for regulators and consumers to manage and determine responsibility.

[1] See Acting Comptroller of the Currency Michael Hsu Remarks before the Exchequer Club, "Size, Complexity, and Polarization in Banking" (July 17, 2024) https://occ.gov/news-issuances/speeches/2024/pub-speech-2024-79.pdf

- **Regulatory gaps:** Federal banking agencies have relied on the Bank Services Company Act for authority to examine third-party service providers and on third-party risk management guidance to inform banks' engagements with nonbanks. But there is a need for more granular regulatory approaches and closer engagement between federal banking agencies and nonbank fintechs. For instance, the risks from deposit arrangements and necessary controls may differ from those needed for payments arrangements, and further differences exist for lending arrangements between banks and nonbanks.

  A significant gap exists between state money transmitter licensing and federal oversight, particularly for customer-facing nonbank fintechs, which are regulated at the state level as money services businesses; none are supervised prudentially at the federal level. This regulatory regime has prompted customer confusion, particularly regarding Federal Deposit Insurance Corporation (FDIC) insurance coverage, and potentially risky practices by fintechs. There is a need for tailored federal payments regulation and supervision to address the inadequacies of the current regime.

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Forming aligned relationships for sustained growth

As fintechs come under closer regulatory scrutiny, anti-money laundering (AML) and sanctions screening are likely to be a key focus. There are no shortcuts to compliance in this area – outsourcing is not an option and while specialist fintechs provide myriad screening solutions, AML is business critical: controls must be seamlessly integrated into fintechs' systems. The costs of doing so could well prompt consolidation across the fintech sector.

The Office of the Comptroller of the Currency and FDIC also seem likely to increase oversight of bank-fintech collaborations to ensure compliance and manage risks. In the immediate term, fintechs will continue to seek alliances with banks to support their business models and growth strategies and banks will continue to see value in forming an alliance with fintechs to bring solutions to market faster than they could alone.

However, in the longer term there is likely to be an evolution in how the two parties engage with one another.

In particular, there could be a growing demand from banks for greater transparency and understanding from fintechs. The most successful bank-fintech relationships will focus on aligning risk appetites between the two parties. This requires a clear understanding of the risks a bank is willing to take.

Early-stage companies might be tempted to pursue "low-hanging fruit," but these opportunities often involve high-risk industries. These sectors, often known as "sin stocks," are typically outside a bank's risk appetite. For example, while cannabis is legal in several states, federally-regulated national banks cannot support cannabis businesses because it remains illegal at the federal level.

Successful fintechs will be those that meet new regulatory requirements and avoid high-risk options that could jeopardize their bank relationships. Rather than chasing easy but risky opportunities, fintech winners are likely to focus on building legitimate, core businesses that align with their banks' risk tolerance, fostering more productive and sustainable relationships and reinforcing their position as a key part of the financial infrastructure.

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