Bank-Fintech Collaboration and Outsourcing Arrangements: The Case for a Fintech Mentorship Regime

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Introduction

“How to build a fintech ecosystem”

- Promote collaboration between fintechs and established banks
- Banks provide start-ups with access to know-how, reputation, access to markets; help overcome regulatory barriers
- Case for an optional regime – “mentorship” – allows fintech to operate under bank licence

(1) The fintech space

- Original fear (or hope): fintech will “disrupt” and “displace”
- Now: collaboration and interaction with incumbent banks
- Advantages of collaboration
  - Data access
  - Knowledge transfer
  - Economies of scale
  - Synergies
  - Marketing advantages
  - Reputational spillovers
  - Regulatory access and compliance culture transfer

The fintech space

Three main forms of cooperation, frequently through “application programming interface” (API)

(1) “White-label banking” or “Banking as a service” – fintech operation is integrated into banking services
   - Consumers perceive such services as being provided by fintech (unless they read small print)

(2) “White label fintech” or “Software as a service” – customer uses technology that looks like the bank’s

(3) Joint ventures and co-branding partnerships

Case study 1

N26

- Partnered itself with Wirecard when junior
- Received banking licence in 2016
- Now major partner with smaller fintechs (e.g. transferwise, Weltsparen, vaamo (Moneyfarm))
- Partners are integrated into N26; customer transacts with N26
- Perspective: increase product range, flexibility, marketing opportunity

Case study 2

Solaris Bank

- Service provider with full banking licence
- Sole purpose is to partner with new startups and to grant them market access (against fee)
- E.g. Tomorrow (banking & lending), Penta (SME lending), qnips (payments), smava (e-marketplaces and aggregation)
- No or very little customer contact
- Other examples: Fidor (D), Sutor Bank (D), SynapseFi (US), Plaid (US), Habito (UK)

(2) Legal perspective: “Outsourcing”

- Fintech includes banking services in the client package but outsources their provision to a bank
- Bank outsources the distribution of its services to a payment services provider

-> Who is the outsourcer and who’s the outsourcee?

- Legally, the bank has the licence, then it’s the outsourcer
- But economic substance is somewhat more blurred: client is often unaware of the bank’s relationship

“Outsourcing”

Banks outsourcing their activities may create risks

- Legal limits on Outsourcing: EBA Guidelines 2019 et al.
- Outsourcing normally part of bank’s risk management; no notification obligation
- Additional requirements when outsourcing is “material”
  - no outsourcing of key managerial responsibility
  - bank required to carry out appropriate due diligence
  - Written outsourcing agreement
  - Supervisor can monitor the outsourcee, including access to premises, examination and information powers

Outsourcee supervision

- Outsourcees may or may not be regulated entities
  - Often payment services firms, but not necessarily
  - And payment services regulation is focused on conduct more than stability
- Supervisor has information acquisition powers
  - But no direct oversight of the outsourcee
  - No early intervention or sanctioning powers based on the banking services performed by the outsourcee
  - Oversees the bank, which is turn has contractual rights vis-à-vis the fintech

(3) Problems?

- **Is the framework fit?**
- Microprudential risks
  - Supervisory gaps?
  - Potential shortcomings where legal infringement by fintech, but action can only be taken against bank:
    - No direct intervention – supervisor can of course ban bank from outsourcing arrangement, but inflexible and untimely
  - Bank may have incentives to delay or obscure detection
    - Possibly due to badly governed agency problems within it
  - Front-end banks: consumer protection concerns?
- Macroprudential risks?
  - Software-as-a-service from BigTech firms?

Problems? (2)

- In a way, status quo allows for **contracting out** of supervisory functions (via technology and outsourcing contract)

➢ Can anything be done to nudge/force these players (back) into the supervisory perimeter?
  - Regulatory sandbox
  - Fintech licence
  - Mentorship regime

(4) Sandboxes

- Regulatory sandboxes: “experimentation spaces” where regulators may relax rules to improve market access
- Useful but imperfect
  - Main purpose rather promoting innovation and competition
  - Limited resources, limited number of firms admitted, limited time
  - Frequently “symbolic” sandboxes to lure fintechs (window dressing)
  - Risks underexplored

(5) Mentorship Regime

- Optional regime
- Bank extends regulatory licence to fintech
- In exchange for equity, fee, exclusivity, etc. Communication to regulator which cannot refuse the arrangement
- Once "in", the fintech is subject to full regulation and supervision for licensed firms

Mentorship Regime (2)

Consequences

- Fintech subject to full regulation & supervision
- But would have to outsource its compliance and internal control systems to incumbent bank
- Responsibility and liability on the bank – therefore ex ante incentive to screening

Mentorship Regime (3)

Advantages?

- Mentorship regime would
  - clarify responsibilities
  - bring the fintech within the regulatory perimeter
- Intermediation of the incumbent would
  - facilitate communication and culture
  - vetting process

Conclusion

Mentorship

- Strategic partnership fintech/bank, should increase innovation
- Fintech can travel on the bank's regulatory ticket (in exchange for consideration)
- Responsibility and liability on the bank – therefore ex ante incentive to screening

THANKS FOR YOUR ATTENTION!

Comments are most welcome.

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