October 30, 2024

Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Washington, DC 20219

Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Federal Reserve Board of Governors
2001 C Street NW
Washington DC, 20551

RE: "Bank-Fintech Arrangements: Request for Information" dated July 25, 2024
Office of the Comptroller of the Currency [Docket No. OCC-2024-0014]
Federal Deposit Insurance Corporation RIN 3064-ZA43
FEDERAL RESERVE SYSTEM [Docket No. OP-1836]

To Whom It May Concern:

Alloy Labs is a consortium of community and mid-size banks that work cooperatively to ensure community banks not only survive but thrive; our membership is exclusively r depository institutions' that are subject to bank supervision through the Federal Reserve, the FDIC, and the OCC, and we do not engage in lobbying activities.

We submit this response to your request for information on behalf of the management of the consortium of our member banks; this response is not representative of the opinions or points of view of any specific member bank. Our submission is informed, however, by periodic interactions with our member banks in eight (8) Centers of Excellence listed below. It is noteworthy that a quarter of the centers of excellence are purpose-built for facilitating candid conversations among partner banks, affording us the timely and relevant insights represented herein.

1. Banking as a Service (BaaS) / Partner Banking
2. Risk Management and Compliance for Partner Banks

3. Strategy and Business Model
4. Innovation Culture
5. Data & Analytics
6. Robotic Process Automation and Artificial Intelligence
7. Marketing
8. Cybersecurity

We also offer an "accelerator" program to build partnerships between member banks and prospective partners to provide additional products and services that are adjacent to, or outside of, what would be defined as a traditional bank service or product. Examples of products and services that Alloy Labs has supported members banks to bring to market include: fraud monitoring for elderly populations; financial health through directed advice for the caring class, [1;] and helping small businesses better understand their cashflow.[2] Each of these serve the bank's existing and target customer base and are controlled by the bank.

Our Alloy Labs team members have been actively involved in building partnerships and using alternative vendors from the three major cores for financial institutions over the last 20 years, including experience in European and African ecosystems. Our founder also co-founded one of the first "challenger banks" in 2008.[3]

Alloy Labs appreciates the breadth of topics asked in the RFI and due to our large member base that is diversified from experienced incumbents to newer entrants, and the ongoing research and development we are engaging in with players like Plaid, Chime, etc., we believe we are in a unique position to comment on the following:

1. *The importance of innovation for traditional community bank*
2. *The definition of fintech and implications for progress*
3. *Managing risk and compliance in partner banking. Complexity is no longer based on asset size, the need for smaller banks to have enhanced risk & compliance*

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[1] The caring class includes teachers, health care workers, and public employees that often experience financial stress because they are mission driven occupations that typically play below market rates.

[2] Alloy Labs' portfolio of partners includes, but is not limited to: Ascent Platform, Atmos, Autobooks, Bolder, Capstack, Carefull, Eko, Lama AI, RiskScout, Sardine, SAVVI AI, The Postage, Themis, Wisetack, Frich, Scam Ranger

[3] Perkstreet, Inc. was a cashback debit card issued by the Bancorp Bank; Perkstreet served as the program manager.

management frameworks that are not necessarily limited to the "community bank" frameworks that the FFIEC agencies have applied in the past.

4. *Recommendations*
5. *Work completed by Alloy Labs BaaS Center of Excellence*

1. The importance of innovation for traditional community banks

It is important for our U.S. community banks to be able to evolve alongside the changes taking hold in our economic market because the traditional U.S. community bank business model is under pressure. The broad influence of technology on banking, from new entrants to financial services who provide modern and entirely digital versions of financial products and service through partnering with banks, to suppliers of technology that modernize the banks themselves, provides new sources of value for customers. As discussed in section 2, the market broadly defines this as "fintech" vs. the narrower version used in the RFI, page 9, footnotes 4 and 5.

This value leads to greater possibility for U.S. economic growth and prosperity, as access to capital underpins our country's entrepreneurs, small businesses, and consumers. Without our unique banking system, which is comprised of thousands of community banks that serve rural areas throughout our country, the U.S. economy may be tempered. Our community banks underpin our economic system yet face several challenges that require innovation to overcome.

The cost of deposits is growing, not just because customers are moving money in search of yield now that rates have risen, but because there are ways of transacting that provide competitive methods to U.S. consumers and businesses to store money[4] across a variety of applications, including: a Starbucks wallet; an instant credit to an Amazon account when doing a return at a Whole Foods; automatically adding money to a Schwab investment account.

Today, using only these examples, U.S. consumers may receive banking products and services through a coffee shop, an online marketplace, a grocery store, and a broker/dealer. The proliferation of parties that are providing these banking products and

[4] Shevlin, R. What's Killing Checking Accounts for Banks? Deposit Displacement, The Financial Brand

services outside of the traditional branch footprint of depository institutions has increased competitive pressure on our community banks. [5][6].

And yet, through innovation, community banks may harness these as opportunities to partner with these new entrants and provide the banking products and services through these non-traditional channels, as the bank behind the coffee shop, online marketplace, grocer, and retail investment platform. This ability to innovate is critical to the success of our community banks. The greatest risk facing banks, particularly community banks, is irrelevance.

Community banks dependent solely on their core provider for products and services are at a severe disadvantage. Third party relationships, either embedding the partner in the bank or the bank into the partner, create value for existing customers, build new customer relationships, and ensure the ongoing relevance of community banks. In the future, many if not most, third-party partnerships will be embedded in the experiences of established companies and brands where the bank products are an enabler of some other experience.[7]

Where banks are historically used to being at the center of a transaction, whether that be a loan or payment, they are beginning to find the transaction will to be part of a larger experience such a farmer ordering feed or a small business sending an invoice.

The recent final rule on 1033 will accelerate a growing digital divide between the banks that can provide modern experiences and services and those who cannot; smaller banks optimizing their implementation timeline against compliance deadlines will find themselves left behind from those who adopt earlier either by mandate or strategy.

The risks of inaction that lead to irrelevance need to be weighed against the risks of improper implementation to encourage the industry to move forward at a sustainable pace. A heightened risk posture that does not consider the severity of the potential impact will freeze out many banks from this future.

2. The definition of fintech and implications for progress

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[5] Brown, C. 23/07/31 Banks report toughest loan standards in years, Axios

[6] McKinsey & Company. 24/09/24 The next era of Private Credit.

[7] Marqeta Inc, 2024 State of Payments Report

"Fintech" is a very broad term that covers a vast array of bank partnerships and vendor relationships. The RFI clarifies in footnote 4 and 5 on page 9[8] the agencies are using the term "fintech" in a more limited fashion to cover what is commonly referred to as Banking-as-a-Service or partner banking. However, this footnote is lost in the daily parlance.

What remains is the message that "third party relationships are risky." The effect of this message on our community banks is a mix of "flight" away from anything adjacent to "fintech" or "freezing" any activities until there is greater clarity provided by, and consistency among, the Federal Reserve, FDIC and OCC regarding these activities conducted through third parties. Whether this pressure is real or perceived is immaterial because of the impact it has on the bank to address its overarching goals of modernization, improved experience, and value delivered.

This has been substantiated in conversations with venture investors that have banks as limited partners: these investors are observing that technologies and products built to modernize bank infrastructure are being treated with the same risk lens as "fintech" defined in the RFI.

Financial institutions have an obligation both for regulatory compliance and a duty of care to their customers to manage risk. Working with external parties can increase the risk profile, however not all these risks are the same. Believe that there are two primary vectors whereby risk can be evaluated:

1. **Agency of the partner** – in some arrangements the fintech partner has been granted extensive agency to bind the bank in relationship to customers. High partner agency correlates with high risk. For example, arrangements through which the fintech partner onboards new deposit customers, and conducts the requisite "know your customer" diligence of those new customers, present higher inherent risk to the bank.

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[8] Footnote 4 This term includes, among many others, intermediate platform providers (as defined below), as well as certain processors and payments platforms. It also includes certain non-financial retail businesses seeking to expand into markets for financial products and services through arrangements that could allow them to leverage their existing infrastructure and customer relationships to offer a one-stop-shop to access financial and non-financial products and services. Footnote 5 These arrangements are sometimes referred to as "banking-as-a-service" or "embedded finance" depending on the structure and parties involved in the arrangement.

In contrast, arrangements through which fintech partners facilitate the bank's loan origination workflow, while the bank retains ownership of underwriting criteria, or arrangements through which the technology facilitates the bank's online account opening per the bank's parameters, are comparatively lower in inherent risk because the bank ultimately retains agency in all decision making.

2. **Distance from the customer** – Greater distance from the end customer correlates with higher inherent risk. For example, there are three distances at which these arrangements may exist:
    a. **Embedded Banking** – a bank may offer its products to end users, whether individuals or businesses, through a direct integration to the partner's platform. This is the most direct form of arrangement where the bank is not removed from the customer relationship. The partner in this business model is a distribution channel to attract new customers to the bank. In other words, every user of the partner also becomes a direct customer to the bank. This is similar to the point-of-sale financing products offered in the past. Another business model that has existed for many years and is based on this same framework is "indirect auto lending". In the U.S., when a consumer goes to purchase a vehicle from a dealer, there is often an "embedded" lending program for that dealership. Once the car buyer has decided to purchase the vehicle from the dealer, the customer may opt to receive financing through a channel agreement that the dealer has with one or more lenders that are introduced to the car buyer. Once the car buyer has purchased the vehicle, using the loan product offered by the selected bank, the dealership is no longer involved in the loan, leaving a direct customer relationship between the bank lender and the borrower. In the same way, there are banks that rely on distribution channels, that are sometimes referred to as "brands", and those channels bring prospective customers to the bank, and the bank retains all discretion whether to onboard the prospect to the bank's products and services.
    b. **Partner Banking –** a fintech offers products to its customers and relies on the bank for access to deposit accounts, payment rails, etc. This is the second most direct form of arrangement where the bank is only one degree removed from the customer relationship. The framework for these arrangements has existed for decades through other products and services, namely IOLTA programs. Similar to a "fintech" that offers a demand deposit

account (DDA) to its customer, there are attorneys who custody funds for their customers. While most banks do not call a commercial bank account opened by an attorney a "FBO" bank account, the framework that banks use to support attorneys is nearly identical to the structure that banks employ to support a partner to bring deposit products to market. In a partner banking arrangement, the bank will open a demand deposit account that is titled "for the benefit of" the fintech partner's customers. An IOLTA account is an "Interest on Lawyers' Trust Account" through which most attorneys hold client funds because attorneys are restricted from commingling clients' funds with the attorney's business bank account. The attorney maintains a subledger that tracks the balances for each client, and the attorney is subject to oversight by each U.S. State's framework. Similarly, the fintech that offers the deposit account product to its own platform users generally opens the "FBO" account at a bank (either titling the account as the fintech's business bank account for the benefit of its users, if the fintech is a Money Services Business (MSB), or the account is titled as the bank's account FBO the fintech's users). Then, the fintech is responsible for the maintenance of the subledger, just as the attorney was responsible for maintaining the subledger for its customers' transactions and balances.

c. **Intermediated Partner Banking**– a fintech leverages an intermediate platform provider to integrate with their bank partner. This is the third arrangement and most indirect where the bank is two degrees removed from the customer relationship. This business model is very similar to existing arrangements that were defined in the FDIC Financial Institution Letter (FIL) 3-2012 "Revised Guidance on Payment Processor Relationships", through which the payment processor has a contractual arrangement with the bank, and the payment processor thereafter onboards its own customers, who are merchants[9], who in turn have their own customers, for whom the bank processes money movement. In current business models, the payment rails may be card networks (e.g. Mastercard, Visa, etc.) rather than solely ACH. However, the same principles apply in these arrangements such that the financial institution is exposed to risks not customarily present in relationships with commercial deposit customers, or treasury management

[9] Payment Processor Relationships Revised Guidance (Revised July 2014) | FDIC

customers. These arrangements pose increased operational, strategic, credit, compliance and transaction risks to the banks involved. Furthermore, there may be legal, reputational, and other risks associated with an increasing volume of customer complaints, errors or disputes, returned transactions, and a greater propensity for claims of unfair or deceptive practices – whether the platform is business focused (e.g. UDAP) or consumer focused (e.g. UDAAP). The business model that is predicated on a "nested" supplier or is an "aggregator" framework, is not new to financial services. These arrangements have been successfully executed for over a decade, and may continue to be implemented in a safe, sound and fair manner for years to come if the existing principles for risk management are applied consistently.

The industry needs more precise nomenclature to distinguish between arrangements that differ materially in risk. An approach that treats all external "third party" relationships as high risk dilutes the energy exerted to monitor and manage the activities where the highest risk resides and stymies innovation that could benefit the customer, the institution, and the industry.

3. *Managing risk and compliance in partner banking*

Page 10 of the RFI that breaks down the various "Descriptions of Bank-Fintech Arrangements" (the "Arrangement") is an important step towards a risk-based approach that puts the appropriate amount of attention on the areas of greatest risk. Each of these Arrangements comes with their own set of inherent risks. Many Partner Banks engage in more than one type of Arrangement. Few, however, engage in all types. It has been our unfortunate observation that exams are conducted using a comprehensive scope that treats a specific Partner Bank as if the bank engages in all forms of arrangements and are exposed to the full suite of unmitigated risks. While we are supportive of a comprehensive and consistent scope to be considered as the starting point for every examination, we advocate for a risk-based approach to the examination process that would consider the specific business models that a particular bank is engaged in, and then tailor the comprehensive scope to that business model. Moreover, we are observing that our community banks are subject to discrete examinations that are more relevant to legacy traditional community banking business models rather than to these complex business models through partners. More specifically, we observe that these partner banks are subjected to a BSA Exam that may have elements of partner banking activities scoped into

the examination, and then later that partner bank may have a separate IT Exam, that is not integrated to the BSA topics. In these arrangements, there is a need for cross functional communication across the bank's personnel, and also across the bank supervision team members. Often, these arrangements use sophisticated fraud monitoring and AML monitoring tools that are relevant to (at least) the IT Exam, BSA Exam, and Model Governance Exam. If the agencies are sending community bank examiners that are unfamiliar with the cross-functional nature of the business model, the examinations are not focused on the relevant risks and are likely to result in findings that may not be most meaningful for the bank's preservation of safety, soundness and fairness. Even within a specific Arrangement, the inherent risk levels versus residual risk levels that are posed to the bank and impact the bank's safety and soundness, are heavily influenced by the maturity and effectiveness of the underlying partner's internal controls and risk management, as well as the capabilities of the bank's management team and risk management programs and IT infrastructure. Assessing the inherent risk must be done at a partner-by-partner level before assessing the risk of the portfolio in its entirety. We advocate for a framework that relies on Partner Risk Oversight (PRO) rather than Third Party Risk Management, whereby PRO is predicated on a holistic approach that considers the individual partner as a standalone entity, then the specific, idiosyncratic arrangement created between this specific partner and this specific bank, and then the impact to the bank due to this specific arrangement and combination of partner and bank. The approach that we are advocating is rooted in principles of prudential regulation of bank or financial holding companies that evaluates the non-depository institutions' impact to the depository institution.

It is our observation that there is intra-agency inconsistency in both the understanding of inherent risks, approach to management of the risks in each Arrangement, and process for the assessment controls. Inter-agency inconsistency compounds the problem. Substantial effort is spent mapping and cross-referencing that is better spent understanding the underlying risks, controls, and efficacy. Inconsistent language and process exacerbate the problem. We recognize this is an evolutionary process but want to highlight what we observe across institutions, exam teams, and agencies.

4. Recommendations

We believe there are three important steps to be taken:

1. **Adopt consistent terminology across the industry.** A number of Alloy Labs Members and industry players first published a nomenclature guide in 2022. We know it is being

used by at least one group within a regulator as well as many companies both large and small. It is apparent the inter-agency RFI worked hard to achieve consistency in language. We believe the effort to expand and "enforce" a consistent nomenclature is vital to removing ambiguity that causes misunderstandings and friction in the process. Alloy Labs and industry partners have begun an update to this taxonomy and will gladly contribute to the public domain, but believe it requires the utilization by regulators as well. We do not believe a formal endorsement is necessary, just an effort to use the same taxonomy across all market participants.

2. **Apply existing rules, laws, regulations and guidance consistently within and across bank supervisors (e.g. FDIC, OCC, Federal Reserve).** New guidance may become necessary; however, we observe across banks and partners there is inconsistency and confusion surrounding the current state.
3. **Create a standardized, comprehensive examination handbook for Novel Activities.** This handbook would provide transparency to any bank that is considering engaging in novel activities, and the regulatory expectations that must be met before bringing products or services to market through these innovative methods. While the handbook would be the comprehensive guide, not all examinations would be conducted using every item from the handbook. The examiners would conduct examinations based on a risk-based approach, and would leverage the handbook when drafting the examination's scope. The publicly available handbook would support the bank to design a risk management program that meets the regulatory expectations yet the bank would tailor the bank's program to the idiosyncratic nature of the bank's strengths and gaps, and the partner's business model and maturity.
4. **Permit the industry to develop the first principles** of a well-managed Partner Program, benchmarks, and best practices to mature the industry. Alloy Labs is working with many industry participants, including several RFI respondents, to develop consistency if not direct partnership on the development of these materials. We believe it is ultimately the banks that are accountable to regulators for compliance but cannot work to mature the industry in a vacuum.

5. Completed Work and Initiatives in Progress

Alloy Labs, with input from member and non-member banks, Fintech Partners, and industry leaders have published the following resources in the public domain:

1. Nomenclature Guide
2. Guide to Implementing Interagency Guidance on Third Party Due Diligence
3. Updated Guide to Third Party Diligence
4. Role and Responsibilities in Partnership
5. Fintech partnership wind-down procedures and best practices

In Progress:

1. Updated Nomenclature Guide
2. Principles of a well-run program

Conclusion

We are encouraged by the interagency approach and the level of specificity in the questions regarding how the risk of Bank-Third Party Relationships are managed. We believe community banks fulfill a vital role in their communities and the innovation economy. Clarity provided by the output of this RFI and industry-led work maintains a level playing field for all market participants.

Please do not hesitate to contact us if we can provide additional clarity.

Sincerely,

Alloy Labs, LLC

In partnership with KLM Advisory, LLC