# The Regulatory Scrutiny of Banking as a Service

regulatory fintechs digital banking

**Summary:** As banking as a service (BaaS) grows in popularity, so does the need for regulatory requirements. We discuss the upcoming trends and concerns with BaaS and how CFIs might prepare for instituting BaaS.

Sonny and Cher; Lucille Ball and Desi Arnaz; Hall and Oates; Wallace and Gromit. The world of partnerships has featured some unforgettable pairings. Could partnerships between community financial institutions (CFIs) and fintechs belong within their ranks?

Banking as a service (BaaS), a method in which an institution provides its banking products and services via a third party, is growing increasingly popular. It's a useful strategy for financial institutions, which gain income from the arrangement, and for nonbanks, which get an opportunity to extend their product offerings into finance. The BaaS market can be as simple as using digital wallets or a credit card issued by a P2P provider to make a purchase. According to Grand View Research, the BaaS market could be worth $74.6B by 2030.

That's not to say that the road ahead is entirely free of obstacles. BaaS is still in the relatively early stages of popular adoption in the US. Higher interest rates, a potential recession, regulatory requirements, and questions of just how big CFIs want to grow are all issues that the industry will have to manage as it moves forward.

**Regulator interest is increasing.**

One of the caveats of BaaS is that the financial institution handles the regulatory compliance, not the fintech. As the industry grows, scrutiny around regulatory requirements is becoming more intense. CFIs involved in BaaS will need to put regulatory compliance toward the top of their lists this year as regulatory interest and the BaaS industry both grow.

Regulators increased their attention to financial institutions' third-party risks in 2022, and there's every reason to think that their interest will continue throughout 2023 and beyond. They will likely stay particularly focused on CFI compliance with the Bank Secrecy Act's provisions around anti-money laundering, mechanisms for holding deposits and how those arrangements are marketed to end users, and credit underwriting standards, especially for consumer loans.

"Regulators are going to spend time making sure that the institutions that are providing these kinds of services to third parties who are interacting with customers on their behalf are in a position to be as compliant as they would be in any other business lines," says David Sandler, co-head of financial services investment banking at Piper Sandler. "That's going to have a profound impact on the space and the entrance into this space."

It doesn't mean, however, that increased regulatory interest and burden is dissuading CFIs' interest in BaaS. Rather, it's boosting CFI awareness of risk management and helping to increase the sophistication and knowledge of both financial institutions and fintechs as they enter into these partnerships.

**Tighter contracts can protect CFIs.**

More regulatory attention may mean that CFIs want contracts that help them stay compliant. Financial institutions might ask for more ability to monitor fintech operations or get information about how a fintech partner handles customer notices, resolves disputes, or harvests customer data. Don’t just depend on what a fintech says it will tell you. Set up contractual rights to that information.

CFIs might also consider contracts that protect their right to leave a partnership that isn’t working. Maybe the fintech partner isn’t performing, or maybe things are fine but the fintech isn’t pursuing compliance in the ways that the CFI’s regulators expect.

**Is bigger still better?**

CFIs working in BaaS have a consideration that bigger financial institutions don’t — the balance between pursuing growth and enjoying the regulatory benefits of staying smaller than $10B in assets.

Financial institutions that stay under the $10B-mark are exempted from the Durbin Amendment and can charge higher interchange fees for processing debit card payments. That matters in fintech partnerships, where both partners typically share interchange income.

On the other hand, BaaS probably doesn’t generate your primary revenue. Going over the $10B-asset level gives you more money to lend and greater economies of scale in your core lending business. Many CFIs with BaaS business are staying under $10B, but that could change.

"People are coming to the realization that business models funded entirely by interchange aren't necessarily going to be profitable," says Jonah Crane, partner at advisory and investment firm Klaros Group. "You might see a shift away from interchange-driven business models to begin with, which I think will make the $10 billion threshold matter less."
BaaS is a growing revenue source for CFIs. Financial institutions that pursue BaaS should be aware of increased regulatory concerns and consider contract terms that help them meet regulatory requirements. They should also understand the pros and cons of staying under $10B in assets. Coupled with our tips for a successful BaaS partnership, your CFI should be well positioned to initiate a strong future BaaS partnership.

## AMERICAN EXPRESS EXITS FX BUSINESS OUTSIDE OF US

American Express has announced it will decommission foreign exchange services to business customers outside of the US by year end. Your CFI doesn’t have to be impacted by this—PCBB offers a variety of foreign payments services. Contact info@pcbb.com to learn more.

## ECONOMY & RATES

Rates As Of: 07/12/2023 05:36AM (GMT-0700)

| Treasury | Yields | MTD Chg | YTD Chg |
|---|---|---|---|
| 3M | 5.49 | 0.06 | 1.07 |
| 6M | 5.55 | 0.08 | 0.79 |
| 1Y | 5.36 | -0.03 | 0.65 |
| 2Y | 4.73 | -0.17 | 0.30 |
| 5Y | 4.10 | -0.06 | 0.10 |
| 10Y | 3.89 | 0.06 | 0.02 |
| 30Y | 3.98 | 0.12 | 0.02 |

| FF Market | FF Disc | IORB |
|---|---|---|
| 5.07 | 5.25 | 5.15 |

| SOFR | Prime | OBFR |
|---|---|---|
| 5.06 | 8.25 | 5.07 |