Consumer Finance Monitor (Season 8, Episode 10): Banking as a Service

Speakers: Alan Kaplinsky and Jason Mikula

Alan Kaplinsky:
Welcome to the award-winning Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. This is a weekly show brought to you by the Consumer of Financial Services Group at the Ballard Spahr Law Firm. I'm your host, Alan Kaplinsky, former practice group leader for 25 years, and now, senior counsel of the Consumer Financial Services Group at Ballard Spahr. And I'll be moderating today's program.
For those of you who want even more information, don't forget about our blog, consumerfinancemonitor.com. We've hosted our blog since July 2011 when the CFPB became operational. So there's a lot of relevant industry content there. We also regularly host webinars on subjects of interest to those in the industry. So to subscribe to our blog or to get on the list for our webinars, please visit us at ballardspahr.com.
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Well, today I think, should be a very interesting program. We have in the past, done many podcasts relating to the subject of FinTech. We've done programs that were focused on various products like buy now, pay later, or earned wage access. And we've done programs dealing with joint ventures or partnerships between banks and non-bank FinTech companies. Well, today's program is hopefully going to bring all of these other programs together to make it much easier to understand what really goes on in constructing these kinds of programs. And I'm going to be talking to Jason Mikula, who I will introduce to you in just a moment.
But before I do that, let me read to you what it says on the back cover of his fabulous book, which was published just this year, this is very up-to-date. Backing as a service or those in the know, call it BAAS, B-A-A-S, that's what I'll call it. It's a game changer in the financial services sector, radically transforming both how consumers experience financial products and the business models delivering them. Banking as a service cuts through the hype to provide a measured overview of BAAS, helping readers to demystify a complex evolving field and understand its key opportunities, challenges, and risks. It provides a framework for understanding where BAAS came from, how BAAS changes the economics and business models of banking products and services. Its impact on key stakeholders and its key regulatory implications.
Banking as a service and referring to the book now, "Explains how business and operating models work, exploring different models such as interchange, deposit gathering, loan origination to distribute legacy, API first own license, matchmaking and bank service providers, and offers a framework for thinking about whether or not they are sustainable." It explores how BAAS operates and business models compare in different global territories and is supported by real-world examples and cases profiling organizations such as Blue Ridge Bank Unit, Synapse, Goldman Sachs, Railsr, Starling, Solaris, Kakao, PayCard, QNB, Onepage, Airwallet, Nium, and Pomelo. And I could go on and on. It literally mentions, throughout the book the major players in the BAAS world.
It also explains the differences between BAAS, embedded finance and open banking. Well, let me now introduce to you the author of this terrific book, which, it should be required reading. And I mean it seriously, for anybody that's already in the BAAS industry, that is, with a bank that has partnered with a non-bank FinTech or anybody with a FinTech company, a joint venture, a company that's thinking of investing in a non-bank FinTech, lawyers in the space and even layman. It's written so clearly and done so well that I can't stop raving about it.

So let me introduce Jason to you. He's the publisher of Fintech Business Weekly, a newsletter going beyond the headlines to analyze the technology, regulatory and business model trends, driving the rapidly evolving financial services ecosystem at the intersection of traditional banking, payments, FinTech and crypto. He also advises, consults for and invests in early stage startups. Previously, he spent over a decade building and scaling consumer finance businesses, including at Enova, LendUp and Goldman Sachs. So Jason, a very warm welcome to you. And again, congratulations on really writing what I think is a tour de force in this particular niche that we call BAAS.

Jason Mikula:
Thank you for that kind introduction and for that glowing review of the book. I think I may be blushing over here.

Alan Kaplinsky:
You may have to add to your book another testimonial because I'd be happy to give it

Jason Mikula:
For the second edition. The second edition. We'll get you in there.

Alan Kaplinsky:
Yeah. Okay. Okay. So let's start off, and the questions I have for you are based on things that were in the book that I thought were important things for our listeners to understand. So let's start off with something really basic, and that is, what do we mean when we say banking as a service or the acronym BAAS?

Jason Mikula:
Yeah, so I think that's a very logical place to start as far as attempting to level set and understand what do people tend to mean when they use that term. And Alan, I know you've been around the industry a long time and are certainly aware that the idea of a bank partnering or working with a non-bank company to deliver a regulated product or service, that idea, it's not new. I trace some of the origin of what we're now calling BAAS to prepaid card partnerships that were common at least as early as the '90s, as well as payday lenders, which partnered with banks as a way around state usury caps. Also in the late '90s, early 2000s.

Alan Kaplinsky:
And I'll give you an example even earlier than that because I was involved in it and that is H&R Block and the old beneficial national bank out of Delaware that offered tax refund anticipation loans.

Jason Mikula:
Oh, the RALS, yeah. Yes.

Alan Kaplinsky:
The RALs to customers of H&R Block. And that was well before the invention of the internet. There was certainly technology involved in offering that program, but not the kind of technology that we have today. But you're right, it goes way back. And the joint ventures and the payday lending industry, something else I was very involved in, that existed before the internet was created. And then eventually, the programs, the payday lending programs became online programs. But at the very beginning, they were done through branch offices. You'd go into a branch of a payday lender, a non-bank payday lender, and you would get hooked up with a bank who'd make the loan to you. So you're absolutely spot on.

Jason Mikula:
The moniker, the name, banking as a service, well certainly, that last part as a service will certainly be familiar to folks in the tech space. It's popularized by the idea or the term software as a service. And really, all that means in the software as a service or people say SaaS context is basically, a piece of software that is delivered typically over the internet, in most cases, through your web browser and in most cases on a subscription basis. And so, I think the popularity of that term really came to the forefront in the mid '2010s as a way of explaining this business model largely to venture capitalists and technologists who are familiar with some of this other terminology. I do like to try to draw some boundaries about what is in that BAAS bucket and what is not. And the way that I go about doing that is really thinking about the partnership or the relationship of the non-bank as a mechanism to distribute specifically regulated products and services to end customers, which could be consumers or businesses and not just as a service provider-client relationship.

So to provide a concrete example of that, Chime, which is probably the best-known "neo-bank", not a bank, but rather, partners with at least two underlying banks, the Bank Corp and Stride to offer consumers. So Chimes customers, regulated products and services, deposit accounts, debit cards and the like. I would consider that to fall into that banking as a service bucket.

By point of comparison, a company like say Airbnb, which does a lot of payment processing, so both customers who are staying in Airbnbs, debiting those payments from them, but also, then, the hosts who are receiving payments, Airbnb, dispersing those. I would not consider that use case to fall under the BAAS umbrella. So I do want to caveat that, I don't think there's an exhaustive list and complete agreement around from everyone in industry about what is and what is not banking as a service. But the core differentiator in my mind, is the relationship between the non-bank or we'll probably just say FinTech in this conversation and the underlying bank partner is the purpose of that relationship to offer a regulated product or service to that end customer. So that's how I try to draw that distinction.

Alan Kaplinsky:
Got it. And embedded finance, you gave Airbnb, I assume, Uber or Lyft, might be other examples of that. Where one party's basic product or service isn't really a financial service, an Airbnb, it's housing, in the case of Uber and Lyft, it's transportation, but they've embedded a financial service in order to make it distinguishable from what used to exist before there was Uber and Lyft, to make it much more convenient for customers to book rides or to book housing if they want.

Jason Mikula:
Yeah, absolutely. In your introduction, you mentioned BNPL or buy now pay later, which I think is a really great example of embedded finance. So that is really talking about the distribution channel. So if Uber is offering some kind of wallet to its drivers, you're absolutely correct that in that case, Uber's primary business on the driver's side is to facilitate matching that driver with a rider who wants to go somewhere if Uber's offering that driver some kind of digital wallet and typically, there's a specific value proposition attached to it. In the Uber case, it's probably about getting paid out more quickly, even in real time or near real time. In Uber's business model, they're offering that really as an enabling function to their main product. There's hopefully, I guess, if you're Uber anyway, hopefully, there's ancillary revenue attached to that, but really, it's about making their driver a stickier, I guess not employee but contractor and then for the underlying bank partner, that relationship with Uber, so, Uber embedding that capability, is really about distribution.

Alan Kaplinsky:
Right. So let's talk now, Jason, about the different BAAS business models and operating models. And I know there are terms that you use in your book. You use middleware as an example of one type of model and direct an another type of model. But maybe if you could elaborate on that.

Jason Mikula:
I think that's a good starting point, but it's probably not completely sufficient at explaining some of the differences. So, when I think about the different kind of business and operating models, you could even break that down further and talk about distinct components like contracting the actual technology and who owns the customer. So it is more complex than just saying middleware, or I think the term popped up at some point, coming from some of the regulatory guidance was intermediary platform provider or something like that. But even that doesn't really answer every component there. But broadly speaking, what we've seen in call it the last 10 years, which is frankly hard to believe, but Synapse, which was an early mover in the space in the United States was founded in 2014, so slightly over 10 years ago, is a distinction between what we're calling the direct model.
So, using Chime again as the example, Chime works directly with Bancorp and Stride on those relationships. Chime has presumably, contracts with them, direct contact with their various legal regulatory product teams, et cetera. That's not to say that there aren't other service providers in the mix like an issuer processor that would actually help facilitate issuing those debit cards and processing transactions. But there's this one-to-one relationship, legal contractual relationship that exists between the FinTech and the bank.
The model that was pioneered by Synapse, although at this point, has quite fallen out of favor, is this idea of an intermediated model. A lot of the challenges that Fintechs had in working with banks, there's quite a number of them, but bank culture, the idea that banks move too slowly, there's too much due diligence, there's too much vendor management, onboarding, their technology stack is bad, they have some legacy core. The idea of a middleware provider and broadly, in that bucket I would put Synapse obviously bankrupt now, Treasury Prime, Unit, Synctera, they really rose to try to address those challenges.
And some of the ways they went about doing that was disintermediating the underlying banks and saying, "Hey, we know that dealing with Bancorp or Blue Ridge or whoever can be frustrating and slow if you're a Silicon Valley technology company, let us do, us the middleware platform, do some of heavy lifting to build the technology integrations and deal with some of the due diligence processes and make your life easier as the FinTech who just wants to go out there and get a product in market." Now, we've seen some of the challenges and some of the problems that can result from that model, and largely, at this point, I think most all of the players I've mentioned have at least paid lip service to moving away from that. But there has been, let's say, some experimentation and some iteration in how these business models actually work in practice.

Alan Kaplinsky:
Right. And, of course, I know we're going to get into this later, but if you are the bank involved in this offering, whatever product you're offering, you're going to be held responsible by the regulator for compliance with applicable law. It isn't going to do any good for you to say to the regulator, oh, we hired this middleware company that really told us that what they were offering was compliant and they were going to be able to be in effect, a middleman, that doesn't catch you off the hook, right?

Jason Mikula:
The caveat that I am not actually a lawyer, and this is not legal advice, but yeah, my understanding has always been and remains that whether or not it is a direct model or a middleware model, at the end of the day, these legal and regulatory obligations, whether that is BSA AML compliance, whether it is UDAP and consumer marketing stuff, at the end of the day, those obligations and the liability rests on the regulated chartered bank entity. Whether you are

using a middleware provider and/or a customer facing FinTech like a neobank, my understanding is that legally speaking, those are third party or fourth party or fifth party service providers to the bank. The bank is the regulated entity. It is the bank's responsibility to ensure that any service providers is is working with are meeting those regulatory expectations. And I do think that that is an area where we saw perhaps, some gaps that gave rise to... I actually lost count, but probably 10, 15 plus consent orders for banks in the space over the last two or three years.

Alan Kaplinsky:
Right. So in your view, what led to the explosion in banking as a service and when did it all begin?

Jason Mikula:
We already talked about one piece of it, which was tech companies or FinTech companies that needed to partner with banks but found it difficult to do. Right? And this isn't even purely unique to BAAS or to bank partnerships in the sense that if you were building in banking and financial services in 2010, and I'm a bit biased because that's really when I started my career in the industry at Enova, actually, a lot of the tools, the service providers, platforms, technology that exists today did not exist 15 years ago. And so, you've seen, definitely more than one cycle of somebody starting a company realizing like, oh, hey, it's actually very difficult to do this underlying technical thing I need to do. Plaid is actually a great example. From what I understand, Plaid was originally started as a PFM type tool, personal financial management tool.
To make that meaningful, you need to have the data of a user's underlying accounts. In the course of trying to solve that challenge, you're like, "Oh, actually, maybe it is a better business to solve this challenge of making customers bank data, transaction data available and portable." And that's actually a better business to be in than running a PFM, which I think is probably quite clearly the case. And then the next generation that comes along has this improved infrastructure layer to go out and build whatever they want to build.
So we've seen at this point, I think, several cycles of that in the FinTech and the financial services space. So talked about, if you were starting Chime, if you were starting Lend-Up where I worked in 2010, 2012, you had a far different set of tools, capabilities, APIs available. So some of the challenges of starting a FinTech company gave rise to this idea of middleware, which as far as I'm aware, Synapse was the first, but then there were plenty of others that have followed and are still in the space.
But in my mind, that is a question about the demand side. Who wants to build and who needs a bank partner? The supply side, the banks that are actually partnering with middlewares, partnering with customer facing fintechs, there needed to be a reason for them to want to enter this market as well. And I think there's many different factors there. One is just the intense pressure on smaller banks, and I guess for the purposes of this conversation, when I say smaller I'll mean Durbin exempt, less than $10 billion in assets, all you need to do is look at a chart of the number of chartered banks in the United States and/or the number of physical bank, both of which are and have been declining for some time.
So if you are that sub $10 billion bank, and many of the ones that play in these BAAS spaces, they're not in New York or California or whatnot, they're in Arkansas, in Tennessee and Virginia. And you are looking for growth BAAS, particularly given the amount of venture capital flowing into fintechs starting in the mid '2010s became an attractive, at least theoretically, attractive business proposition, particularly when you look at some of the financial returns for banks that have been in that space for quite some time.
And I mentioned Bancorp, MetaBank, which of course, is now known as Pathward, Celtic, pose disproportionately high return on equity and return on assets given the nature of the business model. And then particularly, as you went into, let's call it the late pandemic period, so once inflation started spiking and interest rates went up, you also had this acute pressure around deposit gathering and deposit pricing.
So there's certainly a lot of different factors that have intersected, and I give a very quick drive by about some of them, but really, I think about it as perceived as being a lifeline for smaller banks, for community banks to leverage

the number one asset they have, which is a bank charter and the secondary component of that, which is high interchange because they're Durbin exempt as a way to try to gather deposits and generate fee income.

Alan Kaplinsky:
Let's drill down on the last thing that you said. That is, interchange fees and the important role played by interchange fees in prompting non-bank FinTech companies to partner, not with big banks, but with banks of less than $10 billion in assets. And you referred to Durbin, of course, that's Senator Richard Durbin of Illinois, and if we go back to 2010, there's something called the Durbin Amendment in the Dodd-Frank Act. So if you could, I know it's a little bit complicated, but I thought you did a great job in your book on explaining the economics, what is it about interchange? We're not talking about on a credit card now we're talking about on a debit card. What happened here and did Dick Durbin realize what he was going to create here?

Jason Mikula:
I actually grew up in Illinois and technically still vote there, absentee. So I suppose Senator Durbin is my senator. I would love to go back at some point and read contemporaneous debate about the Durbin Amendment. It is certainly not my understanding that the intention had anything to do with FinTech, which certainly, wasn't even a word or a popular term at the time. That amendment would've been debated and passed into law in 2010. As far as what it does, I imagine most listeners are generally familiar, but banks with more than $10 billion in assets have the debit interchange capped by the Durbin Amendment. I'm actually forgetting the exact formula right now, but it's something like 20 basis points plus 5 cents give or take. And actually, the Federal Reserve has been undergoing a rulemaking that would see that lowered because the actual cost of processing debit transactions, at least according to the Fed study, has gone down.
Whereas banks with less than $10 billion did not have these debit transactions, the interchange on them capped. So that has created some interesting, one could argue, distortions in the market. But if you were a FinTech and a main component of your business model was interchange revenue, and that's true, honestly, for a large majority of them, unless it's like a lending model or some other business models. Really, the only game in town was to partner with a bank that's not covered by the Durbin Amendment.
I'll throw a little asterisk on there in the sense that over time, you have seen some other interesting approaches depending on how cynical you are, one might call them arbitrages, as far as issuing charge cards, so something that is actually more akin to a credit card rather than a debit card for the purposes of driving higher interchange. So you have seen some efforts to either not be as dependent on sub $10 billion banks or still working with those smaller banks, but to generate higher interchange by issuing something that technically is a charge card and maybe positioning it as a credit building card.
So there are certainly a lot of granular details that influence that business model, but by and large, if you look at a company, and I'll just stick to Chime as my example, at least in its mainline consumer business historically, and I guess we don't know this as a fact given that Chime is private and we haven't seen the S1 yet for when it goes public, but presumably the large majority of its revenue comes from interchange. And whether or not that is a sustainable business over time, I think, remains to be seen.
And then also, there is this, I would say, low probability, but significant risk of what happens if something changes with the Durbin Amendment? That would've a very radical impact, particularly on the economics of a FinTech partner, although I should point out that generally, every link in this chain is going to be taking some share of that interchange. So the issuing bank, an issuer processor, the middleware company, if one is in play, but typically, the lion's share of that, which would average around 1.5% of a transaction would typically go to the FinTech program.

Alan Kaplinsky:
So just so people that aren't that familiar with interchange to help them understand it, let me add this. Somebody goes to a merchant to pay for a product and they use a debit card, and then there's typically what's called an acquiring bank somewhere in that chain who will buy the receivable but will deduct what's called a merchant discount. So if the item is $100, just to use an example, they might only give the merchant $97.50. So you've got that merchant discount. Out of that, that's the gross revenue you could say, that can be split up in various ways. The interchange is typically the amount that the issuer bank gets, the bank issuing the debit card to compensate that bank for its expenses and issuing debit cards to consumers. And then what I think was so attractive for FinTech companies to get into this is these smaller banks, less than $10 billion weren't restricted by law. I guess you could say the restrictions that MasterCard and Visa, I think, puts on the total amount of interchange fee, MasterCard and Visa gets a piece of that-

Jason Mikula:
Actually, that's not technically right. MasterCard and Visa, the networks don't get a share of the interchange. There's a separate-

Alan Kaplinsky:
I thought they did.

Jason Mikula:
Common misconception. There's a separate network assessment fee that Visa or MasterCard get, but yeah, they stand to benefit by having more cards issued and more transactions run.

Alan Kaplinsky:
Right. But in terms of where this revenue comes for, MasterCard and Visa don't charge the consumer anything, they don't charge the merchant. Doesn't it all basically come out of that merchant discount in one way or another?

Jason Mikula:
Yeah. The short answer is yes. The medium to longer answer is, we've seen the argument that... Ultimately, it is the merchant that is footing the bill because that total merchant discount rate that you mentioned, if you go and buy $100 of stuff at whatever, Best Buy that merchant is getting, whatever, $98. So the cost of payment processing, the all in cost is borne by the merchant that is accepting that card payment, which has been an endless fight in DC and in the courts as far as how those economics are worked out and distributed.

Alan Kaplinsky:
Right. Okay. So everything sounds terrific with this model. It takes off 2010 to 2015 at a time when the technology is just getting more and more sophisticated. It makes it more easier to offer these products to consumers online rather than in branches. So what could go wrong? But there have been some things, right?

Jason Mikula:
There have been some things.

Alan Kaplinsky:
Yeah, let's hear about that.

Jason Mikula:
Yeah, I guess at a high level, these kinds of programs, these kinds of partnerships that we talk about as being enabled by BAAS look quite different than what banks' legacy businesses are. So if you're that small bank, and many of these just to reiterate, are less than a billion in assets. So, in the scope of the United States banking market, are very, very small banks, maybe one branch, maybe a couple branches.
If you are that small bank and historically, your business has been customers walk into my branch, they open a checking account or they apply for a mortgage or they open a business account, moving to a model where you're actually serving customers across the entire United States, or in many cases some of these programs were serving customers outside of the country, Brazil, Mexico, maybe you're offering products that as a bank, you have not actually offered on a direct basis, whether that's certain overdraft credit type looking products, whether it's international remittances, and so, to simplify, my argument would basically be some, certainly not all, but some of the banks that either have been in this space or entered into this space, appear not to have invested the necessary resources in systems and in personnel policies procedure to adequately mitigate the risks of the new business lines that they were entering into.
And the way that has manifested, I already referenced some of the consent orders, that I may be wrong, the guys at Claros would know for sure. I think the number one recurring topic in consent orders for BAAS banks in the last two, three years has been BSA AML, right? And so, linking that back to what I just described, if you have a BSA program, a Bank Secrecy Act program that was built to handle the risks of a customer walking in and opening a checking account or a customer walking in and applying for a loan, directly at your bank, in person, the risks look very different when all of a sudden, same small bank, but now, you are partnering with a middleware provider that in turn, is powering a dozen programs serving customers across the United States and maybe other countries with a different product mix. And so, if you did not make the necessary investments to have proper risk-based controls, I don't think it's a surprise that some of the banks in the space ended up with some problems.

Alan Kaplinsky:
Yeah. And the problems seem to be increasing or accelerating. It just seems that way to me. I'm wondering whether the change in administrations means that the regulators aren't going to be as tough on scrutinizing these relationships. What do you think about that?

Jason Mikula:
I'm always a little bit hesitant to try to read the tea leaves and guess what regulators are going to do. But based on conversations I've had with people who are smarter and better connected than I am, it's worth remembering that these federal banking regulators, so the Federal Reserve, the OCC and the FDIC, the political appointees are really just the very top level of these organizations, and so, it can be quick to see a change in tone. We've certainly already seen that with Travis Hill being made the acting chair at FDIC as far as wanting to have a more pro-innovation, a more transparent approach to technology, not just a BAAS, but some other areas, crypto stable points, whatever. But, how is that actually translated into policymaking, so into rulemaking? How is that translated into supervision and enforcement and particularly, the boots on the ground, who aren't in D.C. but are in the regional offices across the country interfacing with the banks that they supervise?
And so, absolutely, there's been a change in tone. I do think that that is a sincere change in tone. Hill, for example, was as I understand it anyway, a staffer had previously worked with former FDIC chair Jelena McWilliams, who also had a markedly more pro-innovation FinTech friendly posture. So I do expect that some of these things will change.
I do not think it's going to be a light switch. You referenced a sense that some of the actions against these BAAS banks were increasing. And you probably know better than I do, that in the bank supervisory context, these exams run in cycles, and it's not like a bank is just slapped with a public enforcement action overnight. There are many

rounds of meetings and matters requiring attention and whether or not things are being remediated sufficiently and quickly enough to meet what the regulatory expectation was.
So I do think that part of the reason why we saw that spike and I dated at least, it becoming public to late 2022 when Blue Ridge got that first enforcement action, was regulators maybe not being super aware and paying attention to these types of business lines at banks, and then all of a sudden, becoming very, very, very aware and taking a very close look at any bank engaged in these type of business activities. And if you look closely enough at any bank, you're probably going to find some kind of problem. So I think we've seen this pendulum shift from maybe these smaller banks were not getting a ton of scrutiny based on their relative small asset size as awareness within the regulatory establishment increased. We saw a lot of scrutiny presumably starting in 2020, 2021, manifesting in the consent orders we've seen in the past two or three years, and now, there is some indication that pendulum may begin to swing back.

Alan Kaplinsky:
Right. Right. I want to go back to interchange for a minute and want to get your reaction to a development. I think an unfortunate development also, from your native state of Illinois. The state of Illinois has brought a lawsuit essentially, against... Well, it's the industry has brought a lawsuit against the state of Illinois trying to enjoin the state from enforcing a state law that deals with interchange fees. And the judge came out and said, "Well, that law..." Maybe you could describe the law. I think it involves, there can't be any interchange fee paid out of taxes. Is it taxes?

Jason Mikula:
I think that's right. I think that's right.

Alan Kaplinsky:
Yeah, taxes and tips. No, winter change. Sounds like a simple proposition, but I'm sure you know as a technologist, the programming to become compliant with that kind of a law is just mind-boggling and immense. Anyway, the judge said, "Well, if you're a national bank or a federal thrift, you probably don't have to comply with this law. But if you are a state bank, you do have to comply with the law. Or if you're a non-bank, you've got to comply with the law or a state credit union." So that's a killer, right? If that becomes the law, then all 50 states could get in on the action and basically, destroy this product.

Jason Mikula:
So taking the narrow point you're making about this interchange law in Illinois, and I remember reading about this, I believe you're right, it's no interchange on taxes and tips. Is that technically something that is achievable just from a pure technology perspective? Sure. If you take that to the logical extreme of what happens if you have 50 states with 50 different sets of guidelines about how interchange works, and then that's also segmented by the type of issuing institution, as you pointed out, if you're national bank, OCC chartered, maybe you get preemption and you don't have to follow it. It further increases the complexity which nobody really wants. And then to your point on the business model, okay, what percent of the interchange going to a FinTech, is taxes and tips versus the other portion of that ticket? Presumably 90%+ depending on what the sales tax is, not those things, but it's just another headache.
To draw a comparison that it sounds like you'll definitely be familiar with, in the consumer lending space, you don't have to partner with a bank to write loans. There are state issued lending licenses and in fact, the payday industry that I came up in and that you've worked in as well, that is state licensed lending. The caveat or the headache that goes along with that is the terms of every state are different, how much you can lend, how much you can charge, like a whole host of consumer protection provisions. And so, if you are a non-bank lender, there are quite a number

of advantages to partnering with a bank, which we would also generally call BAAS, to originate those loans. And that's why you see, whether it's higher APR lenders like OPFI or even buy now pay later lenders like a firm, leverage those bank partnerships so that they can lend on a nationwide basis using the bank's charter. Typically, the bank will retain like 5% of the loan receivable such that they can lend nationally on one set of rules and avoid the headache of that state-by-state patchwork.

Alan Kaplinsky:
Yeah. No, I'm glad you mentioned the lending model. I think at the beginning of your book, you basically say the three main things types of vast arrangements are interchange, involving debit cards, lending, involving credit cards and installment loans, maybe buy now, pay later. It's not clear under state law or even federal law right now, whether that's a lending product or not. And then payments products. Things that remittances and a variety of other products that relate to payments. Would you agree with me that maybe the riskiest area to be in these days is lending because, well, a variety of things? From a regulatory standpoint, you've got the concern about usury laws that you already mentioned, that state usury laws may apply when the whole idea behind the use of a bank model is to use the usury authority of the bank, which under federal law is generally deregulated.
The federal law applies to national and state plan, as you can charge interest, the rate allowed by the law of the state were located. While most of these banks that are partnering with non-bank fintechs are in states like South Dakota, Utah, Delaware, states that have totally deregulated their usury laws. But the problem is something called the economic tests of who's really deriving most of the revenue. And there have been plaintiff's class action lawsuits and state regulatory lawsuits where the claim is made that the real lender isn't the bank, it's really the non-bank. And if a court accepts that, you got a real problem, right? Because the non-bank is not complying with state usury and other laws.

Jason Mikula:
I'll admit off the top of my head, I'm a little rusty on my true lender/valid when made, like where things are today because they've changed so much over time. But a couple of anecdotes that illustrate the risk, right? Even if the interpretation, the general consensus of the legal arguments is in favor of a bank FinTech partnership being able to preempt a state that it's lending into, that doesn't mean that that state necessarily wants to go along with it. So we've seen probably the most notable case is actually OPFI, which I mentioned, which exited some markets when it received pushback. So I want to say it exited D.C. and a couple of other smaller markets when either state regulators or attorneys general said, "We don't think this is a legal product in this state." And rather than fight, they chose to exit.
California, as you can imagine, being the largest state, largest market in the country, California and OPFI have been engaged in a back and forth related to this topic of whether or not the interest rates it's charging in California are permissible. We've also seen examples of the impact of DIDMCA, which a real throwback because I want to say that's from 1980. Basically the idea that a state would not necessarily need to honor the interest rates of another bank from out of state. I hope I did that correctly. And we've seen that in Iowa, with a buy now pay later lender and more recently Colorado, if I'm remembering correctly, chose or is in the process of opting out of DIDMCA.

Alan Kaplinsky:
They did opt out of DIDMCA, just to give everybody, to level set. In 1980, when Congress passed the Depository Institutions Deregulation and Monetary Control Act, they gave state banks usury parity with national banks, the right to charge interest at the rate of law by law the state were located. But out of federalism concerns, they gave states the right to opt out or to reject the federal law. And then what has happened in Colorado is Colorado enacted a law basically saying, "We're saying that as a matter of state law, if you do business from out of state and you lend to Colorado residents, you're going to be subject to state usury laws." And the industry is saying, "The only law that

matters is a state where the bank is located in doing the lending." And so if the bank is located in Delaware and lending out of Delaware, let's deregulate, doesn't really matter what Colorado has done.
Well, that case now, the industry won in the district court. We represented the American Bank Association and Consumer Bank Association as an amicus, we filed an amicus brief. Believe it or not, the FDIC filed an amicus brief on behalf of the state of Colorado, which shows absolutely bizarre, wondering if they might change their mind right now, the new leadership of the FDIC. Particularly since they flip-flopped on that issue, in a case that I handled for the old Greenwood Trust Company Discover card, the FDIC filed amicus brief for us. And they said the absolute opposite, and the FDIC wasn't even aware of that when they filed this amicus brief in Colorado.
But anyway, that case is up before the 10th Circuit. True lender is still not resolved. That is still an open issue and there's a way to mitigate that risk if you're worried about private litigation, if you have a good well-written arbitration provision with a class-action waiver, you can pretty much mitigate getting hit with a class action. But arbitration doesn't have any impact at all on state regulators. So given the example of California, Colorado at one time, and other states have taken the position that if the bulk of the economic interest, the profits on this transaction are alluring to the benefit of the non-bank, who's also performing other functions, true lender will be applied and that could really crater a program.

Jason Mikula:
This is a perennial game of cat and mouse, I suppose you could say. One of the developments I've seen in this model, to try to further mitigate that risk under the predominant economic interest test is for the bank that is originating, that has their name on the loan agreement, to also provide a debt facility to the FinTech that's doing the lending. And so, through that mechanism, not just retain 5% or some arbitrary percent of the loan receivable, but actually, then, benefit by providing a debt facility to the FinTech lender, which is an interesting take on that model.
I think my takeaway, the high-level takeaway when it comes to true lender and DIDMCA and these issues, particularly as we go through this change in administration, is, even if there is a softening of the posture of the federal banking regulators, when it comes to these issues, you're likely to see more active state regulators in certain states, right? Places like California, New York, whatever, Connecticut. And so, to the extent that a FinTech is looking to operate nationally in these type of lending programs, which presumably, they want to, that's certainly something to be aware of as far as potential risks that exist out there.

Alan Kaplinsky:
Yeah. And really good point to make, Jason. We just did a series on the impact of the election on the CFPB and one of the segments, this is a series of webinars that we did. I had as my guest, the Attorney General of New Jersey, Matthew Platkin, and he talked about basically, how his office and other AG offices probably, principally, those run by Democratic AGs are not going to let consumers suffer in any respect, during the next four years. And if there is a void that gets created, these state AGs will be able to fill that void. While their resources may not be great, they tend to partner together and they divide up the responsibility and they are a definite threat. They're something to be concerned about.
Let me turn to a few other things. I want to ask you, what do you think the role of regulators should be in supervising non-bank entities that are in the past value chain, middleware, customer-facing fintechs, what do you think of that?

Jason Mikula:
I'm of two minds about this, right? There's the question of, how do things work now, and then the question of, how could or should things work, right? So earlier in our conversation, I referenced my understanding that legally speaking, customer-facing FinTech, middleware platform, issuer-processor, whatever, these are service providers to the bank. And so, if you're an OCC chartered bank, you're overseen by the OCC. The OCC would be responsible

via its supervision of the bank for understanding what is happening at any of the bank's service providers, whether that is a neobank or a lender or whatever.

I do think that there, at this point, is a reasonable amount of evidence to at least ask the question of, is this approach to basically, indirectly regulating fintechs, is it fit for purpose? Is it achieving what it needs to achieve? I would argue the answer's probably no, it's not achieving what it needs to achieve, or at least it's not doing so in a efficient, consistent manner.

But that said, there are at least questions about whether or not regulators actually have the right legal tools and authorities to directly supervise those non-bank fintechs. I don't think we have enough time to debate the Bank Service Companies Act or some of the activities we've seen, particularly out of the CFPB as far as designating certain entities as larger participants or posing a risk. So there are various ways that the federal regulators can try to pull these non-bank fintechs under their supervisory umbrella, but as far as I'm aware, there isn't a clear cut consistent approach to how banking regulators can and do supervise these non-banks.

I think that's probably part of the attraction to YVC or why fintechs were interested in building companies in these spaces, in the sense that, calling it a gray area might not quite be right, but the idea that it's outside of this regulatory perimeter, but then the flip side is, it makes it significantly more difficult to oversee these companies and activities that they're undertaking, even when to an average person on the street, Chime looks like a bank, Cash App, probably looks like a bank, but they're regulated quite differently even if they're offering fundamentally, similar or even identical products and services.

Alan Kaplinsky:

All right. In your book you talk about FBOs, first of all, what are they and do you consider them the original sin of banking as a service?

Jason Mikula:

FBO, for the benefit of account, which is a type of custodial account that a bank maintains for a third party in the context of banking as a service in FinTech. So there's a couple of reasons why this structure became so popular and so pervasive. I would really break it down into two things, to make it simple. One is the legacy cores that most banks operate on. The economics of those contracts with the core providers tend to charge, have a fee on a per account basis. So you can imagine if you're a FinTech and you're opening thousands, tens of thousands, millions of accounts, but maybe the revenue generated by those accounts is very low or the churn rate is very high. If you end up having to pay on a per account basis, that might just totally destroy the economics. So, having essentially all of those customer accounts rolled up and in the bank's core system, having one or maybe a couple of FBO accounts, I'm going to make air quotes, "solves that unit economics problem."

Another challenge is just like the technology integration, right? Historically, these legacy cores haven't been accessible through API, through application programming interface, which is a way for one software system to communicate with another software system. And so, while perhaps in an ideal world you would have a customer facing FinTech that programmatically, that through an API is creating an account directly on a bank's core, both because of the economic and because of the technology challenge, historically, that isn't really what we've seen. You would have a customer facing FinTech that was maintaining perhaps, its own ledger or using another technology service provider to maintain a ledger and then this FBO, this custodial account sitting at the bank that just has a big pot of money. I don't think it's the case that this could never be workable, but as far as some of the headaches and reconciliation challenges that we've seen, and we don't need to go into that, I think FBOs or the use of FBOs have certainly played a role there.

Alan Kaplinsky:
Well, I guess the problem that you've identified, and tell me if I'm wrong, is that, if a non-bank has FBO accounts at the bank with whom it's partnered and then the FBO company fails, goes into bankruptcy, is the consumer company to be able to look to the bank for whatever money it had given to the FBO? Is that going to depend on how meticulous the record keeping has been on the part of the FinTech company? So that's another problem.

Jason Mikula:
Yeah, absolutely. As we've seen with the whole Synapse disaster, if you don't have accurate books and records, even if the money's there, you need to know who to give the money back to. We have definitely seen some fintechs and some middleware companies basically attempt to mitigate that risk by having essentially, a failover. So, imagine that neobank X fails, and goes bankrupt. Do you have the system in place to easily either transition those users to the underlying bank itself, or provide some kind of white label or temporary intermediary interface so that users can continue to use that account? There are companies that have been thankfully, smart enough to build that kind of capability in, but my perhaps, a little bit overly simplistic argument would be that it would be better if the end customer's account existed on the bank's core system of record. And some of this stuff with intermediaries and FBOs are a interesting workaround that unquestionably increases complexity and by extension, increases risk.

Alan Kaplinsky:
Right. So you spend, toward the end of your book, Jason, you talk a little bit about what's going on in foreign countries, and I'm just wondering, we don't have the time today to talk about each of the countries and what's legal and what is being done, but I'm wondering, is there anything that people in the United States that are thinking of getting into a BAAS arrangement, can they learn? Can regulators learn anything from what goes on in foreign countries?

Jason Mikula:
Absolutely. I think something that has been a great learning experience in my career is living and studying how banking and how FinTech works in other geographies. I think something that, and this may be more on the U.S. regulator side, but something that is worth examining is the idea of these alternate kinds of licenses or charters that don't really exist in an analogous way in the United States. So the most common being the idea of an e-money institution or maybe like a payment institution.
Certainly, the U.S. has state issued money transmitter licenses, which operate a bit differently, and as I said, are state issued. So you need to go and get whatever it is, 48 or 49 of them. I think Montana doesn't require one. So the idea of some kind of national non-depository charter, whether that is facilitating neo banking type activity, whether it's facilitating nationwide lending, I'm not holding my breath that we're going to see that for a whole lot of reasons, but I do think that when you look at how some of these markets work in other countries, having an e-money licensing regime allows that licensed entity to have a direct relationship with its regulator and to be supervised in a way that really doesn't exist in the United States today.
There's a lot of differences on the business model side when it comes to interchange and how interchange works in other markets, consumer lending and just different preferences and use patterns. But as far as takeaways for folks in the US, cross our fingers that there's some kind of movement on a FinTech charter or FinTech license, but I'm not going to hold my breath.

Alan Kaplinsky:
Well, let me just say that that's a topic that I have done a separate podcast, and I don't know if you've read anything by Professor Dan Awrey-

Jason Mikula:
I have. I have.

Alan Kaplinsky:
At Cornell. Yeah. He is a expert in that area, and I've been very pleased to have him as my guest a couple of times. And the last time he talked about an article he wrote where he proposed a federal payments charter. He didn't call it a FinTech charter, a federal payments charter. His preference would be that it would preempt all the 49 state transmitter laws, and his article made a lot of sense, but almost immediately after our show got released, the Conference of State Bank Supervisors did not like that. They think they're doing a very fine job regulating money transmitter companies, and they're staying abreast of technology, etc, etc.
I hope it's very soon to have Professor Awrey and somebody from the Conference of State Bank Supervisors on one of our podcast shows and let them slug it out. I think it should be very interesting. Well, we're running out of time, but I have two more questions that I'd love to get your reaction to. I'd wonder, number one, what advice you would give to banks considering getting into the BAAS space and how do you see the market evolving from here for banks, technology providers, and for customer facing companies?

Jason Mikula:
Yeah, absolutely. When it comes to banks that are considering getting into the BAAS space, I would look to some extent, to the consent orders we've seen to understand what kind of challenges have other banks run into. In addition to the BSA AML stuff that we talked about, some of the recurring themes were around board governance. So basically, is the bank's board sufficiently aware and directing what is happening in that line of business? As well as strategic planning. So if we're talking about, legally speaking, these non-bank fintechs often being third party service providers to the bank, if a FinTech is out there offering a debit card or a deposit account or a loan or whatever, as the bank, those people, those users most likely are legally your customers. Understanding, even if it's being carried out by a third party, how does this roll up to the bank's overall strategy? Strategy for deposit strategy, for credit, concentration risk, asset liability management, all of that.
I feel like I shouldn't have to say this, but you should think through that. And if you have five FinTech programs, 10 FinTech programs, how do you pick those programs? What are the criteria and how do those programs align with your bank's risk tolerance and your bank's strategy? As far as how the market is evolving, I'm going to go back to that supply and demand framework. We're going through this rationalization process and have been at this point, for a couple of years as far as the amount of venture capital flowing to fintechs has dropped precipitously from its peak in 2021. So, I would argue there's less demand for bank partnerships. And then on the bank side, a whole bunch of banks entered the BAAS space over the course of the last whatever, four or five years. Some have left Blue Ridge exited after those consent orders or those enforcement actions. MCB, there's a number that have wound down their programs.
There are others that have run into issues and plan to carry on, Pyrmont, for instance. So understanding from a supply demand standpoint, if you are evaluating, entering as a bank, entering the BAAS market, is there sufficient demand for what you want to offer for the kinds of companies you're looking to partner with, for it to make sense? And that rationalization certainly flowing through on the customer facing side and the middleware side as well. Right? Synapse, obviously bankrupt. We've seen other consolidation in the space. Rize sold to Fifth Third. Bond was acquired by FIS and rebranded as Atelio. So I would describe it as basically a rationalization of supply and demand, which I think we're probably maybe three quarters of the way through, but don't hold me to that estimate.

Alan Kaplinsky:
Right. Right. So final question is what advice would you give to fintechs that rely on a bank partner or happen to be looking for one?

Jason Mikula:
Yeah. So, the general consensus wisdom is that it has become much harder to find a bank partner, which I think is probably both true and appropriate. The other truism that has come about for the bank side is compliance is competitive advantage. Or the idea that if you're a FinTech, I understand the motivation, if you're an unprofitable early stage company, you want to get to market as quickly as possible, but going with a bank that's asking you the fewest questions means that that bank is also asking every other FinTech program, presumably a comparable number of small questions. Your risk is attached to the risk of every other program at that bank. And it's not theoretical. We've seen this with platforms with customers of Unit where maybe they were on Blue Ridge and then they had to go to Pyrmont and then they had to go to a different bank.
Switching bank partners is expensive and time-consuming and disruptive if you have to issue new ACH information to your customers, issue new debit cards. So understanding like, yeah, bank partner A might be asking harder questions. It might have a longer due diligence vendor management process, but it's for a good reason. And the risk in these relationships, these bank FinTech relationships, the risk runs in both directions. So really applying that due diligence lens to your bank partner in the same way that that bank partner is applying due diligence to you, would be my piece of advice.

Alan Kaplinsky:
Okay. Well, we've come to the end of our program, but let me again, repeat particulars about your book and tell our listeners that it is available on Amazon. It was published this year. The title is Banking as a Service. The subtitle is Opportunities, Challenges and Risks of New Banking Business Models. And I highly commend that you buy that book because it's absolutely essential. So thank you, Jason. Very much appreciate your taking the time to be with us today.

Jason Mikula:
Really appreciate the opportunity. Thank you.

Alan Kaplinsky:
Yeah. Great. Okay, and make sure you don't miss any of our future episodes. Subscribe to our show on your favorite podcast platform, be it Apple Podcasts, YouTube, Spotify, or wherever you listen. Don't forget to check out our blog also going by the name of Consumer Finance Monitor. We have a lot written on that blog about the topics we talked about today. If you have any questions or suggestions for our show, please email us at podcast@ballardspahr.com. Stay tuned each Thursday for a new episode of our show. Thank you for listening and have a good day.