# Building Blocks of FinTech for Community Bankers

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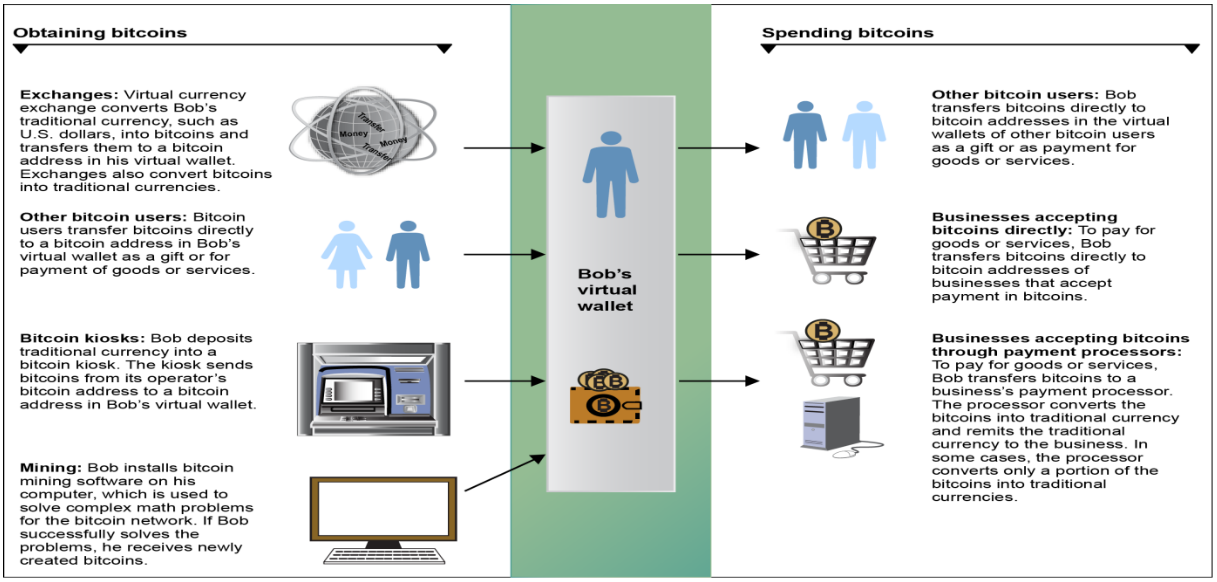
In recent years, an increasing buzz has emerged on FinTech and its related components. A few of our financial institution clients find this to be exciting and innovative, eagerly embracing the opportunity to work in this developing field. However, the majority of clients find themselves in varying stages of skepticism and perhaps even annoyance at this subtle threat of disruption to business as they know it. While technology has a place in a community financial institution's strategic planning and risk management process, FinTech considerations have probably not been front and center in that process.

Bitcoin, blockchain, and FinTech . . . what do they really mean and what do community bankers need to focus on to keep pace with these evolving technology trends? One sure thing is that FinTech will continue to advance at an unprecedented pace, and as with most technology, it is difficult or impossible to keep up with things such as the latest release of software or even who some of the major players out there are. Despite that, understanding certain aspects of the technology can serve as basic building blocks for exploring options in this growing field. In this article, we will take some of the mystery out of the unknown by discussing some of those evolving technologies and trends.

1. What is FinTech? *FinTech* is short for financial technology. FinTech companies constitute a rapidly growing sector of the financial services industry that use technology to offer products and services to consumers with increased efficiency. There are many components to FinTech, which include but are by no means limited to lending platforms, payment processes, investment and savings, blockchain, and digital currencies.
2. Who uses FinTech? Businesses and consumers use FinTech for transactions among themselves or between the two types of entities. That includes just about everyone! Ongoing innovation in technology and trends toward alternate delivery channels create opportunities for businesses and consumers to interact in new and nontraditional ways.
3. It isn't a question of whether FinTech will disrupt the economy, but rather when. It sounds ominous, and perhaps it is, but the truth is that this kind of disruption has happened before. Think of the financial services industry before ATMs or online banking. While they are now part of the everyday financial services landscape, that wasn't always the case. Significant amounts of time and money were required to implement these and other innovations. These and other innovations were likely regarded as disruptions to the daily course of business. FinTech is no different, but some community financial institutions have already started to head down that road. For example, some institutions are allowing users to access mobile banking through Apple's Touch ID biometric technology.
4. The trend of viewing FinTech companies as disruptors and competitors is shifting as opportunities evolve to develop strategic alliances and partnerships with financial institutions. Endless possibilities are being explored through the many faces of FinTech as financial institutions search for ways of delivering new and enhanced products and services. The emergence of blockchain technology, artificial intelligence, predictive analytics, and risk modeling are great motivators to institutions that embrace customer demand for alternatives to traditional banking.[1]
5. Providing banking services to entities such as issuers, exchangers, and intermediaries presents unique risks and challenges. Consider the merchant that accepts the virtual currency, the intermediary that exchanges the virtual currency on behalf of the merchant, the exchange that actually converts the virtual currency to real currency, and the electronic wallet provider that holds the virtual currency on behalf of its owner. With this many players on the field, community bankers don't have to look far to provide services to entities engaged in virtual currency activities.[2] Reputational risk, compliance risk, credit risk, cybersecurity risk, and operational risk are all part of that equation. Appropriate due diligence, ongoing monitoring, and a solid set of internal controls are all necessary to appropriately manage and control these risks.
6. What is bitcoin? *Bitcoin* is a digital currency that is peer-to-peer, for which transactions take place between users directly, without an intermediary. Bitcoin has a fluctuating value and is not backed by a central issuing authority, such as a government. It is untraceable and cannot be recovered if lost or stolen. Bitcoin is one of many digital currencies, and some but not all of them are processed using cryptography.

[1] *The Pulse of Fintech*, *2Q 2016*, August 17, 2016, https://home.kpmg.com/content/dam/kpmg/us/pdf/gm-tl-0890-q2-fintech-global-report.pdf
[2] *Community Banking Connections*, October 2015, Federal Reserve Bank of San Francisco, by Wallace Young, https://cbcfrs.org/articles/2015/q2/virtual-currencies



Source: GAO.

7. What is blockchain? A *blockchain* is a data structure that makes it possible to create a digital ledger of transactions and share it among a distributed network of computers. It uses cryptography to allow each participant on a network to manipulate the ledger in a secure way without the need for a central authority.[3] It is likely that other technologies will have an impact on blockchain and how it is used. Blockchain may also have an impact on other technologies as they are developed.

8. Many people consider virtual currencies to be the same as bitcoin. While bitcoin is one example of a virtual currency, hundreds of similar virtual currencies exist, and new alternatives emerge on a regular basis. In addition to that, consider digital things of value ranging from reward programs offered by credit card issuers to currencies recognized only within a virtual economy (e.g., within online role-playing games) to credits on social media platforms to Apple Pay and Google Wallet.[4]

9. Regulatory activities surrounding virtual currencies in the U.S. may be on the rise. Regulatory activities surrounding FinTech in the U.S. may be on the rise. On July 21, 2016, U.S. Senators Sherrod Brown (D-OH) and Jeff Merkley (D-OR) sent a letter to the heads of the Federal Reserve, Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation, National Credit Union Administration, and Consumer Financial Protection Bureau (CFPB) reminding them that the Financial Stability Oversight Council's 2016 annual report urged regulators to pay close attention to possible systemic risks that could emerge from the rapidly growing FinTech sector. Regulators domestically and globally will at some point be challenged with the task of either creating a new regulatory structure or agreeing on an existing one to govern these currencies.

The CFPB is assuming a no-nonsense approach in this regard and has already taken action against an online lender whose conduct violated multiple federal consumer financial protection laws, including the Truth in Lending Act and the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Each of the federal financial institution prudential regulatory agencies has initiated specific actions. For example, the OCC hosted a forum in June 2016 to discuss FinTech and virtual currencies. The Conference of State Bank Supervisors issued guidance in mid-2014 regarding virtual currencies and related banking considerations.

Separately, on September 13, 2016, the OCC released a notice of proposed rulemaking with request for public comment regarding receiverships for uninsured national banks. There is speculation that this aligns with the OCC's consideration of extending a limited charter for FinTech firms to become limited-purpose banks.

10. The battleground in Washington is becoming home to an increased lobbying presence. In Washington, FinTech companies—and this includes big players such as Apple and Google in addition to online lenders and payment processors—are increasing their lobbying presence. Meanwhile, federal watchdogs stand poised to protect consumers with laws that consider virtual currency and FinTech innovations and technology.[5]

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[3] *Wall Street Journal* Blog Entry dated February 2, 2016, http://blogs.wsj.com/cio/2016/02/02/cio-explainer-what-is-blockchain/

[4] JD Supra Business Advisor, January 7, 2016, by Nicholas Mooney (Spilman Thomas & Battle, PLLC), http://www.jdsupra.com/legalnews/virtual-currencies-and-the-risks-they-61185/

[5] Politico, April 15, 2016, http://www.politico.com/tipsheets/morning-tech/2016/04/big-tech-readies-big-bucks-on-fintech-lobbying-today-house-votes-on-rate-regulation-bill-white-house-wades-into-set-top-box-fight-213787

11. **Compliance issues may not be succinctly defined, but they are there.** Consider different models of crowdfunding and peer-to-peer payments used by FinTech companies. While each model has potential benefits and drawbacks for consumers, it's clear that they fall under the umbrella of certain consumer protection laws, particularly ECOA, FCRA, the FTC Act, and UDAAP. When it comes to business lending, however, it's different. According to a December 2015 issue of *Forefront* released by the Federal Reserve Bank of Cleveland, at least 150 alternative finance companies in the U.S. alone focus on extending credit to small businesses. These nonbank credit providers operate online and offer a variety of products such as loans and cash advances, as well as hybrid products that carry features of both. Marketplace lending platforms, also known as peer-to-peer lenders, are among the largest and most well-known. Other lenders competing for small business borrowers include merchant cash advance providers, direct lenders that keep loans on their balance sheets, and payment processors that lend to their business account holders. These lenders appeal to business owners seeking alternatives to banks for a number of reasons. Evidence suggests that some of the products are much more expensive than traditional credit and their terms and conditions are not clearly described. The question is whether intervention is needed and what supervisory authority agencies might have over alternative small business credit providers. Separately, there continues to be a push around the world in dealing with knowing your customer and the basic requirements of the Bank Secrecy Act, Office of Foreign Assets Control, and other anti-money laundering regulations.
12. **RegTech isn't too far behind FinTech.** In a nutshell, RegTech is all about how to use technologies to be efficient and effective in regulatory compliance.[6] New applications are being developed in a wide array of fields such as data aggregation, risk modeling, scenario analysis and forecasting, and monitoring of payment transactions.[7] A proactive RegTech strategy can help manage regulatory overload.
13. **Trade associations are offering opportunities to those in the world of FinTech.** The presence of trade associations is expected to increase as the financial services industry aligns itself more closely with FinTech. One such organization is the Chamber of Digital Commerce, which works to promote the acceptance and use of digital assets and blockchain-based technologies. This is done through education, advocacy, and working closely with policymakers, regulatory agencies, and others in the industry. Wipfli is proud to be a member of the Digital Chamber of Commerce and looks forward to maintaining a competitive edge in this rapidly evolving sector.

## So Where Does All This Lead?

The next few years promise to be full of innovation as the financial services industry searches for ways to stop considering FinTech as a disruption and starts exploring the hidden opportunities that it brings. Community bankers will be well-served to stay informed on FinTech developments and maintain an open mind as FinTech-related opportunities emerge for their financial institutions. Strategic planning and risk management will be critical as financial institutions reach out from the basic building blocks to shape the future of technology in their institutions.

### About the Author

With over 16 years of banking experience, Susi Massaro utilizes her expertise to serve Wipfli LLP's financial institution clients. Her responsibilities include management of the strategic planning team and assistance on strategic planning engagements, interest rate risk validations, liquidity risk process validations, and asset/liability management (ALM) consulting. Susi can be reached at smassaro@wipfli.com.

### About Wipfli LLP



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[6] *Australian Financial Review Magazine*, June 20, 2016, http://www.afr.com/technology/welcome-to-the-new-world-of-regtech-20160619-gpmj6k

[7] *RegTech is the new FinTech,* Deloitte Report, 2016, http://www2.deloitte.com/content/dam/Deloitte/ie/Documents/FinancialServices/IE_2016_FS_RegTech_is_the_new_FinTech.pdf