AUSTIN CAPITAL BANK

October 18, 2021

Mr. James P. Sheesley
Assistant Executive Secretary
Attention: Comments-RIN 3064-ZA26
Legal ESS
Federal Deposit Insurance Corporation
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Ms. Ann E. Misback,
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Board of Governors of the Federal Reserve System
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Chief Counsel's Office
Attention: Comment Processing
Office of the Comptroller of the Currency
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RE: Proposed Interagency Guidance on Third-Party Relationships: Risk Management

Thank you for taking the initiative to propose joint guidance to align 3rd party management regulatory expectations and requirements for all banks regardless of federal regulator.

Background

Austin Capital Bank is a ~$425 million asset technology first independent community bank located in Austin, Texas. The bank has experience in bank sponsorship of fintechs, providing banking-as-a-service to 3rd parties, and directly serving customers leveraging the bank's own propriety fintech platform. As CEO, prior to founding Austin Capital Bank I was a product manager of a fintech that leveraged bank partnerships and was subsequently acquired by a bank, so I have the unique perspective of seeing multiple sides of the 3rd party risk management issue contemplated in the current proposed guidance.

Recommendation:

Bifurcate and customize 3rd party risk management guidance into two sets of specific guidance based on the party 'in control' of the customer relationship.

- Scenario A: 3rd party as a vendor to a bank
- Scenario B: Bank as a sponsor of (vendor to) a 3rd party

Introduction

Current banking 3rd party risk management guidance is monolithic and does not differentiate between the two major categories of service delivery models. In Scenario A) a bank uses a 3rd party to deliver a service to a customer where the bank controls the customer relationship. In Scenario B) a bank sponsors a 3rd party and the 3rd party controls customer relationship.

Scenario A: 3rd party as a vendor to a bank

Example: Traditional bank core technology provider.

Scenario B: Bank as a sponsor of a 3rd party (bank is a vendor of the 3rd party)

Example: Bank sponsorship of a 'neo-bank'.

In scenario A, a 3rd party is competing with other 3rd parties to become the service provider for a bank. In scenario B, banks are competing against other banks to become or remain (for an existing relationship) the sponsor for a 3rd party.

While there are some commonalties in the considerations for 3rd party risk management in these two scenarios, the fundamental components of prudent third-party risk management consistent with safe and sound banking, protection of the banking and payment systems, and mitigating potential consumer harm are materially different between the two scenarios. Recognizing those differences, the Agencies, and banks they regulate, are likely better served by two discrete sets of guidance, one for each scenario. I would suggest the Agencies split the guidance based on which party is in 'control' of the relationship with the end customer.

Scenario A: 3rd party as a vendor to a bank

Regulatory oversight and guidance and industry practices are well established and understood for this scenario.

The current FDIC guidance (FIL 44-2008) is well written and clearly defines the requirements for this type of service delivery model. Of note, the contractual requirements are very helpful in practice for forming the base required components for any 3rd party vendor contract.

While this guidance could perhaps be enhanced with some minor updating and clarification by some of the content in the proposed guidance and public comments on that guidance, there is little need for wholesale replacement of the guidance.

In practice, the primary issues related to the existing guidance are twofold:

1. The vendor of a vendor of a vendor to infinity conundrum
2. Redundant or commercially unviable 3rd party due diligence

1. Vendors of vendors ('sub vendors')

Many technology solutions today are at their essence custom assemblages of sets of sub vendors integrated to provide a solution to a specific issue or objective for a bank. In turn the sub vendors of the bank's vendor have sub vendors, which also have sub vendors, which again have sub vendors, etc. Taken to the extreme, banks are currently potentially vicariously regulatorily liable for actions or inactions of some far-removed company serving as a vendor of a vendor of a vendor ad infinitum.

I don't have much of value to contribute to the resolution of this conundrum, other than to suggest that the Agencies should consider some sort of 'commercially reasonable' or 'reasonably prudent' level of due diligence of a vendor's vendors.

Banks are often derided for their perceived lack of innovation, but if a bank is operating in an environment where it is held responsible for the actions of every party it interacts with in a material fashion and all the parties that party uses, etc. 'as if the management of the bank took the action itself' it creates a strong bias towards the status quo and analysis paralysis of trying to identify, measure, monitor, and control every single aspect of risk of any new venture or initiative, which is of course is an impossibility, relegating commercially viable and expedient innovation and iteration to an area outside of regulated banks.

2. Redundant or commercially unviable 3rd party due diligence

There are about 5,000 banks all performing varying levels of due diligence on many of the same vendors. This is of course redundant and inefficient.

Under the current guidance each bank is expected to conduct its own due diligence. The proposed guidance allows for banks to use ratings companies or to pool resources to perform due diligence (while remining ultimately responsible for the vendor's actions) which is at least helpful.

Going beyond this concept of pooled or outsourced expert due diligence to an 'FDIC approved' (Federal Regulator Approved) vendor list would likely drastically improve the competency of due diligence performed across the industry, the reliability of that due diligence, and dramatically increase due diligence efficiency for banks and their vendors (i.e. could a community bank really accurately assess the risk of using AWS or MS Azure other than to essentially 'paper up the file' for an examination?). Due diligence could be performed at scale on common vendors that voluntarily submit to be examined by the Agencies on a regular basis. These vendors would pay for the examination, funding the federal examiners performing the examinations, and if a vendor 'passed' it would be certified for some period of time, for example a year.

This certification program or process would be something akin to an embodiment of the 'Voluntary Certification Program to Promote New Technologies' initiative the FDIC put out for public comment in 2020.

This type of certification process would create tremendous value for banks, vendors, and the Agencies. For banks it would reduce the need to become 'experts' in some new technology that the bank likely has limited experience with (hence why it is likely contemplating the vendor in the first place), it would create efficiency for the vendors by centralizing the due diligence process, but perhaps the greatest benefit would be to create a center of knowledge and excellence for the regulatory Agencies themselves to understand system wide the scale and scope of individual vendors impact on the industry, emerging technologies, and developing vendor trends in the industry, which in turn would improve the stability and regulatory oversight of the industry itself.

Scenario B: Bank as a sponsor of a 3rd party

Scenario B is closely analogous to a lending relationship for banks, where banks are the vendors competing for borrowers. Using this analogy, a 3rd party would likely seek the lowest cost, best service, and most 'flexible' arrangement with a bank sponsor. Much the same as in bank lending, it is in this type of scenario where having a common set of regulatory requirements required of 'ALL' banks provides a floor for safe and sound banking for the banks, the Agencies, and the consumers served by the industry. This set of baseline requirements would diminish the opportunity for bank oversight arbitrage and an associated 'race to the bottom' of 3rd party oversight, as non-bank banking service providers seek to avoid direct regulatory oversight and obtain banking powers without the responsibility and direct federal oversight associated with a charter.

Empowering community banks via common regulatory oversight requirements to achieve robust 3rd party oversight systemwide for the banking industry of the United States.

For scenario B, I would suggest the Agencies may wish to take a step back and evaluate a larger picture.

Why does the industry have 3rd party risk management requirements? I presume it is to ensure the safety and soundness of the banking and payment system and its participants, maintain consumer confidence in that system, and mitigate the potential for consumer harm.

For scenario B, what is missing in this rapidly evolving and expanding service delivery model is not just new or updated guidance, but the tools and an effective methodology for prudent regulatory and bank oversight of non-bank 3rd parties that are providing banking services directly to customers.

In my following comments I focus more on the regulatory infrastructure required for this model to continue to grow in a manner consistent with safe and sound banking, rather than commentary on the currently proposed guidance.

There are now over a hundred 'neo-banks' in the United States. Based on a review of publicly available financial information, a current common denominator for most of these neo-banks is that they are unprofitable and reliant on continued new funding to maintain viability. Additionally, some appear to be built on economic models that are currently unviable, with only the hope that future products and services can increase the value of a customer relationship into profitability. Currently funding for neo-banks is bountiful, but what if it wasn't and the cash reserves of one or more neo-banks were depleted?

While the call report system is in place for banks and serves as a canary in a coal mine for the Agencies to identify and address potentially emerging issues in a proactive manner system wide, specific to an individual institution, or with subset of institutions with some commonality, no such system exists for 3rd parties providing banking services directly to consumers via a bank sponsorship model. Additionally, the public nature of the data provided in the call report system serves as a tool for consumers to make informed decisions on the financial stability of the institutions they entrust with their hard-earned money, no such system exits for neo-banks. The truth is that today both regulators and consumers are currently essentially blind to the 3rd party and systemic risk present in neo-banks / nonbank providers of banking services.

For example, does any regulator know how many millions of consumer depositors would be adversely impacted in the event one or more neo-banks fail? We've seen the micro version of this with Beam Financial impacting hundreds of customers, with regulatory sanctions arriving after the consumer harm has already occurred because just such a system does not exist. Now multiply that potential by millions of adversely impacted consumers magnifying the scale of consumer harm and potential threat to the system. Would the failure of one high profile neo-bank be a catalyst for a 'run' on other neo-banks?

As part of offering banking services to consumers via a non-bank 3rd party it would appear prudent and consistent with safe and sound banking that the Agencies should know the answers to the following questions in a centralized and searchable manner on a regular recurring and timely basis:

1. What 3rd parties are offering banking services directly to customers?
2. Who is their bank sponsor?
3. What products are being offered to customers?
4. How are the services being marketed? (Consumer compliance)
5. How many customers do they have and what is the dollar and unit volume of their deposits or credit products?
6. What is the financial condition of the provider?

By implementing a common set of core requirements in proposed guidance for any banks entering a sponsorship model relationship, the Agencies could take a proactive step in preventing future harm and ensuring the stability of the banking system.

While the Agencies have resources and individuals with expertise much more adept at drafting potential regulatory guidance and requirements than I am, below I suggest some components that might be beneficial to such a regulatory oversight architecture.

Of note here is that all of these requirements are for banks. By implementing regulatory requirements for ALL banks that sponsor 3rd party providers of banking services to customers. The Agencies can minimize scenarios where 3rd parties seek the banking relationship that is the most 'flexible' or 'accommodating', by establishing a regulatory minimum required baseline, with strong justification required by a bank for deviations from that baseline, akin to lending standards required systemwide of all banks that allow banks to customize their lending programs, but only within a regulatory framework.

<u>Regulatory Infrastructure</u>

To accommodate improvements in sponsor bank and regulatory oversight, the agencies would need to establish a 'Partner Portal' that would be somewhat analogous to a mini-version of FDIC-Connect and the Call Report infrastructure. By keeping the architecture of this portal somewhat simple and limited it could be created expeditiously and deliver tremendous value to sponsor banks and the Agencies.

Potential framework components for bank as a sponsor of a 3rd party

1. 3rd Party registration and data reporting
2. Consumer protection compliance monitoring
3. Resolution of a non-bank customer accounts / Reserve funding
4. Bank submission of monitoring reports and findings
5. Direct federal examination

<u>1. 3rd Party Registration and data reporting</u>

Today financial and operational data for neo-banks is not available to the Agencies in an orderly or timely fashion. If it is captured at all, it is in different formats with varying frequency and detail held at each individual bank. To facilitate robust Agency and institution oversight and 3rd party risk management programs, the FDIC would create a 'Partner FDIC-Connect Portal'. This portal would serve as a registration database of neo-banks providing banking services to customers.

Agency guidance as part of a bank 3rd party oversight program would compel ALL banks to require a vendor to register and provide data to the bank via the portal as part of sponsorship of the non-bank (or alternatively for the bank itself to enter such information, provided to it by the partner it sponsors as a required provision of the sponsorship agreement). For example:

As part of safe and sound management of a non-bank 3rd party providing banking services directly to an end customer, a bank shall:

Create a partner profile within FDIC Connect for the non-bank 3rd party provider

The bank shall require:

- *The partner to register with the FDIC as a non-bank provider of banking services to customers*
- *The partner to submit its financial statements in a standardized predetermined format quarterly on a calendar basis (a simplified mini-call report; balance sheet, income statement, statement of cash flows), no later than 30 days after the end of each quarter*
- *Supplemental information shall be submitted, including:*
  - *Types of accounts offered*
  - *Number of active customers*
  - *Number of active accounts, by account type*
  - *Number of inactive customers and accounts*
  - *Total deposits $ and #, by account type*
  - *Note: something similar to Schedule RC-O 1. 1 a-d*
- *In the event a non-bank provider of banking services has more than one banking partner sponsor, it shall segregate its account and customer activity by banking partner in its submission.*

With this financial and program scale information on a quarterly basis both the sponsor bank and FDIC would have the data and information to perform prudent program and 3rd party oversight in a timely manner on a regular basis. For example, if the non-bank partner is losing money, how many months of cash reserves does it have before it fails? i.e. how reliant on raising new capital is the 3rd party. If a neo-bank was approaching insolvency, the focus on termination and resolution in the oversight program would increase accordingly.

Additionally, the summary financial statement for any non-bank partner providing depository services via a bank partner sponsorship would be made public so that consumers can make informed decisions about the financial stability of their banking provider. Using Beam Financial again as an example, would ANY consumer have deposited money with Beam if they had a means to know that the company was on the brink of insolvency? If this system had been available, the consumer harm that occurred could have been materially reduced or avoided.

2. Consumer protection compliance monitoring

As part of the 3rd party portal, the Agencies should provide the capability for a non-bank providing banking services via sponsorship model to upload ALL of its advertising no less frequently than quarterly. A bank sponsor would have access to view and review ads submitted by its sponsored partner(s). This system would greatly reduce inefficiencies in the current compliance examination procedure and ensure compliance with consumer protection laws by 3rd party neo banks. A 3rd party that intentionally omitted advertising samples would be subject to regulatory sanction. The FDIC could use OCR to scan for triggering terms and use the system for offsite review and eventually apply ML or AI capabilities to ads and associated data.

3. Resolution of a non-bank customer accounts / Reserve funding

Today there are almost certainly banks sponsoring programs that if the neo-bank was unable to raise more capital and became insolvent, the bank would have no way of winding down the program in an orderly fashion.

For example, one non-bank banking services provider of depository services boasts 10s of thousands of customers (depositors) yet their sponsor bank has less than 10 employees. The non-bank partner almost certainly has an unprofitable economic business model. If the non-bank service provider would fail, who would service the account holders and facilitate and orderly resolution of the accounts? It is unlikely the sponsor bank could with less than 10 employees and reliance on the 3rd party's technology and staff to provide banking services to the depositors.

A question here is how do you enable small banks to safely participate in a sponsorship model and not 'lock out' small fintech startups from the same model?

- *A bank shall require a reserve deposit account sufficient for the resolution of the depositor accounts in event of failure of the non-bank*

The proposed guidance could include requirements for a program resolution plan with sufficient funds held in reserve to wind down a program. By establishing a requirement for all bank 3rd party sponsorship programs to have a plan for program resolution with funds deposited in advance in a resolution reserve account the agencies could inhibit bank sponsors from shopping for banks that are more lenient in program sponsorship requirements while keeping the playing field level for small community banks and small fintech startups.

By way of illustration, say a $25 per account reserve were required. A small start-up could be sponsored by a small independent community bank, because there would be few accounts to resolve and most likely a low-resolution cost. As the program grew in number of accounts, ostensibly becoming more 'successful', the reserve would increase proportionally as the fintech either generated capital from earnings or set aside part of each new funding round. In this manner the reserve account would function similarly to the FDIC DIF, allowing for an orderly resolution of a failed neo-bank.

With this action the Agencies would be accomplishing two objectives; 1) sequestering the resources necessary for an orderly resolution / winding down of a failed non-bank BEFORE a failure when the resources are still available and 2) creating a capital buffer by proxy for the non-bank, eliminating the regulatory whitespace exploited today by non-bank depository service providers to grow rapidly with unproven business models providing banking services with insufficient capital while depleting capital further though operational loses. i.e. One could think of the resolution reserve account as a proxy for a Tier 1 capital account for a neo-bank. It could be based on number of accounts, number of customers, dollar value of accounts, or some combination of these or other risk and cost of resolution factors.

This resolution reserve would not be an impediment to innovation as the required reserve should be determined by the sponsor bank in proportion to the estimated cost for resolution. For example, a startup with just a hundred or so customers might require a reserve of just a couple thousand dollars while a large neo bank would appropriately be required to fund a resolution reserve with millions. While the sponsor bank would be required to set and collect the reserve, any shortfall in the resolution of a program would be required to be paid by the sponsor bank. In this way by requiring the bank to establish a reserve, the Agencies are empowering banks to require it as part of sponsorship agreements and holding banks financially accountable if they are too lenient in allowing insufficient resolution reserves.

4. Bank submission of monitoring reports and findings

Included in the sponsor portal would be the means for a sponsor bank to submit monitoring findings on a real-time basis when applicable. Part of any prudent 3rd party sponsorship arrangement is monitoring. While monitoring is a prudent practice and required, there is currently no centralized means for a sponsor bank to report any finding from its monitoring program for a 3rd party to its prudential federal regulator and no centralized means for the Agencies to share such findings in the instance where a non-bank partner has multiple bank sponsors with different regulators.

Here the regulators should also pause when findings are submitted. Today banks are held accountable for the actions of 3rd parties "as if the bank took the action itself". In a sponsorship model, regulators should seek to reward strong monitoring programs in assessing a self-reported potential issue. For example, evaluating; What is the potential issue? How was it detected? Was it detected in a timely manner? What is the scale of the issue? What was the intent of the sponsored nonbank in taking its actions or inactions, e.g. was it trying to avoid detection? What is the time frame of the issue; a single instance, a pattern, currently ongoing?

For example, a sponsor bank with a strong monitoring and oversight program requires pre-approval of all advertising. Through its ongoing monitoring it discovers that the 3rd party it sponsors, is running advertisements that were not pre-approved that contain potential UDAAP violations. The bank discovers this shortly after the ads are launched publicly and self-reports the apparent violation via the FDIC portal. The regulators should see this as an indicator of a strong oversight program and address the issue in that context and avoid using it as a pretense for regulatory sanction of the sponsoring entity.

5. Direct examination of 3rd party non-banks providing banking services.
The proposed guidance appropriately notes that:

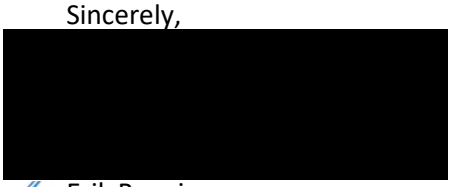
> *The agencies generally have the authority to examine and to regulate banking-related functions or operations performed by third parties for a banking organization to the same extent as if they were performed by the banking organization* itself. See 12 U.S.C. 1464(d)(7)(D) and 1867(c)(1).

Currently in the bank sponsorship model, banks are ostensibly acting as regulators of the partners they sponsor, but with no regulatory enforcement authority. Often the only recourse for a bank when it discovers partner malfeasance is contract termination. A sponsored entity can move to another sponsoring bank and the former bank may be unable or unwilling to communicate with the future sponsor bank in relation to the reason for contract termination.

As part of a bank's 3rd party oversight of partners, a bank should be able to request an examination of a sponsored 3rd party by a federal agency when its monitoring program identifies issues of significant scale or potential impact. Additionally, the Agencies could use the financial information obtained in the partner portal to conduct a direct examination of a neo-bank when deterioration in financial condition or some other factor warranted a timely examination.

Thank you for your time and consideration.

Sincerely,



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