

GROWING TOGETHER

# Collaboration Between Regional and Community Banks and Fintech





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## Methodology

In Q3 2016, Mergermarket surveyed 75 senior executives in the United States to understand their strategy and views regarding collaboration between banks and fintech. Respondents were split across regional and community banks (50%), fintech companies (25%) and private equity firms, venture capital firms and investment banks (25%). For the purposes of this report, fintech includes but is not limited to online and mobile banking technology, marketplace lending platforms, online and mobile payments technologies, robo-advisors for wealth management, virtual currencies and blockchain. For a fintech firm to participate, it was required to have been in operation for at least two years.

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## Foreword

As the fintech revolution advances, U.S. regional and community banks stand at a critical juncture. On one side is an on-ramp to the fintech superhighway—a road that is built for great speed but has significant perils as well. On the other side is the old, well-traveled bank road—one that is familiar and steady but on which institutions risk being left behind.

Thousands of banks are turning onto the fintech freeway. As of June 2016, there were around 6,000 banks in the U.S., and the majority of these are regional and community banks that serve millions of people who want services on their computers, tablets and phones. Fintech startups offer an array of tools and technology that these customers increasingly demand.

In some cases, fintech companies are trying to replace banks with their online offerings. More often,

however, their technology is tailor-made to help banks expand and improve their businesses. Take a fintech firm like eBankIT, which produces digital platforms for banks that include account management software and an online banking app. Then there are internet lenders such as Kabbage, which has already funded more than US\$1B in loans by itself, that are beginning to partner with traditional banks.

Many smaller fintech firms also rely on the liquidity provided by banking partners. “Fintech firms that don’t partner with banks are often at risk when big banks come into their niche, or when market forces turn against them and they don’t have deposits to fall back on,” wrote Telis Demos in a *Wall Street Journal* column in September 2016.<sup>1</sup>

These technologies offer major advantages to banks that adopt them successfully. Challenges loom as well,

<sup>1</sup> <http://blogs.wsj.com/moneybeat/2016/09/02/fintech-startups-face-dilemma-on-banks-are-they-friend-or-foe/>

however. Banks need enough knowledge of the industry to identify proper partners for their size and market. Perhaps most importantly, they must be careful to abide by strict legal requirements when it comes to licensing and disclosure of customer data.

In order to better understand the dynamics between fintech and regional and community banks, Manatt conducted a survey of C-level executives from the two groups in partnership with financial intelligence firm Mergermarket. The results reveal high hopes for the future of collaboration between the two. Banks, in particular, are eager to embrace the opportunities presented by technology. Senior executives from private equity firms, venture capital funds and investment banks were also surveyed, and they expressed optimism about the potential for partnerships and acquisitions between the two sides.

At the same time, all three groups noted flash points to watch out for. Banks are hyperaware of regulatory risks and therefore demand high standards from fintech companies when it comes to compliance. On the fintech side, firms are concerned about the challenges that result from the small scale of regional and community banks, especially their limited customer bases and idiosyncratic technical systems. Dealmakers largely share the concerns of both sides, emphasizing the importance of legal issues and the complexity of integrating fintech functions at banks.

For both banks and fintech firms to succeed in the fast-changing world, working together will be essential. Locating the right avenues of cooperation—and navigating the pitfalls along the way—requires an understanding of the nuanced relationship between the two sides.

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## Executive Summary

### **Optimism reigns among banks.**

Despite the rapid pace of change in the world of finance, the regional and community banking community has a positive view of its role in the future of lending. They are willing to experiment and are aware of the need to adapt to a new technological environment.

### **Banks and fintech have high hopes for collaboration.**

The vast majority of regional and community bank respondents are already collaborating with fintech or plan to do so in the near future. On the fintech side, working with such banks is seen as an opportunity to become established in the industry, legitimize their operations in the eyes of skeptical consumers or expand their market share. Some fintech companies are also in need of capital and see the bank's liquidity as a potential benefit.

### **Mobile services are critical to banks' futures.**

Smartphones are ubiquitous in the modern age, and people young and old expect to be able to access their banking services while on the go. Creating a convenient and reliable mobile platform is one of the key opportunity areas for banks and fintech to collaborate and an important way for banks to retain existing customers as well as attract new ones.

### **Cybersecurity must be a priority.**

The threat of data breaches is part and parcel of digital services, and both banks and fintech firms know how dangerous they can be to their businesses. As a result, the two sides must pay careful attention to the issue when preparing to collaborate.

### **Structuring legally compliant relationships is essential.**

Heavily regulated financial institutions must ensure that structuring any relationship with a fintech firm will meet the scrutiny of state and federal regulators who routinely examine banks for compliance with applicable safety and soundness standards and strong internal controls. Increasing regulatory attention on fintech firms means that those businesses must also enter any partnerships with banks in a careful and measured manner that will withstand consumer and regulatory scrutiny. In addition, in certain cases, prior regulatory approval may be required before a partnership can be finalized.

## Data Overview

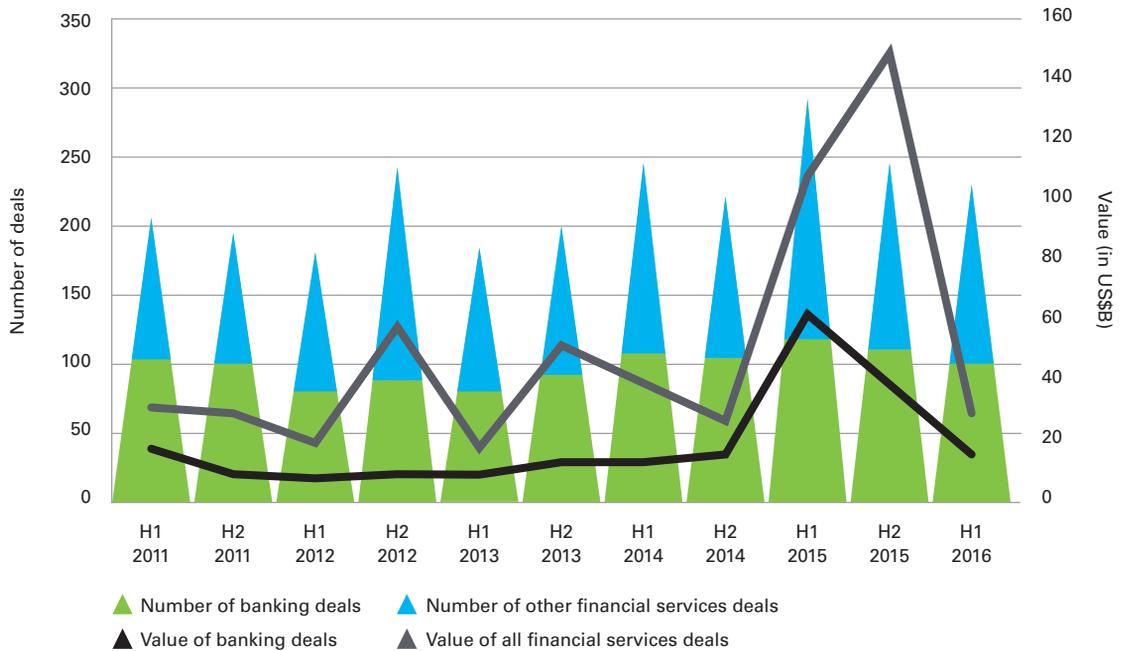
Dealmaking in the U.S. financial sector has remained consistent and robust for the last half-decade. While M&A value has dipped in North America this year from the highs of 2015, deals among financial companies have declined only slightly in volume—from 146 deals in H2 2015 to 130 in H1 2016. Meanwhile, financing to the burgeoning fintech sector has gradually ramped up over the last five years to incredible heights. The total value of funds raised by venture-backed fintech firms reached US\$7.4B in the first half of 2016, just a slight decline from the previous high of US\$7.8B in H1 2015.

The implication of the data is clear: banks are consolidating, while fintech firms are growing in number. Since 2011, the U.S. has seen the number of banks shrink from 7,357 to 6,058, as of June 2016. This consolidation is largely concentrated in the mid-market: more than 56% of the 1,082 U.S. bank acquisitions over the last five years have been valued at US\$250M or less.

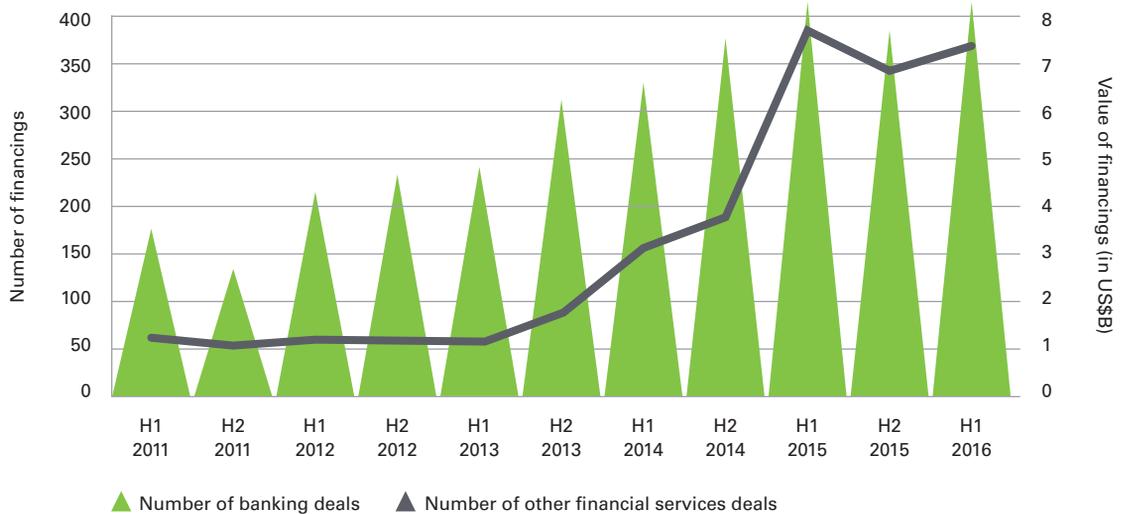
At the same time, the role that fintech plays in the financial industry is expanding rapidly. Online marketplace lenders (MPLs) such as LendingClub and Prosper have become widely known by the public and have loan volumes in the billions of dollars. Payments processed by firms like Square and Stripe are used by tens of thousands of businesses.

As banks seek a competitive edge by adding fintech services to their offerings, partnerships have become increasingly common. Radius Bank has teamed up with online lender Prosper to help make personal loans, for example, while Regions Bank is collaborating with Foundation to offer small business loans. Mergers between the two sides remain rare.

## U.S. Financial Services M&A, 2011-2016



## Global financing to VC-backed fintech firms, 2011-2016



Note: VC data comes from CB Insights and M&A data from Mergermarket. According to Mergermarket classification, the financial services industry includes fund managers, insurance companies, investment brokers, investment banks, and rental and leasing companies in addition to commercial banks.

## Chapter 1: Friends or Foes?

**Regional and community banks are the backbone of the U.S. banking industry. And just like larger institutions, these mid-sized and smaller banks see the rise of fintech with clear eyes. While they recognize the disruptive potential of new technology, they often view the situation with real optimism—and the feeling on the fintech side is mutual. More than half of our bank respondents (54%) and fintech respondents (58%) see each other as potential partners.**

On the bank side, respondents cited a wide range of reasons for viewing fintech in a positive light. They said fintech can improve their ability to offer online services for their customers, decrease technology costs and allow them to offer lower lending rates to consumers and businesses. The CEO of one Southeastern community bank explained that fintech had created wholesale changes in their way of doing business: “Fintech is surely a potential partner to our bank. Technology has turned around our entire operating environment and driven many opportunities to improve our products and services. It has also helped us improve our customer base and satisfaction levels.”

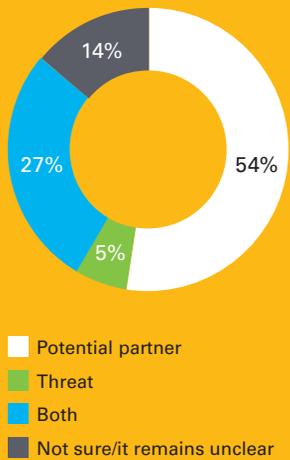
Fintech respondents pointed out that partnerships between the two sides are often a natural fit, given that banks have a built-in customer base and fintech firms have technology that can upgrade banks’ potential. “Financial technology companies have helped banks improve their

services overall,” said the CFO of a peer-to-peer lending service. “Banks have taken advantage of the low costs of fintech services, and this has enabled many regional and community banks to develop and offer better options to their customers.”

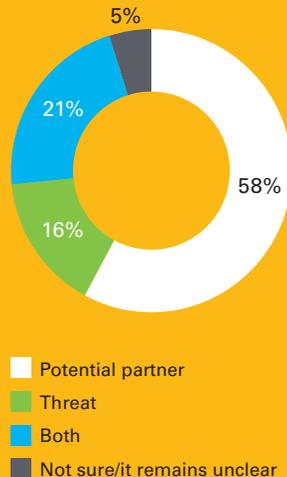
A minority of respondents on both sides believe that fintech is both a threat and a potential partner to banks. Indeed, there are cases in which even a single fintech firm can represent both a threat and a partner over time. Transferwise, a firm started in 2011 that offers cut-rate fees for sending money abroad, started out by using banks as partners throughout the U.S. due to the requirement of a state license to operate. As the company has grown, however, it has increasingly obtained its own licenses in order to cut down on costs.<sup>2</sup> At the same time, it is now forging new partnerships with banks by aiming to integrate its service into banks’ online apps. These types of hybrid models are increasingly being used across the industry.

<sup>2</sup> <http://www.wsj.com/articles/fintech-startup-transferwise-moves-away-from-banks-1472488911>

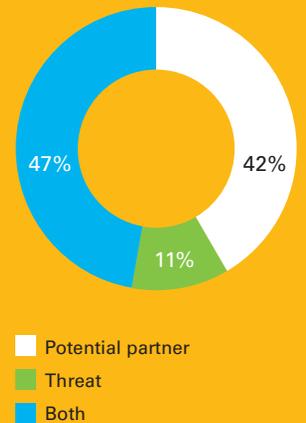
**Bank respondents:  
Would you say that fintech is mostly a potential partner for your bank, a threat to your bank, or both?**



**Fintech respondents:  
Would you say your company is mostly a potential partner for regional/community banks, a threat to them, or both?**



**Dealmaker respondents:  
Would you say that fintech is mostly a potential partner for regional/community banks, a threat to them, or both?**



**An urgent priority**

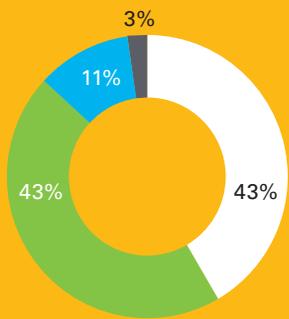
A rather different picture emerges when it comes to the importance of collaboration for each side. For bank respondents, a large majority view working with fintech as “essential” (43%) or “very important” (43%), whereas just 16% of fintech respondents see it as “essential” to work with regional or community banks and 42% see it as “very important.” Over one-third of fintech participants (37%)

said they believe it is “not important” to work with regional and community banks, arguing that they can thrive by pursuing other market segments or by targeting regional customers through different means.

In some cases, bank respondents said the situation is quite urgent, arguing that they run the risk of losing customers if they do not move

quickly to collaborate with fintech. “Competition in the financial services industry has increased significantly,” said an executive vice president at a Northeastern regional bank with more than US\$6B in assets. “Every institution is trying to capture more customers by offering competitive products, especially digital ones. So it is absolutely essential to embrace financial technology.”

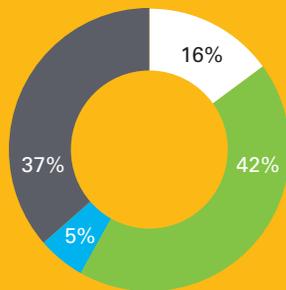
**Bank respondents: How important is it for regional/community banks to collaborate with fintech?**



- Absolutely essential—our institution will not survive if we don't embrace fintech
- Very important—our institution will suffer greatly if we don't embrace fintech
- Somewhat important—our institution will suffer a fair amount if we don't embrace fintech
- Not essential—our institution can take advantage of niches that do not involve the use of fintech

Another respondent, the CFO of a Southeastern regional bank, said the cost savings of fintech services were vital as well. "The most essential component is the reduced costs. We have seen a significant reduction with fintech," he said.

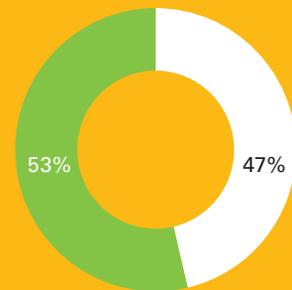
**Fintech respondents: How important is it for your company to collaborate with regional/community banks?**



- Absolutely essential—our company will not survive if we don't work with regional/community banks
- Very important—our company will suffer greatly if we don't work with regional/community banks
- Somewhat important—our company will suffer a fair amount if we don't work with regional/community banks
- Not essential—our company can take advantage of niches that do not involve working with regional/community banks

Several fintech executives said their focus remained on enterprise clients or direct-to-consumer services, and they see little need to partner

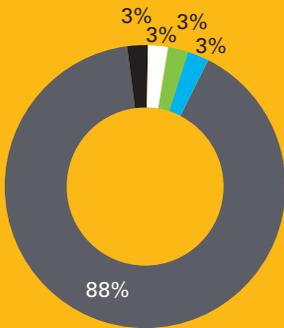
**Dealmaker respondents: How important is it for regional/community banks to collaborate with fintech?**



- Absolutely essential—regional/community banks will not survive if they don't embrace fintech
- Very important—regional/community banks will suffer greatly if they don't embrace fintech

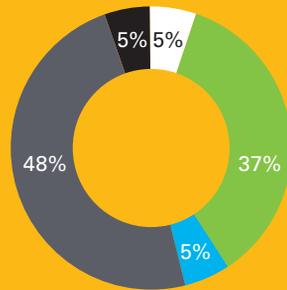
with small or mid-sized banks. However, others said banks played a key role in expanding their customer base. "We have a large database of banks we work with, and working with regional and community banks helps us extend our market reach," said the CFO of a fintech firm with a valuation above US\$3B. "They enhance our business and the services we offer, as well as get us better returns."

**Bank respondents: Which of the following do you think best describes how the banking industry will look ten years from now?**



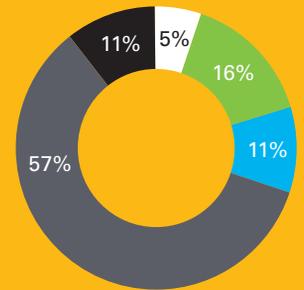
- Dominated by fintech companies
- A few large banks, with fintech serving all other niches
- Regional and community banks experiencing a resurgence, thereby maintaining/growing their position in the marketplace
- Traditional banks partnering with fintech companies in a largely collaborative environment
- Banks aggressively competing with fintech companies to survive

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### The future of banking

Divergence could also be seen between the respondents in their visions of the banking industry ten years from now. While nearly nine out of ten bank respondents (88%) think traditional banks will partner with fintech in a collaborative environment, only 48% of fintech respondents gave the same answer. More than a third (37%) of fintech respondents think the industry will consist of just fintech companies and a few large banks in a decade's time. Dealmaker respondents, meanwhile, fell in between—57% think a largely collaborative environment will prevail, while 16% foresee a few large banks surviving and fintech serving all other niches.

No one has a crystal ball, of course but a body of evidence suggests that, over the medium term, the mutual benefits of collaboration between banks and fintech mean that partnerships will continue to blossom. In August 2016, Moody's released a report detailing the benefits that partnerships between banks and marketplace lenders (MPLs) can achieve, both for themselves and for

small businesses.<sup>3</sup> Banks can achieve greater lending volume and MPLs can reach more customers, it said; small businesses can get funding more quickly than in a traditional loan process. A similar conclusion was drawn by Federal Reserve Bank of Atlanta analyst Robert Canova in a March 2016 article examining the gains achieved by banks and fintech when working together.<sup>4</sup>

The COO of a Midwestern community bank predicts a future in which fintech is active and all banks will be working with technology to serve their customers better. "There is no doubt that in the coming 10 years, the banking industry will see a lot of involvement of fintech companies," he said. "Banks are ready and willing to use these services."

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<sup>3</sup> [https://www.moody.com/research/Moodys-Tie-ups-between-marketplace-lenders-banks-can-benefit-small-PR\\_354308](https://www.moody.com/research/Moodys-Tie-ups-between-marketplace-lenders-banks-can-benefit-small-PR_354308)

<sup>4</sup> <https://www.frbatlanta.org/economy-matters/banking-and-finance/viewpoint/2016/03/15/fintech-companies-banks-allies-or-rivals.aspx>

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## Chapter 2: The Regional and Community Bank Perspective

**Regional and community banking leaders are largely optimistic about their prospects for collaborating with fintech, as Chapter 1 revealed. However, being optimistic and being well-prepared do not always go hand in hand. Banks are clearly enthusiastic about the opportunities offered by fintech, but they are not all confident in their ability to take advantage of them.**

In our survey, nearly half of bank respondents said their institutions were only somewhat prepared (43%) or somewhat unprepared (5%) to address the challenges and opportunities presented by fintech. The concerns of bank respondents ranged widely, from needing to boost their security systems and third-party due diligence to requiring a significant upgrade of their training procedures. In recent years, the Office of the Comptroller of the Currency (OCC) and the Consumer Financial Protection Bureau (CFPB) have released a number of regulations focused on the need for thorough due diligence on third-party vendors, as the risk from these vendors has increased substantially.

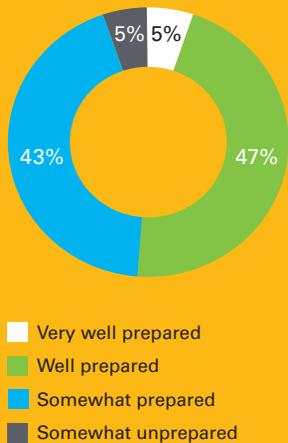
The CEO of one Southeastern community bank said his institution was somewhat unprepared for dealing with fintech, and admitted that they had a long way to go: “We would have to restructure all our processes, and push management and employees through training in order to get accustomed to the new technology. But we foresee a slowdown in our business if we do not find new solutions

to implement. So currently I would say we are unprepared, but on the way to getting prepared, for the necessary changes.”

At the same time, most respondents said their board of directors had taken concrete steps to aid in the effort. More than eight out of ten (84%) said members of their board had attended conferences to learn about fintech, and the same percentage said directors had held meetings with fintech companies to discuss the potential for collaboration. A sizable majority (59%) said their boards had also conducted a formal study of the opportunities and risks associated with using fintech.

Several respondents said their board had significant ties with and interest in technology. The CEO of one 100-year-old community bank said their board had a formal process in place to evaluate and adopt new technologies as they appeared: “Our board has prepared a framework and follows it effectively to ensure we keep up with technological advancements in order to retain our position in the market. They regularly

**Bank respondents:  
In your opinion,  
how prepared is  
your institution  
to address  
the growing  
challenges and  
opportunities  
presented by  
fintech?**



visit technological conferences and events and interact with technology experts to better understand the limitations and opportunities that exist.”

**State of play**

A large majority of regional and community bank respondents (81%) are already working with fintech companies. In most cases, the collaboration takes the form of a formal partnership or joint venture (63%), or banks

**Bank respondents:  
What efforts has  
your board of  
directors made to  
adapt the bank to  
the rise of fintech?**

**84%**

Attended conferences to gather information on fintech

**59%**

Conducted a formal study of the opportunities and risks associated with fintech collaboration

**84%**

Held meetings with fintech companies to discuss potential collaboration

use the technology firms as service providers (50%). Only a small minority have done an M&A deal with a fintech player (10%).

Some respondents said they prefer the use of service providers because this method of collaboration gives them a

chance to get better acquainted with how the firms operate and how valuable their services are. Down the line, they said, an M&A deal or a more formal partnership may make more sense. In other cases, respondents who only use fintech service providers said they did not have sufficient capital to make an acquisition or start a joint venture.

One of the few survey participants whose bank had merged with a fintech firm said he was quite pleased with the deal’s outcome, saying that it spurred gains in efficiency and allowed his institution to seamlessly integrate the firm’s services. “We gained a lot of benefits in this way,” the Midwestern bank CTO said.

In general, acquisitions of fintech firms by mid-sized banks are uncommon. However, there are some active regional bank acquirers, such as North Dakota-based MetaBank, which most recently bought payments solution provider EPS Financial for US\$43M in October 2016. More often, larger institutions make the investments in or purchases of fintech companies, such as Capital One’s deal also in October 2016 to purchase price-tracking service Paribus for an undisclosed sum. In certain instances, formal regulatory approval may be required prior to consummating a partnership or other form of relationship

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with a fintech firm. Depending on the circumstances, close counsel with advisors and regulators prior to commencing a transaction may be appropriate.

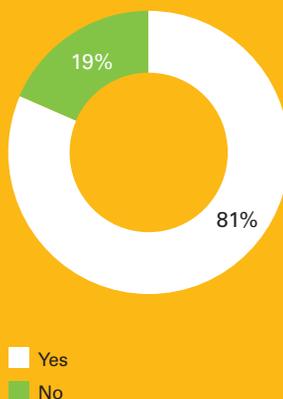
### The essential tools

The difference in banks' usage of various fintech services is stark. The vast majority of respondents use an online banking service provider (97%), payments technology (87%) and mobile banking tools (80%), while other services are less widespread. Just 40% of bank participants said they take advantage of online lending platforms, while 13% use robo-advisors for wealth management and 7% accept virtual currencies. A tiny percentage of respondents (3%) said they use an automated dispute management service.

Most respondents gave a simple explanation regarding why they use the services they do: They are the ones in highest demand by their customers. "These are the services we have opted for based on customer demand, as well as to stay competitive in the market," said the CFO of a West Coast regional bank.

Indeed, digital payments as well as online and mobile banking have become virtually essential for modern banks, as customers expect to be able to manage their accounts

### Bank respondents: Are you currently working with any fintech companies?



remotely. Companies such as Computer Services, Inc. (CSI) and Ebanq provide software suites that make it relatively easy for banks to launch and maintain such services.

Online lending platforms have skyrocketed in popularity in recent years, but regional and community banks are only beginning to collaborate with them in large numbers. Part of the reason is that such platforms often act as direct competitors—the likes of LendingClub and Prosper boast about their ability to cut through red tape that can be experienced at banks. Data security remains a concern for many bank respondents as well.

### Bank respondents: If yes, how are you currently collaborating with fintech?

# 10%

We have acquired/  
merged with a fintech  
company

# 63%

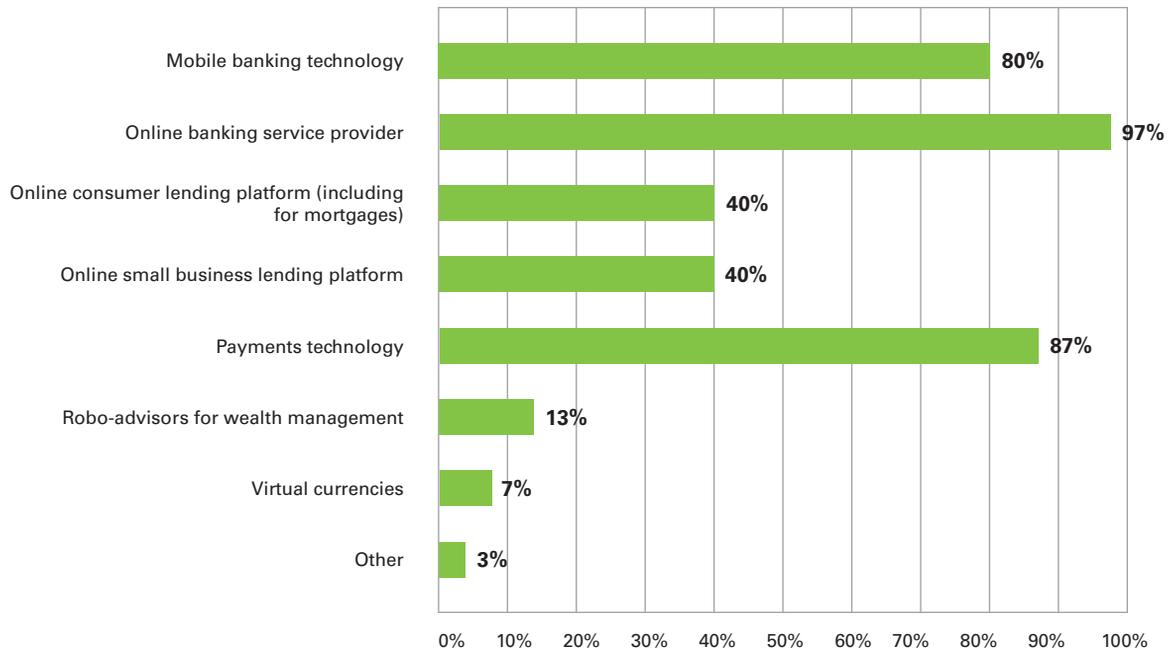
We have a joint venture  
or formal partnership  
with a fintech company

# 50%

We use one or more  
fintech companies as  
third-party service  
providers

Some said they planned to adopt online lending capability but simply hadn't launched it yet. "We are in discussions about using an online consumer lending platform," said the COO of a Midwestern community bank. "We are facing certain issues still, but once they are resolved we will use it."

**Bank respondents: Which types of fintech services are you using?**

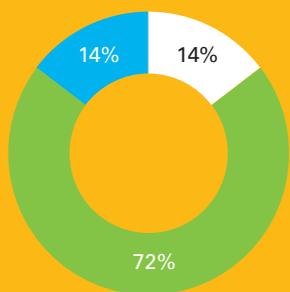


**Waiting to act**

The small minority of respondents who are not working with fintech (19%) called out two issues in particular as reasons why: the security of bank and customer information and the high risk of investment. They argued that the challenges involved in working with fintech justified their caution. Nonetheless, the vast majority said they do plan to collaborate with fintech either in the next 6-12 months (14%) or the next 12-24 months (72%).

Most respondents said their institutions were aware of the benefits of fintech, but they wanted to spend additional time vetting potential partners. "We are still a small bank compared to others, and we have adequate systems to handle our current digital requirements," said a senior vice president for operations at a West Coast community bank. "But we are expanding our interest in digital technology, as we have identified some areas where we could attract new customers with added features."

**Bank respondents:  
If you are  
not currently  
collaborating with  
fintech, do you  
plan to do so in  
the future?**



- Yes, in the near-term (within the next 6-12 months)
- Yes, in the medium-term (within the next 12-24 months)
- No, not in the foreseeable future

**Perks and pitfalls**

As consumers increasingly rely on their phones and tablets, banks are concerned about mobile functionality. More than half of our participants (59%) said better mobile services represented one of the main benefits that fintech can offer them—the most-cited response. Lower capital expenditures (44%), a lower cost of doing business (42%) and enhanced brand

reputation (36%) were also frequently named by respondents as benefits that fintech can provide.

The CFO of a Southwestern community bank with more than US\$500M in assets said they chose a well-established fintech firm partly because they felt it would improve the bank’s reputation. “When we first thought about working with fintech, we knew we wanted to work with a well-established firm, since it would have more potential than a start-up,” he said. “We figured this would also help our brand in the market.”

An executive vice president at an East Coast regional bank noted that the use of online banking had allowed them to save significantly on capital expenditures, since they have a lower need for new branches and personnel.

In terms of risks linked to working with fintech, two in particular stood out for respondents: the challenge of hiring qualified personnel to make the collaboration effective (51%) and legal/regulatory issues (41%). An equal proportion of respondents (27%) also expressed concern about cultural fit, cybersecurity, high investment risk and integration challenges.

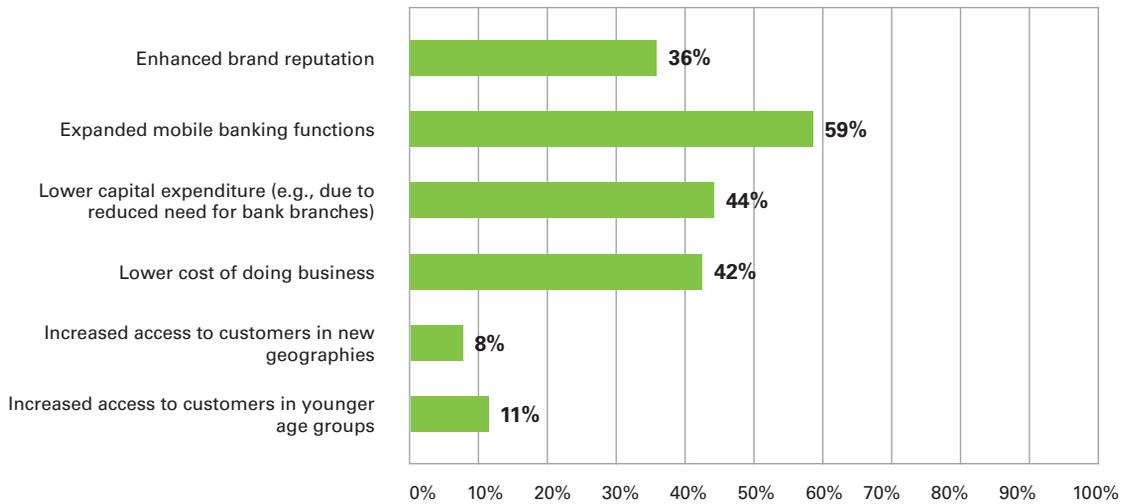
Regulation of fintech is still in the early stages. In March 2016, the OCC floated the idea of establishing a framework for fintech firms, but the rules were still under discussion as of September 2016. Even if the OCC did create a federal charter for fintech companies—which is what many of them want—it remains unclear how other regulators would fit into the picture.<sup>5</sup>

There are also regulatory restrictions on investments made by banks in third-party companies, including fintech partners, such as limitations on the percentage of equity they can own and whether they need regulatory approval to make the investment. “The biggest risk we’ve faced with regard to fintech has been changing regulations,” said the CFO of a Southeastern regional bank with locations in nine states. “As a regional bank, we face a lot of regulatory problems that interfere with the types of deals we can carry out. They limit the amounts we can invest in companies.”

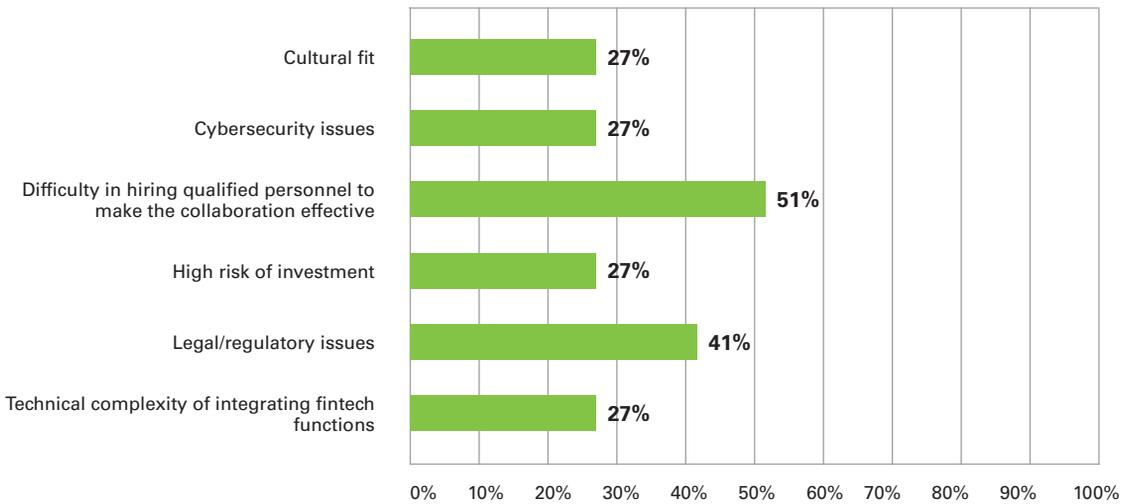
Another regional bank CFO went into detail regarding the technical challenges involved in fintech collaboration. “There are many complexities integrating systems, as we use 256-bit encryption along with other software that makes it difficult for fintech companies to work with us,” the CFO said.

<sup>5</sup> <https://www.bloomberg.com/enterprise/blog/fintech-firms-press-occ-for-specialized-charter/breaches.html>

**Bank respondents: If you currently collaborate with fintech companies or plan to do so in the future, what are the main benefits you think they can bring your institution?**



**Bank respondents: What are the biggest risks/concerns you have about collaborating with fintech?**



**Due diligence and integration**

When it comes to due diligence, vetting a fintech partner for legal and regulatory issues was deemed the most challenging part of the process

by 46% of respondents. About one-third (32%) said cybersecurity diligence was toughest and 22% said financial analyses were most difficult.

According to the CFO of one Southeastern community bank, all aspects of the diligence process serve an important purpose. "I give more importance to

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## Case study

### Fostering collaboration between a bank and fintech

Digital finance is a new world. It is unfounded, complex and hard to navigate, especially when legalities are involved. Over the past year, our clients have had to grapple with weekly headlines from regulators, legislators and the courts while trying to execute business plans and scale operations in new, more effective ways. With increased scrutiny and multifaceted collaborations, this is not easy. However, with the right team in place, it is possible.

Manatt's client, Cross River Bank, a New Jersey chartered bank, is just one example of a firm that has fully embraced fintech. Cross River works closely with marketplace lenders to originate loans for borrowers who apply via online platforms such as Affirm, Rocket Loans, Peerform, Borrowers First and Best Egg. After originating and funding a loan, Cross River often sells the loan back to the online platform who keeps it on its own balance sheet. Many loans remain on Cross River's balance sheet, which gives it "skin in the game." Meanwhile, using banks like Cross River helps originators, since FDIC-insured depositaries are able to export the maximum interest rate of their home state to other states. With all these technicalities, however, come the regulators. This business model and partnership has become a prime target for the FDIC, CFPB, Department of Treasury, FTC and SEC, with recent course cases such as *Madden v. Midland Funding* and *Bethune v. LendingClub and WebBank* having a significant impact on all market participants.

With regular examination by the FDIC and state banking authorities, Cross River is subject to frequent compliance risk reviews. They need to not only understand the evolving regulatory landscape but also how to charter these waters with a steady hand. So they engaged Manatt to assist with some of the requisite activities inherent to such partnerships and to provide guidance on pressing market issues. With our team's guidance, Cross River is enhancing its customer process to make it more than a pure pass-through entity, with greater risk retention and additional roles that will last through the life of a loan. Further, since any one of the Cross River's platform partners could potentially put the bank at risk for disciplinary action, our team carefully monitors legislation and legal developments. We proactively advise Cross River of any changes that need to be made to the underwriting framework or online platforms.

In the end, by combining Manatt's experience and knowledge, we are able to offer cross-functional solutions that employ best practices with state-of-the-art commercial advice while representing Cross River on all aspects of regulatory risk and development. And Cross River isn't the only case. Manatt has been extremely active as we engage in and counsel our clients to succeed in this rapidly evolving ecosystem.

**Bank respondents: Which type of due diligence presents the biggest challenge in vetting potential fintech partners?**



Cybersecurity due diligence

**32%**



Financial analyses

**22%**



Legal/regulatory due diligence

**46%**

regulatory aspects, but all of these are important," he said. "All three are necessary to provide complete information about the fintech company. Scrutinizing only the security infrastructure and framework would not be sufficient, for instance."

Structuring partnerships and relationships between regional and community banks and fintech companies requires internal and external advisory teams that appreciate the complexity associated with such partnerships and can navigate the regulatory landscape associated with those new relationships. Legal knowledge is critical, including working with firms who have strong relationships with regulators and can reach out both locally and in Washington, D.C. to key officials in order to gain insights about process and the latest regulatory and legislative developments.

As for which regulatory issues are most pressing, a roughly equal proportion of respondents called out four: the security of bank information (46%), the security of digital payments (43%), customer bank privacy (43%) and anti-money laundering compliance (AML) (41%). Respondents indicated that any loss of information would pose a critical danger to their reputation. "Transactions have to be kept confidential—there is no scope for any loss of customer or client identity, nor their transactions," said the CFO of a regional bank with more than two dozen locations in the Southeast. "If this were to occur in any manner, it would cost us big time."

Indeed, banks across the spectrum are bolstering their cybersecurity budgets to cope with the rise in hacker threats. Overall in 2015, financial services companies raised

their security budgets by an average of 14%, according to a PwC report.<sup>6</sup> And new types of threats are appearing all the time; as many as 12 banks were investigating possible illegal SWIFT transfers in May 2016 after cyberthieves stole US\$81M from the Bangladesh central bank using this method.<sup>7</sup>

In our survey, the data security measures considered most important by respondents when collaborating with fintech included partnering only with well-established firms (60%) and strictly limiting the scope of the collaboration (60%). For instance, an executive vice president at an East Coast regional bank said: "Data security is of the utmost importance in the banking sector. And with this, it is necessary that we maintain some specific limitations when collaborating with fintech, so that our confidential data is not mistreated in any manner and there is no data loss." A majority (52%) also said performing extra due diligence on potential partners was an important step to take.

The CFO of a Midwestern regional bank said his institution was willing to accept an additional cost burden to ensure safety and reliability when it comes to a fintech partnership. "We do not

<sup>6</sup> <https://www.pwc.com/gx/en/consulting-services/information-security-survey/assets/pwc-gsiss-2016-financial-services.pdf>

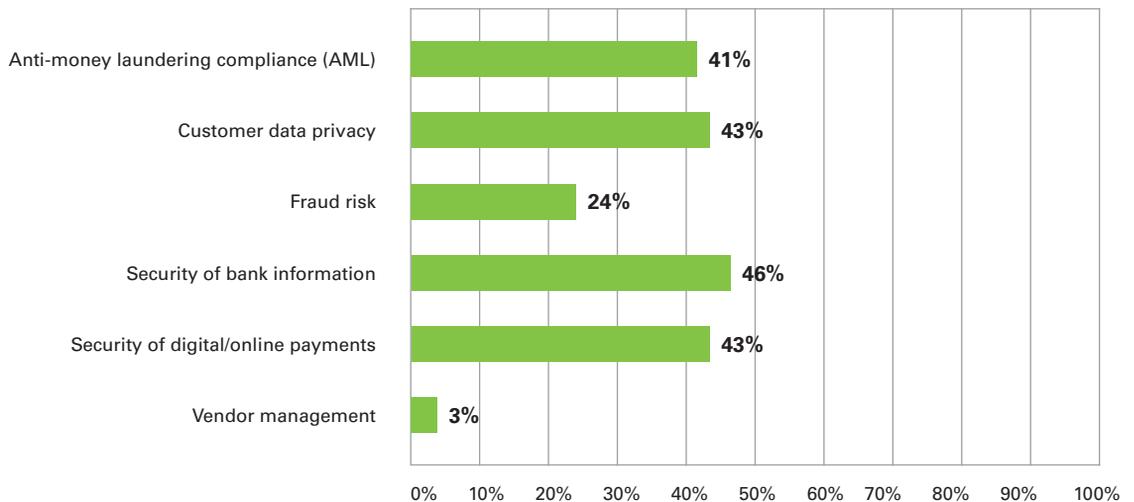
<sup>7</sup> <http://www.csoonline.com/article/3075758/data-breach/up-to-a-dozen-banks-are-reportedly-investigating-potential-swift-breaches.html>

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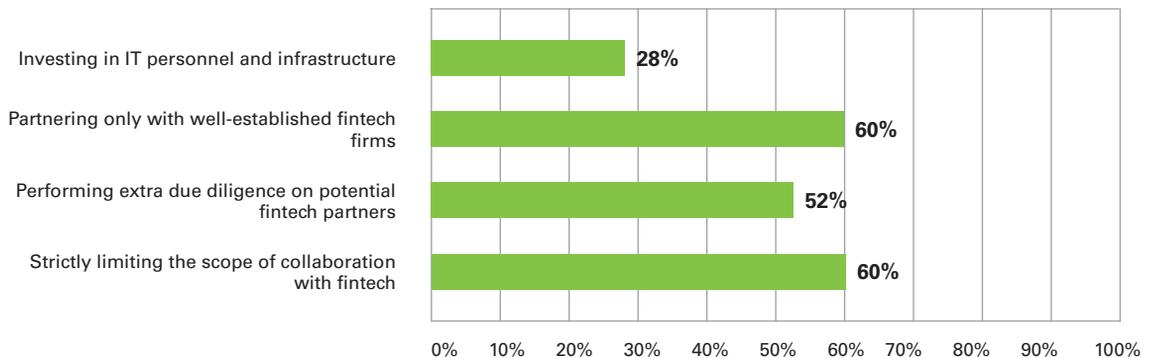
mind paying slightly more but would prefer to partner with a well-established company with a good reputation," he said. "We need their backing and would be at ease knowing that our information is safe. We have an IT team and

infrastructure, but if we had to partner with another company, we would increase our team's capabilities and hire a few more talented and experienced people to help us."

**Bank respondents: Which legal/regulatory issues are most pressing for your institution when it comes to working with fintech?**



**Bank respondents: What are the most important steps to take in order to keep data secure when collaborating with fintech?**



## Chapter 3: The Fintech View

**In recent years, fintech has gone from being a highly specialized niche to becoming a household name. As the category has grown, so have the types of companies that fall under its umbrella. These include everything from mobile payments services such as Square and iZettle, to personal wealth tools like Personal Capital, as well as more esoteric offerings such as bitcoin exchanges and even an investment social network. Many, but not all, of these firms find value in collaborating with traditional banks.**

Among the fintech executives interviewed for our survey, just over half (53%) are currently working with regional or community banks—a significantly lower percentage than the 81% of banking respondents who are working with fintech. Moreover, around 90% of fintech participants who are not collaborating with regional or community banks say they either aren't planning to in the future (56%) or remain unsure if they will or not (33%).

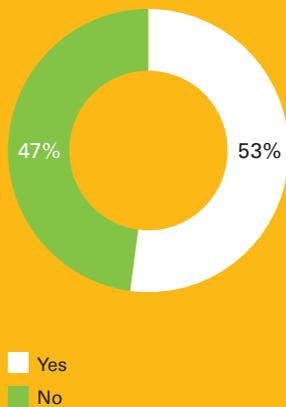
Respondents who are not working with regional and community banks gave a variety of reasons, including that: the burden of accommodating banks' technical and regulatory requirements would be too onerous; the potential profitability of such collaboration would be too low; their firm is a direct competitor to regional and community banks; and their firm has adequate capital and infrastructure to grow without partnering with more traditional institutions.

"We do not feel it would be beneficial for us to work with a regional or community bank," said the chief development officer of a financial software firm worth over US\$1B. "It would disrupt our business—accommodating their requirements would be a big challenge. Their exposure is also limited, so it would not add much value to our growth and expansion."

It should be noted that our survey focused on well-established fintech firms, as opposed to start-ups—to qualify for our survey, each fintech company had to be in operation for at least two years. For younger fintech firms, the benefits of being able to rely on a bank's liquidity are often more important.

One respondent, the head of partnerships at an online brokerage, said his company had only recently begun operating actively in the marketplace but planned to collaborate with regional and community banks in the future. He said the company was still deciding what forms

**Fintech respondents:  
Are you currently working with any regional/community banks?**



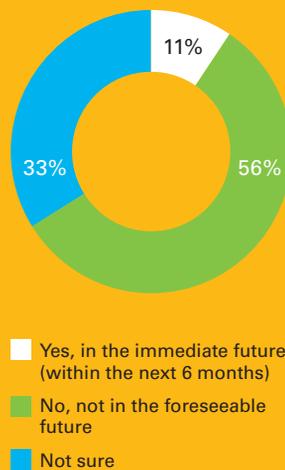
of collaboration would be most profitable for both sides.

**Flexible arrangements**

A substantial majority of fintech respondents who are collaborating with regional or community banks act as third-party service providers (70%) or have formal partnerships or joint ventures in place (60%). No fintech respondents said they had merged with, acquired or been acquired by a regional or community bank.

Many respondents said third-party relationships were

**Fintech respondents: If no, do you plan to collaborate with regional/community banks in the future?**



preferable due to their flexible nature and the advantages of being able to work with a variety of different institutions. "We are always free to move on ...," said the CFO at a payments firm.

Partnerships between banks and fintech abound, although most of them are not publicized. One widely known example is the deal struck between LendingClub, the embattled marketplace loan platform, and BancAlliance, a network of more than 200

**Fintech respondents: If yes, how are you currently collaborating with regional/community banks?**

**60%**

We have a formal joint venture or partnership with a regional/community bank

**70%**

We act as a third-party service provider/platform to one or more regional/community banks

regional and community banks, to provide co-branded loans. Other lending platforms, such as Prosper and OnDeck, have relationships in place with larger institutions.

When it comes to working with regional and community banks, the CFO of an online financial advisory firm noted that the form of collaboration is often dictated by the banks. "With different community

and regional banks, we have different types of collaboration,” he said. “This is not solely in our hands. If it were up to us, we would typically choose a formal partnership, since these are more profitable for us.”

### Benefits and risks

Three items in particular stood out for fintech respondents when it came to the benefits of collaborating with banks: gaining a partner with market credibility (66%), opening access to customers in new geographies (57%) and having a partner with an established legal footprint (47%). For a technology firm seeking to break into the highly regulated world of finance, these issues can be crucial to the success of the business.

Indeed, partnering with institutions that have long histories and solid customer bases is a tried-and-true formula for a start-up to accelerate its growth.

Online lending platforms, in particular, have taken this path. “Marketplace lenders enjoyed explosive loan growth in 2015, but instead of cementing the industry as a disruptive threat to banking, the online companies turned toward partnering with retail banks,” SNL Financial wrote in a December 2015 article.<sup>8</sup>

Interestingly, just as banks often want to improve their brand by adopting fintech services, some of our fintech respondents said collaboration with banks would help their reputation. “Doing business with regional banks and community banks has helped us improve our market presence and has allowed us to get more clients,” said an executive vice president at a digital payments firm. “This has had a positive impact on our value and image.”

As for the challenges of working with banks, fintech respondents pointed to cybersecurity risks (47%) and financial downsides, including the potential for inadequate returns from the banks’ customer base (47%) and excessive overhead to integrate their functions (42%). Overall, these results point to one of the main shortcomings that fintech firms see in regional and community banks: their smaller scale.

This scale can affect integration issues, since fintech firms may have to come up with bespoke solutions for connecting to the banks’ systems, as well as potential profitability, since regional and community banks by definition have fewer customers than large institutions. The fact that many of the banks are in smaller communities means

that culture could be a sticking point as well.

The CFO of one financial software firm was quite blunt in describing the challenges involved. “We have a very strict corporate culture and are not very flexible in the way we operate—this will cause clashes when partnering with a regional or community bank,” he said. “The IT systems of many regional and community banks are also not very secure, which makes integrating systems an expensive and difficult process. This makes it risky to partner with them.”

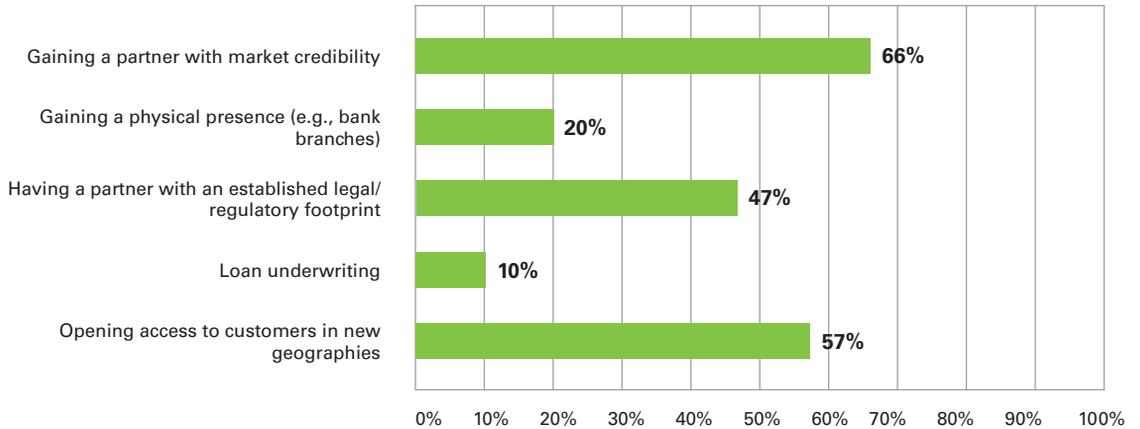
Collaborating with fintech can, however, serve as a useful carrot for banks to overhaul their technical infrastructure. “When we work with community or regional banks, we usually get them to upgrade their systems and have to help them make necessary changes to the company,” said the CFO of a billing software firm.

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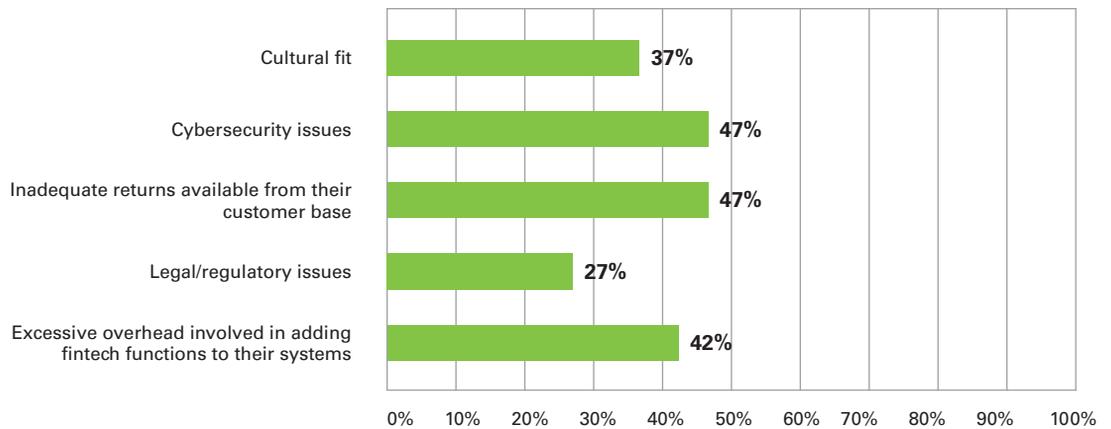
<sup>8</sup> <https://www.snl.com/InteractiveX/Article.aspx?cdid=A-34894498-10023>

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**Fintech respondents: If you currently collaborate with regional/community banks or plan to in the future, what are the main benefits you feel they can bring your company?**



**Fintech respondents: What are the biggest risks/concerns you have about collaborating with regional/community banks?**



## Sidebar: The Potential of Blockchain

**The future for regional and community banks will undoubtedly be influenced by the increasing role technology plays both in back-end and customer-facing roles. However, the pace of these changes will take time, and in different parts of financial services, they're expected to change the game at different paces.**

The financial industry fully expects blockchain to become a key feature across regional and community banks. For the most part, however, constituents expect its adoption to be gradual. Sixty-eight percent of dealmakers surveyed expect these institutions to adopt blockchain in 18 months or later from now, while more than half of banks (62%) and fintech executives (53%) feel the same.

Regional and community banks acknowledge the importance of blockchain. However, the expense of implementing new technologies, particularly for smaller entities, will cause a delay in its use. "A lot of firms and institutions have already understood the importance of blockchain and are looking forward to using it," said the CFO of a regional bank. "The required finances, manpower and other costs all need to be taken into consideration though, after which this will be implemented."

Fintech respondents are more optimistic regarding earlier implementation, with 42% believing blockchain will be

adopted within 18 months. A key driver for this will be banks trying to keep up with the needs of their depositors. "The increasing demand for blockchain technology is driven by the rising demand of online accessibility to customers for all their banking transactions," said the CEO of a fintech company. "It helps create real-time data, and this is highly sought-after by banks."

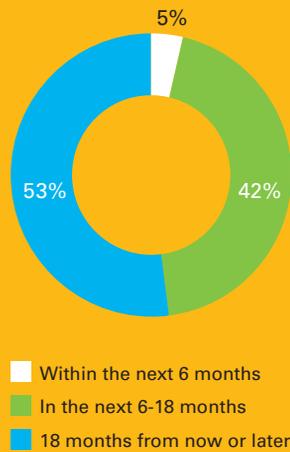
Signs of this adoption are already being seen across some banks. Last year, for example, Kansas-based CBW Bank launched ONE Card, allowing customers to receive funds and settle balances in real time, in partnership with cryptocurrency company Ripple Labs. This year, the bank received recognition for its work in innovation, being named the 2016 Model Bank for its excellence in corporate payments and infrastructure modernization by research firm Celent.

The applications of blockchain won't be limited to just real-time transacting for customers. In particular, regional and community banks believe blockchain will have a

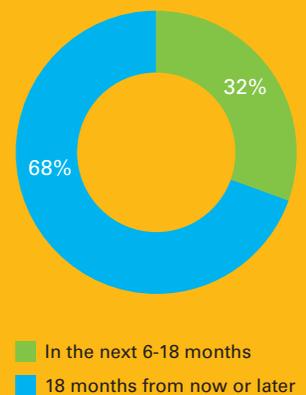
**Bank respondents:  
How soon do you think blockchain technology will be adopted by regional/community banks?**



**Fintech respondents:  
How soon do you think blockchain technology will be adopted by regional/community banks?**



**Dealmaker respondents:  
How soon do you think blockchain technology will be adopted by regional/community banks?**

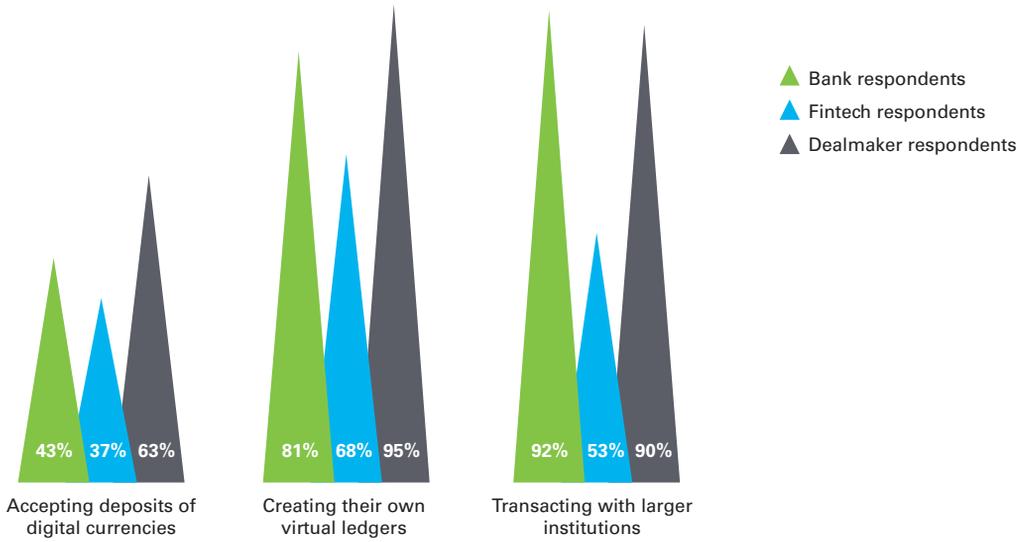


major impact on transacting with larger institutions (92%). Fintech executives largely think the impact will be felt in the area of creating bespoke virtual ledgers (68%), a sentiment shared by dealmakers, with 95% agreeing that creating ledgers is a primary use.

Speed and security are cited by respondents as the key areas where blockchain can improve smaller banks' business dealings with larger

institutions. "Regional banks will use these technologies to accept digital currency deposits and to help send this capital," explained the CEO of a community bank. "It will also help them share information and make transfers with larger institutions much simpler."

**What kinds of applications do you envision blockchain having for regional/community banks?**



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## Chapter 4: Dealmakers' Take

**The investment community is actively involved in forming fruitful relationships between banks and fintech. Private equity and venture capital firms play an outsized role in both industries and have a broad view of the ways in which each side can benefit the other, while investment bankers know the pulse of dealmaking between them.**

All of our dealmaker respondents have worked on collaboration of some kind between regional or community banks and fintech firms. By far the most prevalent form of collaboration is formal partnerships, which 79% of respondents said they are working on, compared to 63% who are negotiating potential M&A deals and 42% who are exploring joint venture possibilities. “We are currently advising a fintech company that plans to collaborate with community banks in the near future,” said a managing director at an investment bank that advised on 15 financial services deals in H1 2016. “We believe formal partnerships or using fintech as a third-party service is a promising arrangement for both sides.”

One type of M&A deal on the table for banks is the acquisition of minority stakes in fintech firms, although there are regulatory restrictions on these types of deals that banks must keep in mind. Thirty-seven percent of dealmaker respondents said regional and community banks had expressed “high” interest in making such acquisitions,

while 53% said they had seen “moderate” interest. “Many regional banks have seen a need to improve their technologies and services, and they have noticed the potential of investing in these services in the long run,” said a managing director at a private equity firm with both bank and fintech assets in its portfolio. “They are also investing in these companies when they are not very old and their valuations are lower, in order to reap the benefits later as they grow.”

### **Pros and cons**

The views of dealmakers regarding the benefits and risks of collaboration largely coincide with those of the banks and fintech firms themselves. This would seem to confirm the objective importance of these priorities when it comes to cooperation between the two sides.

Thus, dealmakers believe lower capital costs (53%) and expanded mobile banking functions (53%) are the most vital advantages fintech can offer regional and community banks. By comparison, 58% of bank respondents named mobile banking as a key

**Dealmaker respondents: What type of collaborations are you currently working on between regional/community banks and fintech firms?**



Merger/  
acquisition  
**63%**



Joint venture  
**42%**

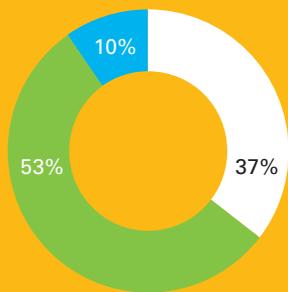


Formal  
partnership  
**79%**



Banks using fintech  
companies as third-party  
service providers  
**21%**

**Dealmaker respondents: In your experience, what level of interest do regional/community banks have in buying minority stakes of fintech firms?**



■ High interest  
■ Moderate interest  
■ Low interest

benefit and 44% cited lower capital costs as another.

“Fintech companies can help regional banks improve their operations and systems, and this will lead to fewer risks,” said a managing director at a PE firm with several banks in its portfolio. “It will also lead to lower capital expenditures, as online and mobile services reduce the need for customers to visit bank branches.”

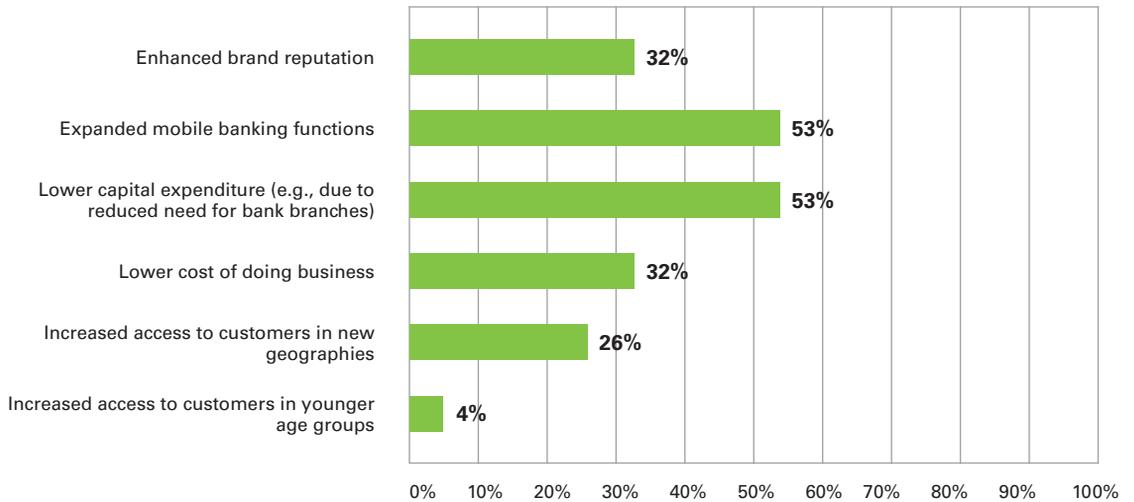
Similarly, dealmakers envision many of the same benefits for fintech firms as the fintech executives do. Fifty-three percent of dealmakers said having a partner with an established regulatory footprint was key; 47% said gaining a partner with market credibility was important; and 42% valued the additional access fintech firms could gain to customers in new geographies. “Fintech companies need to have clients at a regional level,” said a partner at a diversified alternative asset manager. “Partnering with a bank will give them access to a particular region and the clients within that region.”

In terms of risks and challenges, the focus of investors lies in the technical complexity banks face in integrating fintech functions (63%) and possible legal or regulatory issues (37%), as well as the difficulty in hiring qualified personnel (37%). For fintech companies, dealmakers expressed the most concern about similar issues—possible regulatory complications (63%) and the overhead involved in integrating fintech functions with banks (58%).

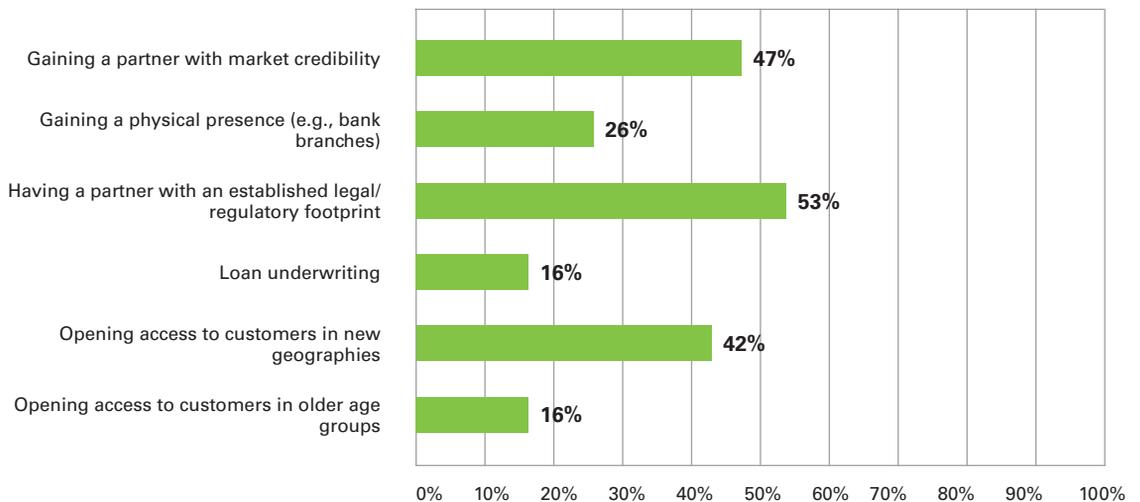
A managing director at one mid-market investment bank emphasized that legal issues are pervasive in financial services and therefore need careful handling in any bank-fintech collaboration. “There are voluminous regulations imposed on the financial and banking sectors, and these have to be dealt with at every point of business,” he said. “Apart from this, when data have to be integrated, there can be technical complexities that arise due to differences in the bank and fintech systems.”

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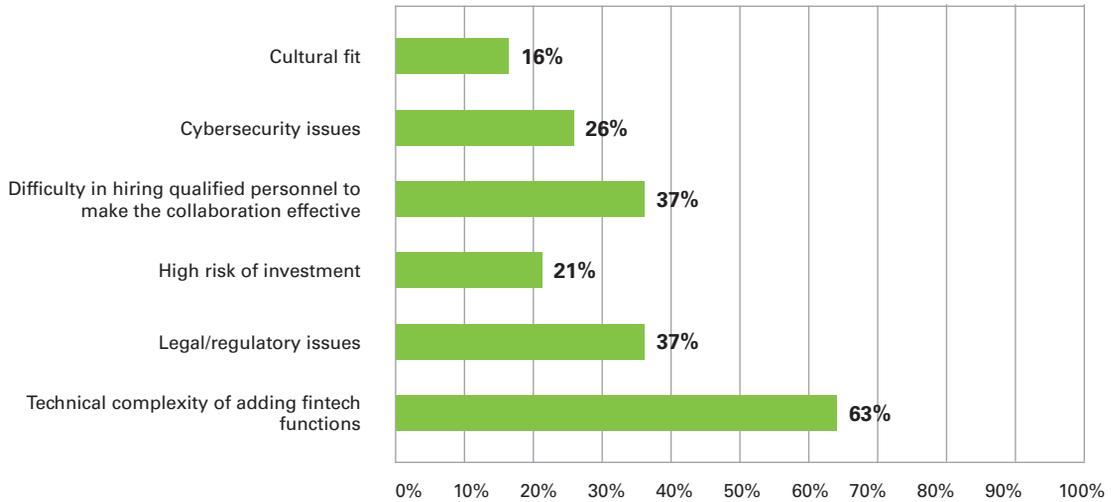
**Dealmaker respondents: What do you think are the main benefits that fintech can bring regional/ community banks?**



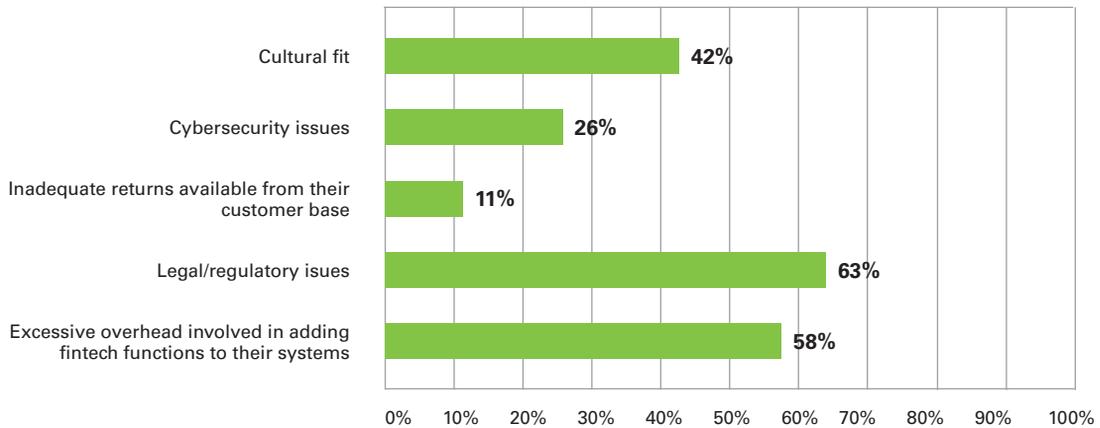
**Dealmaker respondents: What do you think are the main benefits that regional/community banks can bring fintech?**



**Dealmaker respondents: What do you see as the biggest risks/concerns for regional/community banks in collaborating with fintech?**



**Dealmaker respondents: What do you see as the biggest risks/concerns for fintech in collaborating with regional/community banks?**



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## Conclusion

As the financial industry evolves with new uses of technology, institutions must keep pace with advances like never before. In order to stay competitive, regional and community banks are using a wide variety of strategies, including the embrace of fintech. On the fintech side, many firms see clear advantages to tapping into the clients of these mid-sized and smaller banks, while dealmakers are playing matchmaker for the two sides.

Here are four key takeaways that should prove useful to everyone in the banking and fintech sectors when approaching the challenges that come with collaboration:

### **Banks are on board with fintech.**

Regional and community banks appreciate the benefits of cooperating with technology companies and are aware of the dangers to their business that come with missing out on innovation.

### **Data security remains a challenge.**

Both banks and fintech companies are highly sensitive to the ways in which data is shared and secured. This means extra attention must be paid to cybersecurity when the two sides collaborate—especially given the cultural mismatch that can exist between them.

### **Lower costs + a better brand = a win-win.**

For banks, working with a fintech firm can show their customers that they are evolving with the times, while also saving them on costs that come with things like physical bank branches. On the fintech side, companies can burnish their reputation in the marketplace by working with established financial institutions, while at the same time gaining increased access to customers.

### **Regulatory concerns remain paramount.**

For banks and fintech firms, structuring relationships that are regulatory compliant, including, if required, prior regulatory approval, is critical to ensuring success and the opportunity to change the way financial services are ultimately delivered.



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