WILL BANKS FUND THE NEXT WAVE OF FINTECH?

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Global fintech investment slowed in 2020.[1] While this may be primarily due to the COVID-19 pandemic, there were signs even before the pandemic that venture capital financing was tightening for early-stage fintech companies.[2] At the same time, banks' interest in fintech continues to grow. If these trends continue, banks of all sizes will be poised to become important providers of growth capital to the fintech industry.

Large banks have invested in fintech companies for a long time. Today, many of the largest banks have dedicated fintech investment programs. Changes this year to the Volcker Rule allowing banking entities to invest in and sponsor venture capital funds are expected to increase the amount of fintech investment by large banks.[3]

More recently, regional and community banks have joined the fray. These smaller banks have come to realize that technology is critical to their long-term success. Many have “partnered” in some way with a fintech company, usually to enhance the bank's products, services, or operations, but sometimes to facilitate those of the fintech company. There is more and more symbiosis between the fintech and banking industries every day.

For a fintech company that needs growth capital, a bank may be a natural fit. While banks are generally not in the business of making speculative investments, they can and do make investments in bank technology. A bank that has partnered with a fintech company and believes in its technology may wish to acquire an ownership stake that will allow the bank to reap the financial rewards of the fintech company's success. If the bank has come to rely on the fintech company, the bank may also decide to invest in order to keep the fintech company financially strong and able to perform its relationship with the bank.

Obtaining an investment from a bank can significantly accelerate a fintech company's growth. Startup fintech companies often strive to establish a partnership with a bank in order to demonstrate proof of concept to potential investors. Having not only a commercial relationship but also an investment from a bank partner can serve as powerful validation that the fintech company is “investment ready.”

Early-stage fintech companies can be well served to “incubate” inside or alongside a bank. This can provide valuable opportunities to test new technology on the bank's systems and customers, with the support of the bank's information technology resources. It also allows a fintech company to learn firsthand about bank culture, risk management, and regulatory expectations. The FDIC's recent request for comment about whether to implement a certification program for fintech companies seeking to partner with banks underscores the value of a fintech company becoming proficient in these areas early in its lifecycle.[4]

Banks generally have the legal authority to make equity investments in fintech companies, and joint ventures with fintech companies, if they are engaged in activities that would be permissible for the bank to engage in itself. Similarly, bank holding companies are permitted to make controlling investments in companies engaged in banking and “closely related” activities, as well as non-controlling investments in companies engaged in other activities. Changes earlier this year to the Federal Reserve's regulations clarify the circumstances under which a bank holding company is deemed to “control” another company.[5]

The current regulatory environment is supportive of banks collaborating with fintech companies. The OCC, the Federal Reserve, and the FDIC have established offices or groups charged with fostering innovation and technology in banking. The Comptroller of the Currency and the Chairman of the FDIC have each publicly expressed strong support for fintech. Earlier this year, the FDIC published a guide designed to help fintech companies partner with banks.[6] From a regulatory perspective, it is as good a time as ever for banks to consider investing in fintech.

The COVID-19 pandemic disrupted many fintech companies' businesses and financing plans. As the real economy continues to suffer and early-stage financing becomes harder to come by, it is as opportune a time as ever for fintech companies to seek investment from banks.

For further reading about structuring bank and fintech collaborations, please see our article linked here.

FOOTNOTES

[1] *See* Penny Crossman, *Funding for Fintech Startups: Down but Not Out, American Banker*, 20 April 2020 (reporting that globally, venture capital investment in fintech companies during the first quarter of 2020 was down 45 percent from the fourth quarter of 2019 and down 25 percent from the first quarter of 2019).

[2] *See*, e.g., PitchBook - NVCA Venture Monitor, 3Q 2019 (reporting that fintechs are attracting increasingly later-stage venture capital financing).

[3] *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 85 Fed. Reg. 46,422 (31 July 2020).

[4] *See* Request for Information on Standard Setting and Voluntary Certification for Models and Third-Party Providers of Technology and Other Services, 85 Fed. Reg. 44,890 (24 July 2020).

[5] *See* Control and Divestiture Proceedings, 85 Fed. Reg. 12,398 (2 March 2020).

[6] *See* FDIC, Conducting Business with Banks: A Guide for Fintechs and Third Parties (February 2020).

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