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THE IMPACT OF TECHNOLOGY ON BANKING: THE EFFECT AND IMPLICATIONS OF "DECONSTRUCTION" OF BANKING FUNCTIONS

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I. INTRODUCTION

Enactment of the Gramm-Leach-Bliley Act (GLBA)2 in late 1999 punctuated the close of the millennium and, according to some commentators, the beginning of fundamental change in the structure of the Nation’s financial industry. Indeed, GLBA is landmark legislation. It allows types of financial companies to affiliate that previously were not permitted to do so, and it allows companies directly to provide products previously allowed to be provided only by other types of firms. In broad terms, GLBA’s financial modernization facilitates growth in the size of financial services firms, and may encourage consolidations, because it enables financial companies to conduct new activities via ownership of additional types of businesses.

One of the most significant, far-reaching—and technology-driven—trends becoming evident in the financial services industry represents quite a different dimension of financial modernization—modernization based on a type of deconsolidation, or “deconstruction,” of financial functions. The process of separating out the different functions of a financial instrument—origination, servicing, absorbing particular risk components—has been a revolutionary development in financial markets over the

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last twenty years. Today, we see the same process of deconstruction engulfing all aspects of the banking business. By "deconstruction" we mean the separation or segmentation of banking products, services, and operations into their component parts or processes so that they can be provided or obtained separately.\(^3\)

Typically, discussions of how the phenomenon of "deconstruction" affects the banking business focus on how deconstruction of banks' traditional functions enables their competitors to "cherry-pick" segments of banks' business.\(^4\) Indeed, advances in technology make the component functions of banking ever more divisible. But today, a key to a bank's success may lie in its ability to take a deconstructed approach to its own business. Put another way, if banks' competitors gain advantages by "cherry-picking" segments of their banking business, why shouldn't banks do the same? The manifestations and implications of "deconstruction" of the banking business, and how those are aided and abetted by technology, are the subject of this article.

II. "DECONSTRUCTION" OF THE BANKING BUSINESS

What is being deconstructed? The traditional vertically and horizontally integrated banking firm that produces and delivers its products, through its outlets, to its customers is being picked apart. Examples are easy to find. What is easy to miss, however, is how the examples are pieces of a larger picture puzzle that represents a fundamentally different way of looking at the business of banking; one in which the different capacities,


\(^{4}\)This is not a new concern. For example, it arose during the Congressional hearings held in the early 1980's on the effect on banks of the then-new money market mutual funds and "Cash Management Accounts" offered by securities firms which were one of the early forms of deconstruction. See, e.g., Competition and Conditions in the Financial System: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 97th Cong. 1st Sess. (1981).
competencies and attributes of a banking firm are the pieces. Moreover, technology both helps to create more and more pieces and helps to assemble them rapidly and seamlessly.

Consider the example of the most traditional of bank products — a loan. From one perspective, a loan is a single product. From a deconstructed perspective, however, a loan is a series of functions: evaluating risk; originating the loan; funding the loan; servicing/administering the loan; and holding the loan asset. None of these functions is necessarily unique to a bank, and any particular bank could chose to do some or all of them, depending upon its comparative advantage relative to competitors performing the same functions. Moreover, a bank with a capacity for a particular function, such as loan servicing, may “export” that capacity by marketing it to other (bank or nonbank) businesses, while another bank may determine that it does not want to develop that capacity and looks for a third party from which it can “import” the function.

Similarly, a bank may decide that it is important for its customers to have access to a broad range of products, but rather than producing those products itself, it may act as a “finder” and import choices to give its customers access to products from other providers. A bank may even detach its name and regulatory status from its own products and services and market under the bank’s name products or services produced or originated by a third party—in effect, deconstructing its brand and its reputation.

This kind of “deconstructed” perspective on the banking business enables a banking firm to analyze the components of how it does business, what it does, what it does well, and where it may have a particular advantage in an activity. A firm may decide, piece by piece, whether it commits resources to perform a particular function itself, or hires another company to do it; whether it produces a particular product, or makes products originated by third parties available to its customers; whether it has particular capacities and competencies that translate into new business opportunities; and whether there are other attributes of the bank that are marketable.

Why is all this important? Because a view of the banking business as divisible into component pieces enables banks to play
to their strengths; to commit resources to the particular processes they do best, where they have a comparative advantage; and to gain access to skills, expertise and products, without having to develop them in-house. A bank’s advantage in conducting an activity itself may come from economies of scale, its particular competence, or attributes that distinguish it from other providers of the same product or service. When the banking firm does not have an advantage producing the product, service or function itself, however, it can look to “import” it from another source.

In addition, when a line of business is viewed as a series of functions, entry and exit barriers should be lowered since a banking firm may enter a new activity without developing an entire productive process and may exit a business line without having to dismantle the infrastructure for an entire function. A bank may make a strategic, limited entry into a particular activity, limit its expenditures, and exit with a containable exposure. Thus, in general, it should be desirable for a banking firm to have the both ability and the option of analyzing its current and prospective business in a deconstructed fashion.

The range of options for national banks that deconstruction provides is important for banks of all sizes, but may be particularly useful for small and mid-sized banks. These banks can use deconstruction options to obtain an economy of scale in bank processes that is unavailable to them under the conventional approach of fully integrated producer and provider. Moreover, deconstruction of functions enables small and medium size banks to exploit niche markets and to develop business plans with more flexibility than a traditional fully-integrated bank. Thus, the implications of deconstruction can be favorable for community and mid-sized banks—provided they use deconstruction options both creatively and prudently. In the latter respect, it is crucial that institutions have the requisite expertise to understand and oversee the risks presented when they “import” products or functions provided by third parties.

Finally, the ability to deconstruct and segment banking

5. These options include outsource contracts, minority investments, finder activities, sale as agent, and sale as principal both directly and under joint marketing arrangements.
services, products, and operations raises the intriguing possibility that the focus of GLBA on *ownership* relationships between different types of financial firms may not be the main event in financial modernization. Issues of corporate structure, including the debate about conducting activities in holding company affiliates versus bank subsidiaries, may turn out to be of secondary importance to the success of financial firms. It may be less important for a banking firm to be able to directly conduct new types of financial activities, or to own another company that does, than it is for the firm to be able to segment its functions and do more of what is most profitable or otherwise advantageous, and less of what is not. In other words, non-structural options, not premised on *ownership* of companies engaged in particular functions, may be equally or even more effective and efficient for a banking organization than growing its corporate family.

Technology both enables and encourages deconstruction. It vastly enhances the ability of banking firms to deconstruct and segment their business and creates new opportunities for them based upon strategic exploitation of advantages associated with particular segments of that business. Generally, we can categorize the effects of deconstruction of the banking business, and the impact of technology on this trend, in four basic ways:

1. **Use of third parties to perform functions on a bank’s behalf.** A bank contracts with third party providers to perform components of the bank’s operations.

2. **Providing access to products and services of other providers.** The bank makes products and services originated by others available to the bank’s customers.

3. **Marketing processes and activities for which the bank has particular capacities and competencies.** Functions and activities that the bank performs for its own operations are marketed to third parties.
4. **“Franchising” the bank’s attributes.** The bank “franchises” its attributes by lending its name or regulated entity status to products and services originated by others or activities predominantly conducted by others.

A. **Use of Third Parties to Perform Functions on a Bank’s Behalf**

It is well-recognized that third-party vendors, brokers, dealers and agents offer banks a variety of systems and services, as well as products designed to diversify bank assets and sources of revenue, and to reduce costs. Use of third party vendors for various back-office systems and software is common, and the more recent development of banks’ retaining third party vendors to establish and operate an Internet web site is becoming increasingly so. For example, internal OCC studies indicate that of the national banks offering their customers transactional web sites, more than two-thirds are reliant upon a third party to operate that web site.

Today, services commonly outsourced include core processing; information and transaction processing and settlement and activities for lending, deposit-taking, funds transfer, fiduciary, or trading activities; Internet related services; security monitoring; systems development and maintenance; aggregation services; digital certification services; and call centers. Other more unusual recent manifestations of this aspect of deconstruction are initiatives by some banks to contract out bank internal functions, such a human resources administration and internal audit.

When it comes to innovations in technology, this trend has some interesting twists. Traditionally, outsourcing was limited to a single vendor for a particular functionality. In the traditional third party vendor scenario, a banking firm contracts with a third party

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vendor to provide a specified back-office system or function. But today, a bank may be exploring new technologies that support the creation and provision of new financial products and services. In other words, the sought-after technology or new product or function may not yet exist—it is not on the shelf—at least not in the form the banking firm wants.

In this setting, participation in the development of standards and industry protocols for new technology, and in the development of delivery systems and equipment, are vital in order to ensure that the new standards and equipment are optimal for delivering the types of banking products and services that a bank wants to provide. New technologies need to function compatibly with banks’ “legacy” systems. And, involvement of a continuing nature may be necessary in order to insure that the product or system remains available to the bank and is developed consistent with the bank’s needs.

To be able to guide the creation, deployment, and access to an innovation, however, may require that the banking firm participate in some form of joint arrangement with the other companies participating in the project. Theoretically, this might take the form of controlling the technology company that is contributing the technical expertise, either as an affiliate or subsidiary of the bank—and this ownership structure is the model GLBA addresses. But if a bank were exploring a variety of technology-based initiatives, that could mean buying control of a lot of technology companies. A more efficient method may be for a banking organization to make strategic investments in those companies or ventures with which it seeks to partner in the development of technology related to producing and delivering financial products and services. This enables the banking firm to explore a variety of initiatives while containing its exposure by making only the limited investments necessary to gain a technology partner needed for particular technology-based initiatives.

7. Legacy systems are the information resources currently available to the organization. They include existing mainframes, personal computers, serial terminals, networks, databases, operating systems, application programs and all other forms of hardware and software that a company may own.
If banks fail to develop technologies and standards that support their banking business, they risk being burdened with standards and limitations developed with other industries in mind, rather than tailored for the production and delivery of banking products and services. They may find that new systems integrate poorly with their existing system, or that their access to needed technology systems and resources is restricted. At best, this impedes the effective development and efficient delivery of banking products; at worst, it puts banks at a competitive disadvantage as technology-based products and services proliferate.

This scenario illustrates an important current example of deconstruction of aspects of banking activities—the use of third parties to develop standards, products and services based on new technologies. The example also illustrates that the most effective, and perhaps necessary, way to do so is through relationships with third parties that go beyond simply contracting for a product or service.

In this context, the OCC’s precedents regarding permissible types of investments for national banks are significant because they recognize that non-controlling investments by national banks in companies where the purpose of the investment is linked to a business purpose of the bank, are “incidental to banking” because they are “convenient or useful” to accomplishing a bank’s banking business. Indeed, given the pervasive implications of technology on the banking business, such investments could easily be viewed as necessary to the future success of banking firms. The Federal Reserve Board also has recognized this vital linkage in its recent proposal asking for comments on whether such strategic investments should be viewed as financial in nature, incidental to a financial activity, or “complementary” to a financial activity.8

OCC has developed two related but distinct lines of precedent on the authority of national banks to make strategic investments. These have different standards and different limitations. First, OCC permits minority investments, subject to

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four requirements, where all the activities of the target entity are either part of the business of banking or incidental thereto. Second, OCC permits limited equity investments in entities engaged in activities that are not bank-permissible, if the bank’s investment is “incidental”—convenient, useful, or necessary—to performing permissible banking functions.

With respect to the first category, “minority investments,” the OCC has permitted national banks to own, either directly or indirectly through an operating subsidiary, a noncontrolling interest in an enterprise provided four criteria or standards are met. These standards, which have been distilled from previous decisions in the area of permissible noncontrolling investments for national banks and their subsidiaries, are:

1. The activities of the enterprise in which the investment is made must be limited to activities that are part of, or incidental to, the business of banking (or otherwise authorized for a national bank);

2. The bank must be able to prevent the enterprise from engaging in activities that do not meet the foregoing standard, or be able to withdraw its investment;


3. The bank's loss exposure must be limited, as a legal and accounting matter, and the bank must not have open-ended liability for the obligations of the enterprise; and

4. The investment must be convenient or useful to the bank in carrying out its business and not a mere passive investment unrelated to the investing bank's business.

Specifically, the OCC has found that under their incidental powers, national banks have authority to make minority investments where the investment facilitates the banks' participation in a connected and otherwise permissible banking activity. This requirement is met when the investments are convenient or useful to the investing bank in conducting its banking business rather than a mere passive or speculative investment. This is a long-standing position of the OCC.

The OCC has frequently permitted national banks to exercise this minority investment authority either to acquire technology necessary for the business of banking or to have an active role in establishing standards for technology-based systems and processes that are part of or are convenient or useful to the banking business. Thus, with respect to acquiring necessary technology, OCC has authorized national banks to own minority interests in firms developing financially related software.

12. OCC Interpretive Letter No. 692, supra note 10 (concluding that a national bank may make a minority investment in a limited liability company that supports a savings amending program for parents of prospective students).

13. Id.

14. See Letter of James J. Saxon (Oct. 12, 1966) (unpublished letter, on file with author) (discussing a minority interest in a corporation that operated a credit card clearinghouse for the benefit of the owner banks). Banks considering operating subsidiaries and minority investments in conjunction with outsourcing arrangements should refer to OCC regulations 12 C.F.R. §§ 5.34, 5.36 (2000) regarding the permissibility of the activities to be conducted.

15. OCC Corporate Decision No. 2000-01 (Jan. 29, 2000), 2000 WL 303083, available at http://www.occ.treas.gov/interp/feb00/cd00-01.pdf (last visited Feb. 2, 2001) (concluding that a national bank can acquire a software company that owns software that enables users to make changes to their web sites where the bank will sell the software only as part of a bundle of Internet web hosting services provided to
Likewise, OCC has authorized minority investments in joint ventures that develop and operate industry-wide standards, processes, or systems to support electronic banking activities.¹⁶

In addition, the OCC has also permitted other equity investments in entities engaged in activities that are not part of the business of banking or incidental thereto, if the bank’s investment is convenient, useful, or necessary to performing a particular and permissible banking function. For example, the OCC has concluded that it was permissible for a national bank, through its operating subsidiary, to hold various insurance company products and investment funds that contained bank-ineligible securities in order to hedge the subsidiary’s obligations to make payments to its employees under permissible deferred compensation plans.¹⁷

Likewise, the OCC has found that a national bank may, through a minority investment in an investment adviser, indirectly hold limited equity interests in private and public investment funds for which the adviser serves as investment manager even though the portfolio of those funds contained investments that were not bank permissible investments.¹⁸ These limited and normally bank impermissible holdings were found to be necessary by the adviser in order to compete effectively in the investment advisory business due to the demands of the market and certain practical considerations.¹⁹ Accordingly, the limited holdings were allowed because they were necessary to enable the investment adviser to conduct its bank permissible investment advisory activities.

Similarly, the OCC permitted national banks to have limited holdings of bank impermissible securities to hedge bank permissible equity derivative transactions that were originated by bank customers.²⁰ In that context, the OCC concluded that the activity was a permissible incidental activity to the business of


¹⁹. The OCC found that these holdings were necessary because 1) investors generally demanded that advisers hold an interest in the managed funds, 2) they secured favorable tax treatment for investors, and 3) they support compensation arrangements required to attract and retain qualified staff. *Id.* at pp. 90,253–55.

banking because the holding of the hedging securities was convenient, useful, and necessary to the banks’ ability to conduct permissible equity derivative transactions. In another case involving hedging of risks arising from bank permissible activities, the OCC concluded that a national bank may buy cash-settled options in certain commodity future contracts where the underlying commodity is the primary collateral on an agricultural loan made by the bank in order to hedge the bank’s risk with respect to the value of the collateral.\textsuperscript{21}

These two lines of precedent authorizing minority investments in firms engaged in activities where the investment is incidental to the business of banking provide support for limited strategic investments by national banks in firms developing or producing technology essential to the bank’s operations.

From a bank supervisory perspective, these types of strategic investments may have some advantages. Ordinarily, bank supervisors’ key concerns with third party provider arrangements include worries about due diligence in vendor selection and quality control of vendor performance. When the banking firm chooses a technology partner for a particular venture and remains involved, with the capacity to participate in the development and implementation of systems and services produced by the venture, those worries could be lessened because the risks associated with outsourcing are reduced by the bank’s ongoing level of involvement.

However, in any case where a bank, by contract or otherwise, causes functions or operations to be performed for itself by a third party, the federal bank regulators have the authority to examine and to regulate the performance of the functions or operations to the same extent as if they were being performed by the bank itself on its own premises.\textsuperscript{22} Despite this direct authority over service providers, the regulators have emphasized that the management of banks engaged in outsourcing functions and operations to third parties has a responsibility to adequately


manage the servicing relationship and to identify and control the risks that can arise from it.

Accordingly, the OCC and the other federal banking agencies recently issued joint guidance on “Risk Management of Outsourcing Technology Services” to assist banks in effectively managing the risks of outsourcing arrangements. This guidance urges bank management to assess risks in technology outsourcing, exercise due diligence in selecting a provider, ensure that there are appropriate provisions in contracts to address business requirements and key risk factors, and exercise appropriate oversight regarding a service provider’s controls, condition, and performance.

In the Outsourcing Guidance, the regulators emphasize the importance of conducting appropriate due diligence regarding the third party prior to entering into any contract for outsourced services. This includes an evaluation of the service provider’s financial strength, reputation, policies, controls and risk management procedures. The Guidance notes that particular attention should be paid to policies and controls governing the security, customer privacy and disclosure, and availability of services to insure their adequacy.

Likewise, the Guidance counsels that contracts between the bank and a third party provider should appropriately address the key risks and essential needs and standards identified by the bank with respect to the outsourced function. The contract should ensure that the accountabilities of all parties are clearly defined and that measurable performance standards are set. It should include provisions for the timely and orderly intervention in the event of a substandard performance by the outsourcer. Finally,


24. A similar requirement is contained in the recently issued interagency guidelines establishing standards for safeguarding customer information that implement sections 501 and 505(b) of the Gramm-Leach-Bliley Act [hereinafter the 501 Guidelines]. 12 C.F.R. pt. 30, app. B (2000) (as amended by 66 Fed. Reg. 8616 (Feb. 1, 2001)). Specifically, the 501 Guidelines require that an institution conduct appropriate security due diligence in the selection of service providers, including a review of measures taken by the service provider to protect customer information and a review of the controls the service provider has in place to insure that any sub-servicer used by the service provider will be able to meet the objectives of the Guidelines.
bank management should ensure that the contract addresses security and privacy issues.25

Most importantly, the Guidance emphasizes that bank management should establish a comprehensive, well-defined, and ongoing oversight process for managing outsourced relationships and third party dependencies supporting the bank. The increased reliance upon third parties and partners to perform critical banking functions lessens management's direct control, and as such requires intensified vendor management. Such intensified management requires proactive oversight over all third party dependencies including joint ventures, outsourcing activities of vendors themselves, and other outsourcings that have a material impact on the bank. The oversight program should monitor each service provider's controls, condition, and performance and should be performed by personnel with appropriate expertise.26 To that end, management should also ensure that vendors provide sufficient timely and accurate information concerning outsourced functions and activities so as to allow management to carry out their monitoring responsibilities.

The OCC has focused also on outsourcing relationships that concentrate on particular functions or products. The OCC recently issued Advisory Letter 2000-9 (August 19, 2000) that warns about third-party risk with respect to arrangements relating to the origination or servicing of extensions of credit. Among other things, this Advisory noted that while outsourcing is a useful method to obtain expertise, banks must have a sufficient knowledge about the activity and the risks involved in order to provide adequate oversight and controls.

25. The Outsourcing Guidance suggests that the outsource contract should prohibit the service provider and its agents from using or disclosing the institution’s information, except as necessary to or consistent with providing contracted services. Outsourcing Guidance, supra note 6. Similarly, the recently issued 501 Guidelines provide that a financial institution’s contract with its service providers require the provider to implement appropriate measures designed to meet the objectives of the 501 Guidelines in maintaining the security and privacy of customer information. 501 Guidelines, supra note 24.

26. Likewise, the 501 Guidelines indicate that each financial institution must exercise an appropriate level of oversight over each of its service providers to confirm that the service provider is implementing the provider’s security measures. 501 Guidelines, supra note 24.
It is notable that a bank may be better-positioned to manage many of the concerns raised by the Outsourcing Guidance and Advisory Letter if the bank’s involvement is more than that of simply contracting with a third party vendor to supply a product or service. It is in this regard that bank strategic investments may have some collateral supervisory benefits because they facilitate an involved and ongoing role for the bank in the product or service being developed and provided for the bank by another entity.

B. Providing Access to Products and Services of Other Providers

The offering of financial products and services also can be deconstructed, focusing on the choices banking firms make regarding how, and which, financial and non-financial products and services to make available to their customers. A banking company may decide that it wants to meet customers’ desires for access to certain financial or non-financial products and services and may arrange for them to be available from a third party. For example, banking companies could offer insurance from an affiliated insurance company, or securities brokerage through an affiliated brokerage firm, or could choose to make arrangements with one or more non-affiliated third parties to provide those products and services to the bank’s customers.

These choices may take the form of marketing arrangements, where, for example, a bank will contract for a company to offer its products or services to the bank’s customers from the bank’s premises. Or the bank may provide statement-stuffers and other marketing materials from sellers of various financial products and services, or identify other service providers as an accommodation to customers. Essentially, these are old-fashioned examples of how a bank deconstructs aspects of its relationships with customers; determining what products and services they want and then how best to provide them. Traditionally, these types of activities were referred to as acting as a “finder.”

The authority of national and many state banks to act as “finders,” bringing together buyers and sellers of products and
services for transactions that the parties themselves negotiate and consummate, is well-recognized. With advances in technology and increased use of the Internet, banking firms are able to act as a finder electronically on a far broader scale. New technology introduces a new dimension of finder activities, providing not just a new channel for banks to market their own financial products and services, but a vastly expanded means to provide customers with access to those of third parties. Technology also helps a bank couple functions offered by the bank with the products and services of third parties that it makes available. Thus, banks may become full service providers without being full service producers.

For example, both national banks and financial holding companies have been recognized to have authority as finders to host electronic marketplace Internet web sites that provide links to the web sites of third party buyers and sellers, and allow sellers (or buyers) to submit expressions of interest, bids, offers, orders, and confirmations at the linked sites.27 Similarly, both national banks


and financial holding companies are able to operate web sites that allow multiple buyers and sellers to exchange information concerning the products and services they are willing to buy or sell, locate potential counterparties for transactions, aggregate orders for goods and services with those made by other parties, and enter into transactions between themselves at the bank's site.

In either approach, the bank or financial holding company may negotiate with sellers to provide preferred terms to buyers that purchase through the web link or web site, and establish rules of general applicability governing how its finder function operates. These operating rules could, for example, establish parameters under which buyers and sellers submit bids and offers to the finder, the circumstances under which the finder will match bids and offers, and rules that govern the manner in which buyers and sellers bind themselves to the terms of a transaction facilitated by the finder. The finder authority is not limited to provision of financial products and services, so these activities could pertain to transactions involving virtually any product or service.

This last point raises various issues. One vital question concerning the bank's role is the extent to which it may couple its functions and activities with the products and services of third

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31. See, e.g., OCC Corporate Decision No. 97-60, supra note 27 (concluding that a national bank may operate a web site providing consumers and dealers with detailed information on used cars for sale that meet purchaser preferences — a virtual used car lot).
parties that it makes available. In the case of financial holding companies, the finder authority has only recently been recognized, and no precedents yet exist outside of the new rule. In the case of national banks, precedents do exist that support combining the finder authority with other functions that are permissible as part of the business of banking. These include activities such as payments processing and information management, as well as a limited amount of non-banking activity that is permissible because it is "incidental"—convenient or useful—to the bank-permissible activities including the finder function. For example, national banks offering to host commercially enabled web sites also, as an incidental service, may offer web site design and development.\textsuperscript{32}

Increasingly, national banks are finding that they can combine products and services they produce themselves with third party products and services to provide their customers with a full-service menu. For example, the first Internet-only national bank to focus on the small business niche planned to offer loans and deposit products for small businesses as well as a virtual mall with links to third parties providing services and products of particular interest to small businesses.\textsuperscript{33} Likewise, the OCC has found that a national bank may make a minority investment in a firm that, as a registered broker, will use the Internet to provide retail brokerage services, lending, and insurance-related services to clients who are customers of financial institutions that have agreements with the firm.\textsuperscript{34} Finally, a national bank may provide, via Internet links, its merchant-processing customers with information and access to third party vendors of services for the merchant processing industry.\textsuperscript{35}

However, whenever a banking firm is providing its

\textsuperscript{32} OCC Interpretive Letter No. 875, supra note 28 (concluding that a national bank may, incidental to its offering of commercially engaged web site hosting, provide web design services to its merchant customers).

\textsuperscript{33} OCC Conditional Approval No. 347, supra note 28.


customers with access to products not originated by the bank, it must recognize that a wide range of customer relationship issues inevitably arise. Does the customer utilizing a bank's finder service understand that the products and services being obtained are those of a third party, not the bank, and that the bank does not warrant their quality? How realistic is it for the bank to assume that it can divorce itself entirely from the product or service procured through the bank's facilities and how involved does the bank want to become in quality control of those products and services?

One of the core competencies of banks is acting as a customer interface and managing customer relationships. From the customer's perspective, a bank adds value most fundamentally by assuring the quality that is expected or sought by the customer. Deconstruction offers banks an opportunity to fully exercise this competency, but to fulfill its customers' expectations, the bank must exercise appropriate controls and oversight as a manager of the contacts that are occurring with its customers. The bank's reputation (its key market advantage) rests upon its ability to devise and enforce standards meeting customer expectations regarding the quality of products and services that are provided through the bank.

Similarly, a bank must consider what risks consumers face (and are willing to accept) in situations where the bank facilitates arrangements with third parties. If a banking organization establishes operating rules for transactions conducted via its web-based finder capacity, can its rules allocate the risk of unauthorized use to a consumer? If so, what is the consumer's potential exposure and how effectively is he or she informed of this?

High-technology finder functions are also fertile ground for privacy issues. When a bank acts as a finder, what kind of information does the bank acquire about the customers of that service and the transactions they execute? What does it do with that information?36

36. National banks establishing web links or virtual malls to third party sites have generally committed to adopt a privacy policy concerning the treatment of personal customer information that recognizes customer expectations for privacy and provides
Because of these concerns, the OCC in its electronic finders letters has provided significant guidance with respect to what prudent measures are expected of banks acting as electronic finders by establishing links between the bank’s web site and the web site of third party providers of products and services.

The OCC expects banks engaging in such activities to have adequate risk controls. The bank should conduct appropriate due diligence on the third party and its site. Does the third party deliver what it promises? Does it have adequate security for its web site and data? Does it have a privacy policy that is similar to the bank? Also, the bank should provide adequate disclosures to its customers, especially with respect to its limited role and responsibility with respect to the third party products and services. The bank’s web site should also clearly and conspicuously indicate that the bank does not provide, endorse, or guarantee the products of the third party.

Because of deconstruction, banks have the option to move away from being complete vertically and horizontally integrated providers of financial services and are adopting a more flexible
approach of relying upon and supporting third party products, services, and relationships. In that new role, however, banks become increasingly involved in managing relationships with third parties that are producing and providing services to the bank or to customers of the bank. A new and evolving type of service, aggregation, demonstrates just how far this evolution as relationship manager may develop. In providing aggregation services, a bank no longer is providing products, or even access to products, but rather is managing the data and, in some cases, the substance of relationships that their customers have with third parties.

This acquisition, compilation, presentation, and storage of information pertaining to customers' relationships with third party providers could expose the aggregator to risks and certainly requires appropriate control mechanisms. Aggregation services are rapidly evolving; however, industry standards and practices have not yet matured. Moreover, considerable uncertainty remains with respect to compliance obligations relating to legal and regulatory requirements.

C. Marketing Processes and Activities for which the Bank has Particular Capacities and Competencies

Yet another manifestation of a deconstructed perspective of the banking business happens when a banking firm has a particular skill, competency or other advantage in providing a

39. Aggregation is a service that gathers information from many source web sites and presents that information in a consolidated format to the customer. The information normally pertains to the customer's account at the source site, such as credit card, brokerage, and banking data. Typically the aggregator obtains the personal account information using customer-provided user names and passwords to enter target web sites on behalf of the customer and then downloading (or "scraping") the data. Some aggregation sites also offer customers the ability to initiate transactions effecting accounts at source sites by entering instructions at the aggregation site that the aggregator then enters on behalf of the customer at the source site after signing as the customer.

40. Currently, Regulation E (12 C.F.R. § 205), which implements the Electronic Fund Transfer Act (15 U.S.C. §§1693-1693r (1988)), does not specifically address the responsibilities of aggregators. However, the Federal Reserve Board staff has requested comments to determine whether additional staff commentary should address this issue. See Electronic Fund Transfers, 65 Fed. Reg. 40,061 (proposed June 29, 2000) (to be codified at 40 C.F.R. pt. 205).
specific product or service. In that case, the reverse of the first situation, discussed above, occurs. Rather than “importing” a particular function from a third party vendor, the bank “exports” to third parties components of operations that it conducts for itself. In so doing, the banking firm is optimizing the use and value of its facilities and competencies as well as avoiding economic waste. In this type of deconstruction, the bank is effectively cherry-picking its own operations.

This can occur in a variety of settings. There may be some activities where large scale is a comparative advantage, and a bank with a capacity for the activity will exploit that competency by performing the activity, not just for itself, but also for other banks and non-banks. Current examples include mortgage servicing, credit cards, payments processing and administration, and the fiduciary and securities custodial business.

Technology affords new opportunities here as well. And national banks have been recognized to have the authority to pursue these opportunities in marketing their electronic competencies and capacities to others. For example, a subsidiary of a national bank approved to act as a certification authority\(^1\) is also “manufacturing” digital certificates for third party certificate authorities. Since the issuance of digital certificates is part of the business of banking, the production of such certificates for others to issue is likewise permissible.\(^2\) The bank is exporting to others its competence in producing digital certificates.

Undoubtedly, the correspondent authority of national banks can also enable them to engage in these deconstructed activities. Correspondent banking activities are not limited to core banking functions, but instead can extend to any corporate or banking service a bank may perform for itself.\(^3\) Thus, the range of

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42. See OCC Conditional Approval No. 339, supra note 16 (finding that a national bank may invest in multi-bank venture to establish an entity that will support a multiple bank CA network system by, among other things, generating digital certificates to be issued by the participating banks).

43. See, e.g., Establishment of Operating Subsidiary Offering Real Estate
electronic correspondent banking services offered by national banks continues to expand and so too may the range of entities to whom a national bank may offer correspondent services.44

For example, the OCC recently authorized a national bank that has developed extensive competence in digital imaging to export that service to other financial institutions. This is a permissible correspondent service.45 The OCC has also permitted national banks that develop competence and capacity in electronic finder activities (including commercially enabled web hosting) to sell these services wholesale to other financial institutions that wish to offer them to their merchant customers. This is both an exercise of the bank’s electronic finder authority and a valid correspondent service.46 The OCC has permitted a national bank that developed competency in the selection and design of computer network services and related hardware to sell those services to other financial institutions as a correspondent banking service and, thus, part of the business of banking.47 The OCC’s letter also concludes that the subsidiary’s sale of full function hardware as part of a package of network services is “incidental” to those correspondent services.48 A long line of OCC precedent


The broader range of activities permissible for financial holding companies under GLBA may also have implications for the scope of potential customers of banks’ correspondent services.


46. OCC Corporate Decision No. 2000-08, supra note 36.


48. Id.
permits national banks to provide data processing and communications services to other financial institutions as a correspondent service that is part of the business of banking.\textsuperscript{49} Moreover, the OCC has found that national banks may, as part of the business of banking, market to non-financial firms imaging services that focus predominantly on banking, financial or economic data.\textsuperscript{49} The OCC has also held that where a national bank has acquired good faith excess capacity in imaging (due to, for example, the batch nature of its operations), the bank may sell that capacity to others without regard to the nature of the firm or its images.\textsuperscript{51}

\textsuperscript{49} As noted in an OCC Interpretive Letter approving an operating subsidiary that sells computer network services and related hardware to other financial institutions:

\begin{quote}
[i]the OCC has allowed national banks as a permissible correspondent activity to provide data processing and other computer-related services to other financial institutions. For example, national banks may provide strategic planning and corporate development services, including assistance with program installation, simulation, and computer modeling. [ ] National banks may also provide other financial institutions with electronic "gateways" to communicate and receive financial information and to conduct transactions. Interpretive Letter No. 516, [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83-220 (July 12, 1990) (bank operating subsidiary may participate in creating, leasing, and licensing communications systems, computers, analytic software, and related equipment and services for sharing information concerning financial instruments and economic information and news); Interpretive Letter No. 346, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85-516 (July 31, 1985) (bank operating subsidiary may provide electronic information and transaction services and linkage for financial settlement services). Moreover, national banks may market specially designed computerized "smart phones" that enable other financial institutions to communicate with their customers through a supporting network of computers and software. Interpretive Letter No. 611, [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83-449 (Nov. 23, 1992). Finally, the OCC has previously concluded that national banks may provide communication support services to other financial institutions, including the use of electronic networks for transmission of visual, voice, and data communications. Interpretive Letter No. 513, [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83-215 (June 18, 1990)].
\end{quote}

OCC Interpretive Letter No. 754, supra note 47, at p. 90,271.

\textsuperscript{50} OCC Interpretive Letter No. 888, supra note 45.

\textsuperscript{51} Id.
Finally, a national bank that has developed competency in stored value systems may design, install and support closed SVC (stored value card) systems at universities and other institutions and, incidental to that, may set-up those systems to support non-banking smart card functions (e.g., library records and building access control). The latter feature is incidental to the stored value function because it is "necessary for customer use" and "necessary for successful marketing" of a SVC system based upon smart card technology.

From a bank supervisory perspective, banks providing electronic banking services to third parties need to insure that their operations, responsibilities, and liabilities are sufficiently clear so that serviced institutions can adequately carry out effective due diligence reviews and all ongoing oversight of the relationship. Servicing banks also have a responsibility to provide serviced institutions with the information necessary to identify, control, and monitor risks associated with the electronic banking service arrangement.

D. "Franchising" the Bank’s Attributes

The fourth form of deconstruction occurs when a bank enters into relationships with third parties in which, effectively, the bank sells or leases its reputation, attributes, or legal status so as to enable the third party to use those in connection with activities or services predominantly conducted by the third party. Specifically, some banks have recognized that deconstruction can enable them to exploit certain reputational and regulatory attributes that may give them a competitive advantage. To that end, services or


53. Id.

54. The Outsourcing Guidance does not exclude from its scope services received from other financial institutions. See Outsourcing Guidance, supra note 6. Thus, banks that provide services to other banks should expect to be held to the same standards of due diligence, controls, and oversight as would apply to other servicing entities.
activities are performed in the bank’s name, but in association with third parties with potentially minimal activity by the bank. In these relationships, the third party’s products or activities may be endowed with various attributes of the bank.

Technology both encourages and facilitates this approach. Non-banks increasingly find that technology enables them to successfully offer “bank-like” services, but without the expense of a bank branch system or a bank charter. Moreover, computer systems enable these non-banks to integrate a set of distinct operations—some performed by banks and some by themselves—such as scoring a loan applicant and funding a loan, into what appears to the consumer as a single seamless product or service.

This approach goes beyond deconstruction of the bank’s special skills and competencies; it involves deconstructing the advantages in market perception and legal treatment that arise from status as a regulated financial institution. For example, because they are subject to an extensive regulatory regime, banks generally benefit from a high level of public trust. In addition, banks have unique access to payments systems that non-banks covet. All types of banks and thrifts are authorized to use the interest rates on loans permitted by the state in which they are located, notwithstanding more restrictive rates required by states in which their customers are located.55 And, for national banks and federal thrifts, certain types of state laws are not applicable because of principles of federal preemption.

This fourth type of deconstruction is the newest, and potentially most problematic. In this type of deconstruction, a bank is detaching its name, reputation and legal status from its own activities and permitting its attributes to be used in connection with the products and services of a third party. The implications of this type of “franchising” of a bank’s attributes are considerably more complex than when Harley Davidson decides to associate its brand with a new line of clothing.

Recent manifestations of this type of deconstruction appear in various efforts by non-banks to obtain access to bank funding and payments systems. One example is the so-called “Rent-a-
BIN” arrangement, designed to afford a non-bank access to a credit card payments system. In this type arrangement, a bank permits a non-bank to use the bank’s BIN (“Bank Identification Number”) issued by VISA, by issuing a credit card to be used for the third party’s products or services. In exchange for a fee paid to the bank when the account is opened and periodically thereafter, the non-bank acquires all the credit card receivables, receives all interest payments and other finance charges, and benefits from the bank’s authority to use the interest rates permitted in the state in which the bank is located, regardless of the limits on rates that may apply in the state in which the customer is located.

In another example, non-bank financial product vendors seeking to avoid the application of state consumer protection laws may approach banks to enter into marketing arrangements where banks and thrifts fund certain types of loans marketed by the vendor, such as so-called “payday” or “title” loans. The loans are actually offered, not at the institution’s regular branches, but at offices of the third party vendor at other locations. After the institution funds the loan, the third party then immediately purchases all or virtually all of the loans from it. For this activity, the institution is paid a fee. Through high-tech loan scoring systems and funds transfer arrangements, the actual roles of the institution and the third party will be invisible to the customer.

In these situations, the third party’s general objective is to involve a national bank or a federal thrift, both of which enjoy the ability to “export” interest rates allowed by the state in which they are located to customers in other states,56 and which, under principles of federal preemption, are not subject to certain types of state laws. By having its loans funded by an entity that enjoys federal preemption, the third party seeks to avoid compliance with a variety of state usury and consumer protection laws, yet the third party itself is not subject to the responsibilities and federal regulation applicable to a national bank or federal thrift.

Finally, in connection with joint marketing arrangements of deposit and payment products by non-banks, usually conducted over the Internet, some banks have entered into agreements with

56. As noted above, state banks that have thrifts also have this ability.
third parties authorizing them to initiate ACH transactions that result from the sale of bank products. Under these arrangements, the non-bank is endowed with the bank’s authority to access the payments systems—and the bank can be exposed to considerable risk. In one case where a national bank authorized a non-bank to initiate ACH debit transactions under a joint marketing arrangement of its deposit products, the non-bank third party failed to provide adequate controls to ensure that the resulting ACH debit transactions initiated were properly authorized. When fraud resulted from this activity, the bank incurred reputation loss and potential exposure under breached ACH warranties.

Generally, when a bank allows products and services actually originated by third parties to be presented as its own, the bank can be exposed to substantial financial loss and damage to its reputation if it fails to maintain adequate quality control over those products and services and adequate oversight over the third party activities. The act of simply delegating customer interactions to a third party also risks a priceless asset—the bank’s good name—if customers are not treated according to standards expected from the bank. Often these relationships involve an element where the third party is acting as a service provider since it conducts activities on behalf of the bank in originating products or services, e.g., the third party originates loan or deposit accounts for the bank or initiates payments.

Obviously, the issues with this kind of deconstruction are quality control, adequate oversight, and reputational exposure.


58. Under the current ACH rules, a third-party service provider may transmit ACH entry directly to the ACH operator, provided it has obtained permission of the originating bank (ODFI) to do so under the ODFI’s routing number. In these transactions, the ODFI makes a number of warranties under the ACH rules for each entry transmitted by the service provider regardless of whether it is seen by the bank or not. Most significantly, the bank warrants that the customer originating the entry has obtained proper authorization for each entry including ACH debit transactions. See NAT’L AUTOMATED CLEARINGHOUSE ASS’N., ACH RULES, A COMPLETE GUIDE TO RULES & REGULATIONS GOVERNING THE ACH NETWORK (2001) (available for purchase from the NAHCA at http://www.nacha.org).
This is particularly true with respect to oversight of the servicing activities conducted by the third party on behalf of the bank.\textsuperscript{59} Unfortunately, in recent examples of this type of deconstruction we have seen banks associate their name and special status with products that were abusive to consumers and third party vendors that did not conduct their operations with the diligence expected of a regulated financial institution. Frequently, the bank failed to conduct adequate due diligence and on-going monitoring of the third party.\textsuperscript{60} The result was both credit losses and damage to the banks' reputation.

For this reason, the OCC (in conjunction with the Office of Thrift Supervision) recently issued two Advisory Letters alerting national banks and federally chartered thrifts to the significant concerns that can arise from abusive third-party marketing efforts such as "title loans" and "payday loans."\textsuperscript{61} These letters urge national banks to think carefully about the risks involved in such arrangements and to use its supervisory authority to examine the operations of vendors who act as service providers to national banks sought out to deliver potentially abusive products. Moreover, if litigation should result from such abusive deconstruction of the national bank charter, the OCC has indicated that it will not necessarily support arguments that such

\textsuperscript{59.} These fourth type of relationships frequently are a blend of the first and second, i.e., banks will enter into relationships with third parties that combine characteristics of a both a servicing relationship and joint marketing arrangement. In these situations, the bank must be sure to adequately control both aspects of the relationship, e.g., it should not focus only on the joint marketing, and neglect the servicer aspects.

\textsuperscript{60.} Indeed, with respect to the servicing portions of these relationships, the bank should probably conduct enhanced due diligence and oversight. Unlike the normal servicer that has no independent interest in the underlying operations that it processes, the "franchised" servicers are primarily interested in those operations as the source of their profits. Thus, the franchised servicer will be tempted to conduct those operations and processes in a way that enhances the success of the underlying operations even at the cost of increased risk to the "serviced" bank.

joint arrangements with national banks exempt the products from state consumer protection laws.

All of this is not to say that this type of "franchising" deconstruction is always inadvisable or inappropriate. Experience does strongly indicate, however, that when a bank's role in the origination and marketing of a product or service for which it carries primary responsibility is only superficial and it has little substantive involvement, the bank may have placed its reputation and safety and soundness at significant risk. Moreover, in those cases, it is questionable as a policy matter whether the bank or thrift should be able to simply bestow the benefits and attributes of its regulated entity status on a third party that is not subject to the responsibilities and regulation that apply to the bank and thrift.

III. CONCLUSION

This framework of analysis demonstrates how technology is propelling fundamental changes in the financial industry. Although we have touched on many issues in this review, in many ways, we have barely scratched the surface. But, the abundance of issues to consider should not obscure the core message: "Deconstruction" of the banking business should not be confused with "destruction" of the business. To the contrary, when coupled with the potential of technology, prudent, strategic and responsible deconstruction of the banking business may be vital to the future business of banking.