THE BANK BEHIND THE INDUSTRY’S NEW CHALLENGERS
(And the Woman Behind the Bank)

BETSY COHEN AND THE BANCORP ARE ALLOWING ALTERNATIVE CARD AND ACCOUNT PROVIDERS TO HOOK INTO THE BANKING SYSTEM. THE FEES ARE LUCRATIVE, BUT THE UNUSUAL MODEL ALSO HAS INVITED REGULATORY SCRUTINY.

BY DAVE LINDORFF
AS A PIONEER in academia and in the financial services world, Betsy Cohen, one of the first female law professors on the East Coast, an accomplished banker and an active patron of the Philadelphia cultural scene, has never been one to take things slowly. Her latest venture is no exception. Founded in 2000 as a fairly typical commercial bank - if you can call a bank founded and run by a woman typical - The Bancorp Inc. has spent the past five years moving away from the standard model of banking as fast as possible.

Instead of relying on the thin margins to be made in the traditional business of taking deposits and making loans, The Bancorp is mainly in the business of offering private-label banking services and prepaid cards to nonbank companies, which in turn are then able to offer bank-like services to their customers.

The unusual approach has aligned the bank with potential disruptors like PayPal and T-Mobile. At The Bancorp, these are clients, not competitors.

As the bank that enables many nonbanks to delve into payments and smartphone-based checking accounts, The Bancorp has increased fee income at an impressive clip. But the swift expansion has come with a cautionary lesson, one that Cohen says has her thinking these days about the old adage, be careful what you wish for.

While business was exploding on the front end, back-end systems were struggling to keep up. The imbalance caught the eye of the Federal Deposit Insurance Corp., which recently declared the bank out of compliance with Bank Secrecy Act requirements.

In June, The Bancorp signed a regulatory consent agreement that puts restrictions on its lucrative prepaid card issuance and payment acceptance businesses until the necessary compliance upgrades are in place.

“We had had enormous growth and were in the process of broadening out our infrastructure,” Cohen says, “but clearly we hadn’t gotten it all down yet.”

What has really rankled shareholders, though, is the way the disclosure was handled. Just days before the consent agreement was announced, Cohen took part in a roadshow, meeting with analysts and investors. Cohen says she was “legally constrained” from reporting in advance that the company was in discussions with the FDIC over the compliance problems. But analysts argue that the company could have made a public statement about the negotiations, which would have allowed it to forewarn investors without violating fair disclosure rules.

When the consent order finally was disclosed, investors were predictably spooked. The stock plunged 29% that day. Through early July it had not recovered much ground.

The compliance issues were “something the bank could have seen coming, and I think a lot of investors now are saying enough is enough,” says William Wallace, an analyst at Raymond James, who suggests the episode has triggered a crisis of confidence in the bank’s leadership.

THE BANCORP’S evolution from a typical commercial bank to a back-end provider of bank products and services for nonbanks has mainly taken place since 2009. But according to Cohen, the strategy dates back to the bank’s beginnings almost a decade earlier.

“When we founded The Bancorp, we sat down as a board and said, ‘You know, with the Internet, banking is going to change. You could see it already. We thought, ‘How will people be accessing their financial information and their money 10 years from now?’” Cohen recalls.

The key, Cohen says, was realizing that those were two different questions. They began planning for a bank that would answer both, with an online component to respond to the shift they predicted toward digital banking, and a prepaid card business that could act as a custom bank for just about any type of business that wanted to start offering financial services.

The Bancorp now has relationships with about 400 firms that, like asset manager SEI Investments or insurer Genworth, are in competition with banks. Google is a client, too.

Paypal offers its customers private-label Visa and MasterCard debit cards that are issued by The Bancorp. T-Mobile turned to The Bancorp earlier this year when it launched Mobile Money, an offering that pairs a smartphone-based checking account with a reloadable Visa prepaid card issued by The Bancorp.

In nearly all these arrangements, it’s not the cardholders’ deposits that the Bancorp wants, nor their loan applications. Rather it’s the fees from the nonbanks that rely on The Bancorp as their plug-in to the banking system.

“We see ourselves not as selling banking services,” says Cohen, “but as helping our clients, like Paypal or T-Mobile, to solve banking problems for their customers.”

NOTABLY, The Bancorp has been in the vanguard with other important business lines. It was early in getting into Health Savings Accounts, for example, which has generated about $500 million in deposits.
The company also offers SBA loans and is in the transportation leasing business, primarily financing squad cars used by police departments and buses used by school districts.

The Bancorp also makes margin loans—$500 million worth at present—to customers of independent trust companies. “We’re the only people doing this,” Cohen says. “We enable smaller firms in the security business to compete with the JPMorgans and Morgan Stanleys, and we can do it on a low-cost basis.”

In large part, the bank can do so because of its own cost structure. There are no branches; bricks-and-mortar expenses are limited to a single office, in Wilmington, Del.

The fee income collected from nonbank clients has been especially attractive in a low-rate environment that has kept spreads narrow. (In the first-quarter the bank earned $24.2 million in noninterest income, just shy of its $26.6 million in net interest income.)

If and when rates rise and spreads improve, The Bancorp can capitalize on that by shifting its emphasis from fees to deposits and loans, Cohen says. Many of the bank’s contracts give the company the option to require that clients keep a minimum level of low-rate deposits with the bank. Then the funds could be lent out at a higher rate, and The Bancorp could pocket the spread.

“Since The Bancorp is not locked into a lot of low-interest, long-term loans, it is one of the banks that would benefit most from rising interest rates because of these contract provisions,” says Mark Palmer, a bank analyst with BTIG.

But the company arguably has been less successful at protecting itself from credit risk. Loan charge-offs in the first quarter topped $9.1 million, up from $3.7 million in the same quarter a year earlier, with the problems evenly split between commercial and construction loans. The company reported that nonperforming loans jumped to 2.2% of total loans, up from 2.08% in the previous quarter and 1.8% a year earlier.

“The quarterly results were obviously disappointing on this front as we thought that [the company] was over the hump on credit,” Sandler O’Neill & Partners analyst Frank Schiraldi wrote in an April 24 note to clients. “It continues to be difficult to get our arms around why these issues are showing up so late in the game when credit elsewhere is improving.”

Analysts suspect the problem stems from a legacy portfolio of commercial loans to Philadelphia-area borrowers.

“We’re in the process of scrapping those nonperforming loans,” Cohen says confidently. “The process should be completed by the third quarter.”

Meanwhile, the company can lean on its fee-based businesses, which have been a stand-out contributor to earnings. The Bancorp reported a 13% year-over-year increase in first-quarter prepaid card fees, and a 26% increase in total noninterest income.

Analysts say revenue from fee businesses should continue to grow—though a bit more slowly for the time being, due to limits on some new prepaid card business imposed by the consent agreement.

Matthew Kelly, an analyst at Sterne Agee, lowered his rating on the stock from “buy” to “neutral” after the consent agreement was disclosed. In a note to clients, he said the bank would face challenges in the near term because of the increased infrastructure and staffing...
expenses needed to reach full BSA compliance, and because earnings would be constrained by the consent order’s limitations on signing new relationships in the prepaid card business.

But Raymond James’ Wallace, who is projecting earnings growth at The Bancorp of 22% this year and 21% in 2015 even with the new FDIC restrictions on growth in the prepaid business, maintained his “buy” rating on the stock. In his view, he says, The Bancorp’s “long-term story” is “still intact.”

Wallace says it’s The Bancorp’s president and chief operating officer, Frank Mastrangelo, “who really understands all the nuances of the fee business.”

But there is little doubt as to who is shaping the strategy. “Betsy is running the show,” Wallace says.

IT TAKES a certain boldness and intestinal fortitude to be an entrepreneur; perhaps even more so, given the heavy regulatory constraints, to be an entrepreneurial banker. Analysts who have watched Cohen operate say she has plenty of both, which is probably all the more critical for an entrepreneurial woman in banking.

Throughout her long career, Cohen has been cognizant of a gender divide. She recalls sitting on the board of a bank in Virginia: “It was a bunch of old southern gentlemen. As a woman, you were there, but invisible. I would make a suggestion and there would be dead silence. Then one of the men on the board would say the same thing, and everyone around the table would say, ‘What a great idea!’”

At least by that point, she was prepared for some of the typical male reactions to women in authority roles.

When Ruth Bader Ginsburg became an assistant professor of law at Rutgers University in 1963, there were fewer than 20 women in the country appointed to tenure or tenure-track positions on the faculty of an accredited law school. The numbers were little changed by the time Cohen followed in the future Supreme Court justice’s footsteps and started teaching business law at Rutgers in 1967.

“Being a pioneer was challenging,” says Cohen, who has a law degree from the University of Pennsylvania and an undergraduate degree from Bryn Mawr College, an all-women’s school 10 miles west of Philadelphia.

“In my class, the students, almost all men, weren’t happy about having a woman teaching them, and I could hear murmurs of ‘bitch’ under students’ breath in the classroom when I would do something like give a hard assignment. But I was happy to assert my professional credentials. My goal was to be professional, not to be loved. I can’t remember being angry - amused, yes, but not angry.”

In 1969, she co-founded a commercial law firm with her husband and remained a senior partner there until 1984. But by then she already was deep into banking, having founded Jefferson Bank in 1974. (She later established Jefferson Bank New Jersey, in 1987.)

In 1999, when the dot-com boom was still going strong, Cohen and her team started contemplating the changing environment for banks. They considered using Jefferson as their vehicle for trying out the new commercial bank model they had in mind. But Jefferson was a “general banking business and it was what it was,” Cohen says, “so we decided to sell it, and start from scratch.” They got a good price – three times book – and used the proceeds to start The Bancorp.

“The new bank, focused on electronic banking, was something that hadn’t been done before. We were among the first to attempt to do this, and it is difficult to be ahead of the game. But it’s stimulating when every day you get up you can be doing something that hasn’t been done,” Cohen says.

In addition to her day job, Cohen is a trustee at the Philadelphia Museum of Art and of Bryn Mawr College, where she is vice chairman; she also is on the board of the health insurance giant Aetna.

Her primary focus, though, is on getting The Bancorp to meet its full financial potential.

“We have been investing in being in the right place to handle mobile banking over the past four to five years and, I’ll tell you honestly, not making any money on it,” she says.

But this could change with the T-Mobile relationship. That one deal alone puts T-Mobile’s 45 million subscribers within The Bancorp’s reach.

Another bright spot for The Bancorp is its international business, including a new platform for circulating prepaid cards across Europe.

“They’re three to five years behind the U.S. in terms of prepaid cards, with lots of different regulatory and privacy rules,” Cohen says.

The Bancorp’s European platform was built a year and a half ago and launched continent-wide in last year’s fourth quarter, Cohen says.

Asia is another area of potential, long term.

Cohen says the bank already supports prepaid debit cards offered by China UnionPay, a Chinese card service that is comparable to Visa and MasterCard and recently entered the U.S. market.

But after the experience in Europe, where the bank established itself in a handful of countries as early as 2012 and took nearly 18 months to finish the rollout, Cohen sounds uncharacteristically willing to take things slow, at least on the international front.

“It’s a learning process,” she says. “We learn ahead of doing, and then we evaluate as we go along, picking up the pieces when things don’t work.”

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