Payments Pros – Navigating New Compliance Challenges: The Impact of the Money Transmitter Modernization Act on Payroll Processing
Host: Keith Barnett
Guest: Eli Polanco
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Keith Barnett:

Welcome to another episode of *Payments Pros*, a Troutman Pepper podcast, focusing on the highly regulated and ever-evolving payments industry. This podcast features insights for members of our FinTech and Payments practice as well as guest commentary from business leaders and regulatory experts in the payments industry. My name is Keith Barnett, I'm one of the hosts of the podcast.

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Today, I have the pleasure of being joined by Eli Polanco, the founder and CEO of Nivelo, to discuss issues concerning payroll processing. By way of background, Eli launched Nivelo in 2020. Nivelo is a software company with the objective of supplying the critical risk infrastructure required in labor marketplaces to provide the missing risk infrastructure to ensure that everyone has secure access to contemporary economy in a fast and reliable way. Nivelo serves originators, third-party senders, and bank payment providers. Nivelo specially focuses on payments in the payroll industry. As we all know, payroll is a hot topic in the payroll industry, especially recently with respect to legal regulatory and compliance.

By way of more background, on the legal end, money transmitter laws are a big issue these days. Before 2023, most state money transmitter laws stated that a money transmitter is a person who is in the business of receiving money for transmission or transmitting money. These state laws did not mention payroll processing, with the exception of four states. Those states are California, Ohio, North Carolina, and Washington. But those states expressly excluded payroll processing from its definition of money transmission.

Eli was going to talk about this a little bit more today. But CSBS, the Conference of State Banking Supervisors drafted what they call the Money Transmitter Modernization Act around 2021, 2022, and began pitching it to the states around that time. The CSBS was trying to achieve uniformity in the state money transmitter laws across the country. Now, there's a lot to unpack with MTMA. But what is relevant here is that the MTMA expressly states that payroll processors are money transmitters, so that represents a shift from prior statutes. The Model law imposes a lot of compliance requirements on payroll processors, such as a bond and other things.

So, beginning in 2022 or 2023, some state lawmakers began voting on whether to adopt the Model law in portions or in its entirety. Some states adopted or proposed a Model law either with the payroll processing portion of it, as money transmission, but many adopted it without including payroll processing. Some states have been in a wait-and-see approach.

In any event, there are a lot of legal and technical issues. And you also have regulatory and compliance issues and that's what Eli is here to talk about today. So, Eli, without further ado, welcome to the podcast and thank you for sharing your insights today.

Eli Polanco:

Thank you for having me. Excited to be here.

Keith Barnett:

We're excited to have you. So, let's just dive right in. I don't think people truly know or understand how important the payroll processing issue is in the US and the fact that there are a lot of payroll processors. Could you just tell our audience how big the payroll processing industry is in the United States?

Eli Polanco:

Yes. Absolutely. I think when folks think of payroll, they rightly understand that it's the process via which everyone gets their paycheck. That's about 115 million workers in the US that depend on that process, working seamlessly. But also, on the government side is the process via which taxes are paid, as you earn. It's a huge industry. One of the most critical players in that industry are the payroll outsourcing services, these payroll providers that facilitate the calculation of those taxes, the tracking of hours spent working, and the movement of money. There's about $10 trillion worth of money moved within this industry alone in a single year. It's incredibly large, incredibly complex, but tied to every single worker and person in the US because of the taxes that are being used to fund our government.

Keith Barnett:

Thanks for that. That's very helpful background. Could you tell our audience what the role is of the payroll providers and their bank partners in that movement of money for payroll?

Eli Polanco: Sure. So, we talked about those $10 trillion worth of money that is moving. You can bucket that melee and into two. One is the wages, that's about $7 trillion. That is effectively moving very fast or as fast as possible between an employer or company and their workers right away, every week, every two weeks. And the 4 trillion or so in taxes that are being paid out to, over 10,000 government jurisdictions. The payroll providers within this space, and there's about 5,000 or so in the US. That's actually a number that typically surprises folks. When you ask folks, “Do you know a payroll provider who is the payroll provider that you can identify easiest?” Most people think of ADP. They think ADP holds 90% or so of the market.

But in fact, there are thousands of payroll providers that provide not just the tax calculation and critical HR services, but are also involved in facilitating the money being moved for wages, as well as the collection of those tax funds that are later paid to those jurisdictions. One of the interesting things about how taxes are collected in the US is, you are paying your taxes via the withholding method. Meaning that taxes are calculated and collected by the payroll providers as workers are earning, but they are paid via quarterly, or annual basis to the IRS, or the different regional jurisdictions.

These two buckets represent two different types of bank or rail access that these payroll providers need. They would need an ACH processing relationship. Most of our paychecks today are received via direct deposit. So, if a payroll provider wants to facilitate those payments, they will go to a bank and ask for sponsorship into the ACH rails. So, that's one component of the payroll providers and how they interact with bank partners.

The second is related to those tax funds. Because the government and the different jurisdictions accept taxes on given quarterly or annual dates, but the money is calculated and collected as workers earn, there is usually a period of 30 to 90 days where those tax funds are held. This is the second component where banks come in, and they will provide escrow-like deposit accounts for the benefit of holding those funds, while they're waiting to be paid out to those jurisdictions.

So, we've got the thousands of payroll providers with their relationship to their clients, ensuring those wages are getting paid, and those taxes are getting paid on time. You've got the bank partners who are providing them with access to the needed ACH rails, and the escrow-like accounts to hold those funds. So, it's a very critical relationship, and very critical to ensuring that this process of work happens seamlessly in a country.

Keith Barnett:

Thanks. That's very helpful. Just to add on to that, and then you mentioned this, that payroll goes through the ACH network. Also, let's keep in mind that the NACHA rules also play a central role here, right? So, some banks that might be processing payroll may require sock audits. But NACHA also requires independent audits and that includes reviewing every contract between payroll processor, an employer, and also reviewing the transactions. So, these audits are pretty robust, and that brings me to my next question. I know earlier, I gave a broad overview of the Model law, now, I think it's a good time to take a deeper dive with you, Eli. So, what are the key payment regulatory issues that are affecting the industry right now?

Eli Polanco:

Yes. I think as you rightly called out, this is an industry that is mature and for the longest time, has existed without requiring no-money transmission licenses. But because of the new Model law changes, we now have quite a few states that have adopted the definition of who requires a money transmitter license and payroll processors in many states are now being required to hold a license, or they're in the process of clarifying whether they need a license. So, now you have the issue that a lot of any payment processor or requiring an MTL needs to contend with, which is dealing with a patchwork of license requirements across states and payroll providers, even regional payroll providers, typically don't stay within a state. That's because of how the future of work has evolved.

Right now, especially post-COVID, remote work, moving between borders as workers is a lot more prominent. So, you may be a company that is based out in New York, you have a payroll provider in New York, all of their clients are based in New York. But you may need to track where all of your employees are that you're serving, so that you can contend with the MTL law that each of those states represents.

So, the first thing that it's introduced to the payroll industry is complexity. Tracking and monitoring and complying with each state's regulation, which needs to happen in an industry where work is fluid work. Work is fluid across state borders, therefore, you now have that needed visibility across the borders of that regulation. So, that's the first thing. There are a lot of resources being ingested into the industry right now to track and contend with that patchwork of regulatory guidance across states, because not all states have consumed where they lie in terms of clarifying whether payroll providers are exempted or not, from money transmission laws. There's still also a lot of uncertainty. I think that uncertainty will remain for least a couple of years.

You can talk more about, at least, about how long it will take to get clarity, but the fact that you may be operating in a state, facilitating payroll money movement in that state, but it's still a yay or nay. There's still live legislation being discussed and passed through around whether you're exempt or not from this law, is causing a lot of concern. So, in addition to that complexity, you also have uncertainty and without a doubt, that's adding to the costs of providing payroll services.

You've talked about NACHA. Obviously, ACH is a critical payment rail for payment providers. Most payment providers are comfortable with the NACHA regulation, conduct their audits, are very cautious and where risk management is top of mind in terms of abiding by those NACHA rules. So, in a way, the NACHA rules haven't really changed anything for the payroll providers. That's something that they've always been contending with. The MTL regulatory changes are truly the biggest cause of concern, complexity, and costs for the industry right now.

I would add that this issue is happening at the same time, that there's increased regulatory scrutiny from the FDIC, from the OCC, from different state banking supervisors, on bank partners, and how they offer banking services to third-party non-financial institutions, like payroll providers. With that regulatory scrutiny, payroll providers are also contending with more scrutiny as well, themselves. I would say that across the board, whether it's from NACHA, whether is from the money transmission laws, whether it's from the OCC or FDIC-related scrutiny on third-party bank relationships, there is one thing that is a key trend on all which is the focus on risk management.

I will say without a doubt, every payroll provider right now is reviewing how they process their payments and making sure that they are doing what they can to verify who their clients are, and tracking their money movement and the deposits that they're holding for their clients as a best practice, because regardless of where the source of scrutiny is coming from, that is one key element that all these laws, all these regulatory agencies are asking of them.

So, things like KYB, know your business, know your client, who are you serving, the Bank Secrecy Act-related anti-money laundering rules, reconciliation of your client's funds, those types of things that you can operationally do today have never been more important. Part of that is due to the elevated scrutiny coming from those regulatory agencies.

Keith Barnett:

That was all extremely good information. One of the things that you did mention is that these laws are just all over the place. Some have adopted MTMA, others have not. And then, just for our listeners, at least, as of the date of this recording, you have the states of Kansas, Iowa, Minnesota, New Hampshire, South Carolina, South Dakota, Wisconsin, Arizona, Arkansas, Connecticut, Hawaii, and Indiana that have all adopted portions of MTMA. But they have not included payroll within their definition of money transmission.

In fact, some of those states expressly exempt payroll from their definition of money transmission, or they have sort of like an agent of the payor exemption. But then again, you have the other states like Georgia, Maryland, Nevada, North Dakota, Tennessee, Texas, Vermont, and West Virginia, that have adopted that portion of MTMA and expressly require payroll processors to have money transmitter licenses.

Another great point that you bring up is that some of these questions not only involve whether or not you have a remote worker who might live in a state that hasn't adopted MTMA, but the employer is in a state that has adopted MTMA. So, you have the legal issues, right? Whether the location of the employer or the location of the employee is the driver behind whether a person should be licensed. There are issues with NMLS, even. Their inability to correctly categorize payroll processors. Then, there are issues with state applications themselves requiring payroll processors to register as money services businesses with FinCEN, as a prerequisite to state licensure, even though FinCEN does not expressly require payroll processors to have money transmitter licenses.

So, you have all of those things that are going on, in addition to payroll processors having to keep up with their other compliance requirements that you mentioned. So, my next question to you, might be a loaded question, but I'm going to ask it anyway. How are the payroll providers and their banks addressing these regulatory changes?

Eli Polanco:

Yes. I'll start with the payroll providers, and then I'll briefly talk on the banks and what we've seen. I'm drawing from conversations with hundreds of payroll providers, and obviously, serving in the space. Our software specifically serves payroll providers in their money movement needs. There's a few approaches that we're seeing, and I'll start with the, I would say, the bazooka approach.

You've got companies like ADP, Ceridian, Paycom, who have effectively in the last couple of years said, “You know what, trying to keep up with the complexity of indifferences between each state's requirements, is going to be incredibly difficult and time-consuming. The way that we're going to solve for this is to become a bank.” And actually, I think that's fairly interesting. They've applied and gotten approvals for a Bank Trust National Charter from the OCC. Obviously, this is not an option for all payroll providers due to size and capital requirements.

But that's one approach on one end of the spectrum, really large public company, a lot of capital, a lot of staff, and they've decided we'd rather have a single holistic national bank charter to contend with than having to deal with it with the patchwork of MTL licenses across states. On the other end of the spectrum, you have payroll providers that has been serving their communities for a really long time. They're focusing on a specific region or specific community or specific sub-industry. They're small and they've been operating well. But this just elevates the costs and complexity of their business to such an extent that we've actually seen those smaller payroll providers just say, “You know what, I'm going to exit the room,” and they've decided to sell their business closed shop and move on to other things.

Then, in the middle, you have payroll providers that are trying to figure out how do we operate to serve our clients effectively, while still being compliant with MTL? What we've seen is first having a very thoughtful understanding of where they operate, which states are relevant for them by doing a review of their business and where the workers are located. One approach has been let's go out and get these licenses.

Because payroll providers were just not explicitly regulated under MTL across the board. But these payroll providers have been existing and operating for decades that usually requires a conversation with regulators to help them understand, “Look, we want to get our license. However, we have been operating this way.” They usually have to have conversations about potential fines that some states will apply retroactively. So, the initial conversation with regulators can be really scary.

But we do see folks that are committed to growth within the industry, committed to continue to serve their clients. That's one approach that they're going to – confirming which states are operating in and going and getting their license. Trying to minimize the type of penalty fines that they have. Overall, changing the way that their business operates to ensure that they have those bond requirements, that they have the additional audits that they need to do, and whatnot. There are others in the space that are really looking to leverage their partner banks to solve this.

There are tens of thousands of payroll providers that are actually registered, for example, with the IRS to facilitate tax payments. But there are only a few thousand payroll providers that are actually involved in money movement, that are actually in the flow of money, where they themselves are acting as a third-party sender with an ODFI institution or a signatory on an escrow account for their client’s funds. For these clients, they are really leaning into either effectively removing themselves from their flow of funds entirely, which means working with bank partners, so that the clearing accounts and client fund accounts that are being used for money transmission, or that temporary holding of tax funds to be completely sponsored and owned by the bank. So, they're leveraging for benefit of accounts, as well as an a fully sponsored ACH processing. Effectively taking themselves away from the flow of money.

To recap, you can exit the room, you can just become a bank, you can get your MTL license, or you can strongly partner with a bank so that you as a payroll provider are not in the flow of funds. You, at any point, are not holding client funds in your accounts, and all those funds are being held and managed by a bank partner. That takes me to the second part of your question, which is how our bank partners interacting or addressing these regulatory challenges.

As I mentioned earlier, bank partners themselves are under really strict rules and intense scrutiny. You've seen a lot of consent orders, over the past few months, for banks that are providing banking as a service type business. What we're seeing is that the bank said understand payroll business, where their bankers fully understand the flow of money, that complexities of the parties involved, they are leaning in and partnering with their payroll providers, by helping them offer really strongly risk controlled for benefit of accounts and ACH processing rail relationships.

Those banks are few, and I think it works because of their understanding of the industry. These are folks that have been operating in payroll before that understand the criticality of the business, and they are trying to figure out what is the best for benefit of an ACH relationship that we can offer to these payroll providers. Usually, that means higher requirements around audits, Bank Secrecy Act-related risk management from the payroll provider that's supervised by the bank, and really strong reconciliation, so that at any point in these for benefit of accounts, it is known exactly how much funds are being held for which client, for which tax jurisdiction at any given time.

Keith Barnett:

Also, just a follow-up on one of the things that you said. One of the dilemmas that a payroll provider faces if they do decide to get a license, and one of the states that now expressively requires them to be licensed. Is just to know that these states are going to say, “Well, what have you been doing for the past X amount of years?” Then, that's when they will have to disclose that, “Hey, I've been in this industry for many years.” As you mentioned, some of these states will retroactively monetarily penalize the payroll providers for past activities. We've seen these penalties be in the high five figures, or even in the six figures, really, depending on the volume and how long it's been going on.

So, these alternatives that you mentioned, for both the banks and the payroll providers are very important for them to know. Let me ask you one last question and I'm asking you to get out your crystal ball and make a prediction here, or maybe even several predictions. What does all of this mean for the future of work and payroll in the United States?

Eli Polanco:

Yes. Look, I think this idea of borderless work will continue. I think whether it's within different states in the US, or different countries, that is something that our society demands that workers are also demanding. So, we're going to see, in my opinion, a landscape of an industry that is realigning to serve that, which means that you will need to figure out a way to either grow large enough to become a bank trust yourself, or be able to comply with the different regulations across each jurisdiction.

What I think that will mean will be an increase of the costs of providing payroll outsourcing services. I don't think it will be possible for you to, for a payroll provider, to manage the additional costs that are going to come from these additional supervisory requirements, that their margins are getting squeezed. I think, at some point, you're going to see that being relayed to either higher prices for the consumers. In the other end, the squeezing out of smaller players. So, I think we're going to see a consolidation of the industry. You're already seeing a lot of M&A uptick in payroll. I think there's definitely economies of scale at play, a new ability to manage these extra regulatory and money movement costs.

So, I do think in terms of the payroll providers that are able to move money, it's going to become a smaller industry from tens of thousands, to maybe half of that, or whatnot. I think some of the smaller providers will, if they stay in business, will have to kind of focus their business to serving companies and employers that don't have border less work. So, maybe local manufacturing shops, local restaurants, in a non-franchisee way. But yes, it's going to affect the costs of payroll services. It's going to affect who provides those services, and you're going to see, in my opinion, consolidation. In that consolidation, you're going to see strong partnerships with very payroll-focused thing partners that understand the inflection point of the industry right now, and are going to provide the needed kind of FBO and ACH relationship accounts that are needed to fund those payments.

But at the end of the day, it's such an important industry. We talked about, you mentioned, payroll providers being an agent of the payor. But in a way, they're also agents of the payee as well. They're agents of the government. Without payroll providers, the ability to collect taxes via withholding would be incredibly difficult is one of the reasons this industry was created, came to be in the first place. So, it's a social good that I feel like these payroll providers are doing, but it's definitely going to cause a meaningful shift into what they look like, how small they can go, and definitely, I think will drive consolidation in the industry.

Keith Barnett:

Yes. It's funny that you say that, because while the lawmakers and the regulators say that they're doing this for consumer protection. But to your point, it's actually just going to stifle competition and innovation, and actually raise the costs for consumers and quite possibly provide them with fewer resources when it comes to payroll-related things. So, that was great.

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