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Testimony to Joint Committee on TEFFIs November 7, 2023

Good morning, Mr. Chairman and members of the Joint Committee on Fiduciary Financial Institutions Oversight. My name is David Herndon. I am the Kansas State Bank Commissioner and appear before you to update you on the Technology Enabled Fiduciary Financial Institutions Operation, known as “TEFFI” in the State of Kansas from the perspective of the Office of the State Bank Commissioner (OSBC). Thank you for inviting me to appear before you this morning and provide my frank testimony. I am joined in person today by OSBC Deputy Bank Commissioner Tim Kemp and OSBC General Counsel Brock Roehler. Both will be available to offer comments and answer questions with me this morning. I appear before this committee today to report on regulatory activities conducted by my office regarding the only TEFFI chartered and existing in Kansas, Beneficient Fiduciary Financial, LLC, Heston, KS, now known as BFF, LLC.

On December 7, 2021, the first meeting of this Joint Committee which was created by the TEFFI ACT was held. The action of this committee resulted in BFF receiving a charter as of December 31, 2021. The Kansas Legislature, not the OSBC nor the State Banking Board, granted the charter during the 2022 legislative session through passage of SB 337, allowing the charter to be retroactive to the December 31, 2021, date. Subsequently HB 2489 amended the TEFFI Act. The TEFFI Act and amendments are codified as Kansas Statutes Chapter 9, Article 23 (the Kansas Banking Code). The OSBC is the sole regulator for TEFFIs. There is no federal financial regulator counterpart.

In that capacity, examiners from OSBC completed three examinations of BFF since the legislature granted a “special” charter to BFF.

The first two were reported to this committee in December 2022 and included examinations focused on the Information Technology (IT) systems and compliance with Bank Secrecy Act and Anti-Money Laundering laws (BSA/AML).

The scope of the third examination consisted of reviewing BFF’s administrative and operational practices and procedures as well as a review of selected Fidfin transactions. This examination evaluated potential areas of risks pertaining to BFF’s business model and to the state of Kansas. Examiners appraised BFF’s board and management of apparent statutory or regulatory violations and unsound fiduciary practices and procedures except as allowed by the TEFFI Act.

In accordance with K.S.A. 9-1712(a), all information the state bank commissioner generates in making an investigation or examination is considered confidential information. BFF, nor any of its directors, officers or employees may disclose or make public, in any manner, the Report, its findings, recommendations, or directions. Consequently, other than to say the Reports of Examination were presented to BFF’s board and management with each director’s signature attesting to that director’s personal review of the Reports of Examination, I will not comment on the findings contained in the Examination Reports. I will, however, address other matters related to the TEFFI Act and BFF.

First, the bill established a pilot program with an economic growth zone designated in Harvey County, Kansas. BFF was the sole participant in the pilot program. I reported in my December 1, 2022, report to this Committee that as a result of the State Banking Board’s recognition of the transactional authority

granted BFF by the Kansas legislature and upon the completion of the examinations, the OSBC and State Banking Board considered the provisions of the pilot program complete, and the program could end.

Since the enactment of the TEFFI Act and conclusion of the pilot program, OSBC has not received any inquiries or applications from subsequent entities seeking a TEFFI charter in Kansas. Further, to my knowledge, no other state has passed legislation creating the same or similar TEFFI legislation. Kansas is the only state authorizing TEFFIs. BFF is the only TEFFI in Kansas, none are pending. Therefore, the OSBC makes no other statement regarding the market or worthiness for TEFFIs.

Since the TEFFI legislation was introduced, I have repeatedly expressed concerns with some of the regulatory components contained in the Act. Those concerns remain, and in some cases, have deepened. To be clear, my concerns exist for any entrant into the TEFFI marketplace as the TEFFI legislation is not specific legislation for BFF, but rather legislation that will govern any future TEFFI should there be interest from other entities in entering the industry.

It is still impossible to conduct a meaningful Safety and Soundness examination. We conduct Safety and Soundness examinations on our regulated banks following international industry standards and assign ratings in Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk (CAMELS) components in compliance with the Uniform Financial Institutions Rating System. Our examinations on regulated trust companies and trust departments assign ratings in Management, Operations, Internal Controls and Audits, Earnings, Compliance and Asset Management components in compliance with the Uniform Interagency Trust Rating System. The Act specifically disallows an examination to consider earnings as a component and assigns any goodwill asset as a capital component, departures from the Uniform Financial Institutions Rating System, the Uniform Interagency Trust Rating System and Generally Accepted Accounting Principles (GAAP). By the nature of the business model, a significant asset category is the Fidfin transaction created by a TEFFI which is a debt instrument. In most cases, and as confirmed in testimony by BFF, no structured repayment of principal or interest nor any firm maturity date is created for these debt instruments. Consequently, under the rating system guidelines, every such instrument would be considered at least a Substandard asset with a very strong likelihood of it being rated Doubtful or Loss, at which point would be charged off the books. The legislature should revisit these departures if a worthwhile Safety and Soundness examination is sought.

The original Act also failed to meet the requirements established by the FBI that permitted complete background checks on the organizers of any TEFFI. The shortfall specifically dealt with fingerprinting. The OSBC is working with the Kansas Bureau of Investigation to introduce legislation that will amend this and other similar state laws to comply with FBI standards.

Recent transaction announcements by BFF have been funded with consideration other than cash, raising questions about the viability of BFF being able to fund itself going forward. Therefore, I again state our concerns about the restrictions imposed against OSBC by the TEFFI Act and caution this committee and the Kansas legislature that no standard exists to determine the Safety and Soundness of any TEFFI, especially the only TEFFI in existence – BFF.

Concerns exist about several negative press reports involving BFF's parent company Beneficient, federal regulatory actions taken against Beneficient, the freefall of Beneficient's publicly traded stock, public statements by Beneficient as well as its accounting firm regarding the company as a going concern. BFF is one of several subsidiary companies of Beneficient. OSBC only regulates BFF, not the parent or any other subsidiary. OSBC has only examined BFF so has only limited knowledge, derived from public filings and statements, about the other subsidiaries. But by the very nature of traditional business models, a parent company should provide strength and support to its subsidiaries.

Thank you for allowing me to appear this morning.