



October 31, 2017

By Electronic Submission

Re: *Sound Practices: Implications of fintech developments for banks and bank supervisors*

Ladies and Gentleman:

BAFT (Bankers Association for Finance and Trade) appreciates the opportunity to comment on the August 2017 consultative document issued by the Basel Committee on Banking Supervision (“BCBS”) entitled *Sound Practices: Implications of fintech developments for banks and bank supervisors* (the “Consultative Document”).¹

BAFT is an international financial services trade association whose membership includes banks headquartered in roughly 50 countries around the world, financial services providers, as well as a growing number of non-bank and financial technology companies. BAFT provides advocacy, thought leadership, education and training, and a global forum for its members in the areas of transaction banking including trade finance, cash management, payments, liquidity, and compliance. For nearly a century, BAFT has played a unique role in expanding markets, shaping legislative and regulatory policy, developing business solutions, and preserving the safety and soundness of the global financial system.

In 2016, BAFT established an Innovation Council which brought together financial institutions and financial technology companies to provide awareness, education, and guidance with regard to emerging technology impacting the transaction banking industry. The Council channels its expertise to: (1) promote innovation, (2) drive regulatory change commensurate with the evolution of the transaction banking business through the delivery of new technology, and (3) develop industry best practices and standards. The comments included in this letter are reflective the members of the BAFT community.

BAFT would like to thank the BCBS for its analysis of fintech and issuance of the Consultative Document. We appreciate the BCBS’s proactive analysis of financial technology innovations and emerging business models in the banking sector. The Consultative Document is a significant contribution to the development of a rational policy framework. We recognize that tackling a space as diverse, complex, and dynamic as financial technology is not easy. We are grateful for the BCBS’s leadership in supporting innovation and for its recognition of the important role technology will play in providing greater financial inclusion, more robust, efficient, and cost effective financial tools, and more secure transaction capability, while protecting the safety, soundness, and integrity of the global financial system.

¹ BCBS, *Sound Practices: Implications of fintech developments for banks and bank supervisors* (“*Sound Practices*”), August 2017. <http://www.bis.org/bcbs/publ/d415.pdf>

I. Comments on Fintech Developments and Forward Looking Scenarios

The financial sector has always strived to develop innovative tools and products to better serve its customers. But, the rates of investment in fintech and progress of innovation over the past several years is virtually unparalleled. As a result, financial services are undergoing a major transformation.

A. Definition of Fintech

We support the BCBS's adoption of the FSB's definition of fintech. The definition is consistent with the vision of the financial services sector as a fast-evolving ecosystem that includes banks, new entrants, technology companies, and regulators/supervisors. The innovative application of exponential technologies to revamp the provision of financial services, regardless of the nature and size of the provider of those services, is at the core of the definition.

In its description of the fintech landscape, however, the BCBS has the tendency of equating fintech with smaller new entrants, without encompassing banks or big technological companies. This seems inconsistent with the FSB definition of fintech. Early this year, BAFT encouraged regulators and the financial industry alike to be more precise with its use of the term "fintech."² We agree with the BCBS's view that definitions can influence regulatory/supervisory approach and, therefore, suggest that the BCBS ensure the term is used consistently throughout the document.

B. Forward Looking Scenarios

In combination, the five forward looking scenarios present a fairly bleak future for incumbent banks. Indeed, fintech is described as an extinction-level event for incumbent banks: too slow to adapt, most incumbents will be dismantled by new entrants and bigtech.

BAFT believes that the current financial services ecosystem will develop into a more rich and complex end state that includes incumbent banks, better banks, neo banks, new fintech entrants, and bigtech. We note that fintech does not occur only outside of or "to" banks. Many incumbent banks are driving and enabling (rather than just reacting to) innovation. Banks are developing innovative solutions in-house and through consortiums. Some have incorporated new products and models into their businesses by acquiring new entrants outright. Others encourage and enable innovation by sponsoring innovation labs and investing in early-stage companies.³

Most banks are adapting to the increased pace of change, adopting fintech, and evolving into "better banks" or "distributed banks" that maintain control of the customer and banking platform. Even smaller incumbents have incorporated investment in digitization and modernization into their strategic planning. True, incumbents are burdened with legacy infrastructures and physical distribution networks. Nevertheless, they have been able to modernize by building, buying (acquisition or licensing), and white labeling fintech. Increasingly, they choose to outsource services or open their core banking

² BAFT, *Letter to the Office of the Comptroller of the Currency re: Exploring Special Purpose National Bank Charters for Fintech Companies*, January 17, 2017, p. 4. <http://www.baft.org/docs/default-source/policy-department-documents/baft-occ-fintech-charter-consultation---0172017.pdf?sfvrsn=2>

³ The BCBS itself notes that "In addition to the investment made by VC companies, many of which are backed by financial institutions, banks and other institutional investors are also making large direct investments in fintech companies." BCBS, *Sound Practices*, p. 11.

platform to third-parties for the development of value-added APIs. Banks also have been entering into diverse types of mutually beneficial partnerships with new entrants and established entities. Because these changes are already taking place, BAFT finds the “better bank” and “distributed bank” the most compelling of the five forward-looking scenarios.

The neo-bank, relegated bank, and disintermediated bank are unlikely to become dominant scenarios in the future. Neo-banks face similar regulatory restrictions as incumbents, must build their customer base and trust from scratch, and may be unable to satisfy all of their customers’ financial needs. Of those few challenger banks that have been organized over the last ten years, many have been acquired by large global incumbent banks. The relegated bank scenario seems limited to those situations in which a fintech company is the bank’s largest customer or the fintech company acquires the bank for its license, essentially becoming a bank or bank holding company. The disintermediated scenario also seems far-fetched because building a centralized pool of trusted providers of niche products is difficult and customers are unwilling to manage a different provider of each core banking service.

II. Comments on Observations and Recommendations

BAFT agrees with each observation and recommendation (“Item”) that the BCBS sets forth in the Consultative Document. In fact, in comment letters to and roundtables and bilateral meetings with national authorities, BAFT has espoused similar views on a balanced approach to regulation, regulatory coordination, and modernization of supervisory models, tools, and skills. We offer the comments below as supplementary information for the consideration of the BCBS as well as other multilateral bodies and national authorities active in the development of a rational framework for innovation in financial services.

A. Balancing Safety and Soundness with Innovation (Items 1 and 9)

BAFT believes that government as a whole (not just bank supervisors) should ensure that the framework for financial services is holistic, balanced, and future-proofed. Thus, we encourage governments to undertake a comprehensive review of the legislation and regulation applicable the financial services traditionally defined as banking and the supervision of the entities providing those services. The purpose of such a review is the identification of risks that must be addressed (gaps) and of barriers to innovation that must be removed.

Government should introduce new laws or regulations only if they will effectively mitigate a material risk. Government should note that a rush to judgment or action, without cause or significant potential for harm, would have a chilling effect on financial innovation from which the sector would have difficulty recovering. To make informed policy decisions, government must better understand the likelihood that a risk may materialize and the impact it may have. A number of national authorities and the BCBS have contributed to the identification and assessment of fintech risks, but additional work is required.

Government should attempt to prevent regulatory arbitrage and maintain a level playing field amongst competing providers. The same activity presenting the same risk should receive the same legal and regulatory treatment, irrespective of the type of provider, authorization relied upon, or technology utilized. Accordingly, BAFT supports the design and implementation of narrow licenses addressing specific activities and risks. Full-service banks should be allowed to perform any of the activities covered

by these narrow licenses. Non-banks licensed to provide a narrow service should not consider authorization as a shortcut to provide other services falling outside the initial scope.

We agree with the BCBS that principles based, rather than highly prescriptive or tightly tailored, laws and regulations are appropriate to address the iterative and evolutionary nature of fintech and will assist in “future-proofing” the financial services framework. Principles allow for growth and change over time, functioning as a force multiplier for innovation and the maintenance of safety and soundness of the financial system.

Government should revise or rescind laws and regulations that impede fair competition and innovation in financial services. Both incumbents and new entrants face obstacles inadvertently created by the current legal and regulatory framework. For instance, in a 2014 opinion, the EBA instructed national supervisory authorities to prevent credit institutions, payment institutions and e-money institutions from buying, holding or selling virtual currencies. Unregulated new entrants, of course, were free to engage in such activities. If buying, holding and selling virtual currencies presents a material risk, all service providers performing such activity should be similarly regulated. In the United States, non-bank providers of national payment services are required to obtain individual licenses from almost all 50 states or a special-purpose national bank charter from the Office of the Comptroller of the Currency (“OCC”). The multiple state licensing regime involves great cost and duplication of effort for both providers and regulators/supervisors. The OCC charter contains requirements that appear superfluous, given the provider’s decision to engage in a single business activity. Each regime imposes additional burdens without the reduction of risks associated with the regulated activity.

B. Fintech Opportunities and Risks (Items 1 and 2)

BAFT appreciates the BCBS’s effort to identify and assess both the opportunities and risks associated with fintech. The Consultation Document presents a clear summary of the BCBS’s findings. BAFT advocates for the additional study and analysis of these opportunities and risks. With respect to the opportunities, government should determine the actions that it needs to take so that the societal benefits promised by fintech may be fully realized. With respect to the risks, more attention should be given to the likelihood and subsequent impact of materialization. The party best positioned and the method most appropriate to mitigate each risk also should be carefully considered, as not every risk requires governmental action.

The BCBS rightly identifies regtech as one of the more important opportunities presented by innovation in financial services. Industry believes that regtech offers the most promise in the areas of regulatory reporting and anti-money laundering (“AML”) compliance. BAFT notes that recent work by the Institute of International Finance (IIF) provides valuable insights with regard to regtech, discussing barriers to regtech implementation and development of the regtech market.

BAFT agrees that the widespread and rapid adoption of fintech exacerbates systemic operational and cyber risks already present in the financial system. In particular, we note the possible emergence of systemic operational risk with concentration in cloud computing services. Entities engaged in banking are likely to use the same three bigtech companies – AWS, Microsoft, and Google – for their cloud computing services given (1) the economies of scale in the provision of such services and (2) the specific and more stringent requirements for providing these services to the financial industry. Regulators and supervisors should carefully monitor this area.

The probability that cyber risk will materialize and the enormous impact of cyber breaches calls for a more standardized and coordinated approach within the financial services ecosystem. The use of internationally recognized standards for cybersecurity would create a minimum baseline for all providers of financial services. A principle based certification program could be established and incentivized. Government authorities should simplify the current regulatory framework for cyber breaches, centralize incident reporting, and standardize the format and content for incident reports and taxonomies. Finally, regulators and supervisors should promote information sharing about attempted or actual cyber incidents, placing a premium on efficient and timely distribution.

C. New Enabling Technologies (Item 3)

Maturity and legal/regulatory clarity are required for the widespread adoption and full realization of the benefits of the new enabling technologies. Relative technological immaturity and legal uncertainties have inhibited the use of DLT in financial services. Experts agree that DLT is still a young technology. Industry has a few technological issues to resolve and has yet to develop technical and operational standards. Challenges related to the use of DLT in financial services include: scalability, interoperability, cybersecurity, privacy, and screening transactions for potential money laundering and fraud. Common operational issues not specifically connected to financial services include: management of the transition from current technology infrastructures, acquisition of specialized knowledge and skills by the workforce, and system governance and participation rules.

A number of fundamental legal questions regarding DLT also need to be addressed. In many cases, the answers to these questions require the reconciliation of the unique characteristics of DLT with existing legal constructs. Such questions include:

- How will the “right to be forgotten” be interpreted, given the immutable nature of the ledger?
- How will territoriality issues be addressed, given the instantaneous recordation of information across distributed ledgers?
- How will errors be resolved, appropriate access granted, and security ensured given the absence of a single, trusted, centralized authority?
- Will smart contracts be recognized as legally binding and enforceable?

With respect to maturity and legal/regulatory clarity, cloud computing provides an excellent contrast to DLT. Cloud computing is a mature technology, but regulatory and supervisory obstacles have contributed to a slower adoption by financial services providers. There has been to date uncertainty around the application of existing outsourcing requirements to the cloud services business. We strongly support efforts by regulators to provide increased certainty in this area, such as the EBA’s draft guidelines published in May 2017. We also encourage regulators to collaborate with cloud service providers and financial services providers to address diverging interpretations regarding the applicability of regulatory requirements and to harmonize supervisory expectations. Finally, regulators should consider alternate approaches to risk management that reduce regulatory burdens on financial services providers without sacrificing control. For example, shared assessments of the small group of cloud services providers used by the financial services industry would be extremely beneficial.

D. Cooperation among Regulators / Supervisors (Items 5 and 6)

Cooperation amongst regulatory and supervisory authorities is essential across functions (data protection, consumer protection, competition, anti-financial crime agencies) and across national borders. The establishment of a rational, holistic financial services framework and creation of an even playing field for all providers would be impossible without such cooperation. BAFT encourages continuous and open dialogue amongst the relevant government authorities that incorporates input from the private sector. Conversation and interaction amongst all stakeholders is imperative to gain a true understanding of the current digital transformation and provide a stable foundation for the future.

Over the last year, BAFT has seen increased coordination amongst regulators and willingness of regulators to engage with the private sector. For instance, a number of financial services regulators from different jurisdictions have entered into bi-lateral agreements commonly referred to as “fintech bridges.” Regulators attempting to modernize their internal structure and improve their functional effectiveness have conducted outreach to their sister agencies and the public.

BAFT believes that such cooperative efforts need to become more frequent and sustained. Arguably, BAFT is well positioned to facilitate the process. International transaction banking, whether traditional or innovative, is cross-border. Our membership includes large global banks, regional banks, non-bank financial services providers, and technology companies. We consistently advocate for the harmonization of regulatory standards, where appropriate. BAFT respectfully recommends that the BCBS leave the development of technical standards and establishment of best business practices to the industry. However, BAFT recognizes the important role of government authorities in the validation and promotion of such standards and practices.

E. Internalization and Facilitation of Innovation by Regulators / Supervisors (Items 7, 8, and 10)

The increasing rate of innovation will result in greater need for new skills and technological knowledge across all market participants, including regulators and supervisors. Regulators/supervisors must acquire or develop a staff that is able to understand and manage new technologies, business models, and risks. This goal can be achieved in various ways. In recommendation 7, the BCBS mentions the adjustment of training programs and hiring policies. In addition, BAFT suggests that agencies identify existing expertise and incentivize the transfer of knowledge from those experts to other staff. Agencies also should provide various informal and formal opportunities for staff training and encourage wide staff participation.

Interaction with other regulators/supervisors and private sector stakeholders, as alluded to in recommendations 5, 6, and 10, is a particularly effective way for agency staff to gain knowledge. BAFT suggests that regulators/supervisors establish a staff exchange program and engage in more frequent and targeted outreach. In addition, BAFT supports the organization of innovation hubs, accelerators, and regulatory sandboxes for the use of incumbent banks, new entrants, and technology companies alike, as they reduce the expenditure of resources during the innovative process. However, we note that these publicly-organized mechanisms are not a substitute for privately-lead initiatives, like industry sandboxes, in which regulators/supervisors can also participate.

BAFT supports recommendation 8 because the exploration and adoption of supotech by regulators/supervisors will contribute to their understanding of innovative technologies and increase

their efficiency and effectiveness in carrying out their mandate. BAFT has advocated for the use of suptech by financial intelligence units in particular. Suptech and regtech are complimentary and benefit the entire financial services ecosystem. Relationships improve as the public and private sectors work toward the same goal.

III. Conclusion

In closing, we thank the BCBS for its consideration of our comments and contributing to the construction of a rational policy framework governing banking activities. BAFT appreciates the opportunity to provide its thoughts on the BCBS's Consultative Document and to advance the dialogue on these issues. If you have any questions or require further information regarding our comments, please contact Samantha Pelosi, Senior Vice President for Payments and Innovation at spelosi@baft.org or (202) 663-5537.

Very truly yours,

A handwritten signature in black ink that reads "Tod R. Burwell". The signature is written in a cursive, flowing style.

Tod R. Burwell
President and Chief Executive Officer