October 30, 2017

Re: Comments on consultative paper “Implications of fintech developments for banks and bank supervisors”

Dear Madam/Sir

Duff and Phelps appreciate the opportunity to comment on the Basel consultative paper “Implications of fintech developments for banks and bank supervisors” dated August 2017.

We would be pleased to further discuss our comments with the Basel Staff. Please direct any questions to either of us via the contact information set forth below.

Sincerely,

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Observation 1: *The nature and the scope of banking risks as traditionally understood may significantly change over time with the growing adoption of fintech, in the form of both new technologies and business models. While these changes may result in new risks, they can also open up new opportunities for consumers, banks, the banking system and bank supervisors.*

Recommendation 1: Banks and bank supervisors should consider how they balance ensuring the safety and soundness of the banking system with minimizing the risk of inadvertently inhibiting beneficial innovation in the financial sector. Such a balanced approach would promote the safety and soundness of banks, financial stability, consumer protection and compliance with applicable laws and regulations, including anti-money laundering and countering financing of terrorism (AML/CFT) regulations, without unnecessarily hampering beneficial innovations in financial services, including those aimed at financial inclusion.

Comments

We support the development of a regulatory environment that provides the flexibility necessary to foster innovation while balancing the safety and soundness of the financial system.

We recommend that the regulatory framework established by different regulators should consider the different levels of sophistication of fintech companies. The level of sophistication of fintech companies should be measured in terms of the quality of business plans, governance, risk management. compliance, financial inclusion programs, capital, etc. Minimum standards, should be established for managing significant operational risks such as AML risk, cyber risk, compliance risk, valuation risk, etc.

We recommend that regulators should encourage the adoption of a fair value approach for fintech companies that originate loans (consumer, small business, student, real estate, etc.) for sale to regulated banks. Fair value accounting has proven highly valuable in promoting objectivity, transparency and market discipline. Fair value accounting is specifically relevant for products originated by fintech companies since neither the companies nor their products have a sufficiently long performance history through different market cycles.

The regulatory framework should be a function of the type of fintech company. For example, there are fintech companies that provide services similar to a bank and as such should be subject to the appropriate banking regulation for similar risk types (e.g. AML risk, faulty credit scoring risk models, etc.). Separately, there are fintech companies that provide products or services to banks (e.g. mobile banking interfaces, payment services, loan origination customer front-ends, etc.) and as such would not necessarily be subject to the same regulation as fintech companies who provide services similar to banks. The degree of sophistication of a fintech company providing technology or services to a bank needs to be a factor that is incorporated into a bank’s risk management process which is designed to protect the bank against loses from implementing a new technology or service.

The regulatory framework should recognize that fintech companies are at different stages of their evolution and will have a level of maturity that is much different from a bank that already has a mature, well defined and tested business model.

To avoid complicating the regulatory environment, there could be a relatively low number of maturity levels. For example, a fintech company providing services similar to a bank can be classified as follows:

- Low - Start-up company with a relatively small number of customers served and no impact on financial markets systemic risk;
- Medium - Company that is a recognized player in its space and may have some impact on financial markets systemic risk in one country in case of distress; or
- Large –Company that is either public or a leader in its given market and may have a material impact on financial markets systemic risk in case of distress.

For each maturity level we suggest that regulators provide a road map of expected best practices in terms of governance, risk management, compliance, financial inclusion, capital, liquidity and risk modeling. The regulatory approach shouldn't be too prescriptive. Nevertheless, we suggest that fintech companies that have a viable business model and are becoming more significant players in their market would benefit from a listing of what regulators consider best practices as they develop and mature.

Observation 2: *For banks, the key risks associated with the emergence of fintech include strategic risk, operational risk, cyber-risk and compliance risk. These risks were identified for both incumbent banks and new fintech entrants into the financial industry.*

Recommendation 2: Banks should ensure that they have effective governance structures and risk management processes in order to identify, manage and monitor risks associated with the use of enabling technologies and the emergence of new business models and entrants into the banking system brought about by fintech developments. These structures and processes should include:

- **robust strategic and business planning processes that allow banks to adapt revenue and profitability plans in view of the potential impact of new technologies and market entrants;**
- **sound new product approval and change management processes to appropriately address changes not only in technology, but also in business processes;**
- **implementation of the Basel Committee’s Principles for sound management of operational risk (PSMOR) with due consideration to fintech developments; and**
- **monitoring and reviewing of compliance with applicable regulatory requirements, including those related to consumer protection, data protection and AML/CFT when introducing new products, services or channels.**

Comments

As mentioned in observation 2, key risks associated with the emergence of fintech companies for both incumbent banks and new fintech entrants in the financial industry include business risk, strategic risk, reputational risk, operational risk, cyber risk, valuation risk, and systemic risk. We support the recommendation that banks **should ensure that they have effective governance structures and risk management processes brought about with the use of enabling technologies and the emergence of new business models and entrants into the banking system brought about by fintech developments**.

We suggest that an important component of managing these key fintech related risks is to clearly define and construct a taxonomy of risk that can be used to guide the development of effective governance structures and risk management processes. Risk factors can be broadly grouped into major categories. For example, we recommend that:

- **Business risk** should refer to the classic risks of the world of business, such as uncertainty about the demand for products, competition, market or product shifts, or the price that can be charged for those products, or the cost of producing and delivering products. However, there remains the question of how business risk should be addressed within formal risk management frameworks that have become prevalent in the financial industries. Although business risks should surely be assessed and monitored, it is not obvious how to do this. There is also room for debate over whether business risks need to be supported by regulatory capital.

  Business risk is affected by factors such as the quality of the strategy and related reputational risks. Therefore, some view strategic and reputation risks as components of business risk, and the risk literature sometimes refers to a complex of business/strategic/reputation risk.

- **Strategic risk** should refer to the risk of significant investments for which there is a high uncertainty about success and profitability. It can also be related to a change in the strategy of a financial institution vis-a-vis its competitors. If the venture is not successful, then the financial institution will usually suffer a major write-off and its reputation among investors will be damaged.

- **Reputation risk** should refer to two main classes: the belief that a financial institution can and will fulfill its promises and the belief that the financial institution is a fair dealer and follows ethical practices. Financial institutions are under increasing pressure to demonstrate their ethical, social and environmental responsibilities. Reputational risk has become prominent with the rapid growth of public and social networks. Anybody can spread a rumor over the Net and the viral spread of news, the use of talkbacks on digital news pages, and the growth of blogs, can all create headaches for corporations trying to maintain their reputation. Reputation risk poses a special threat to financial institutions because the nature of their business requires the confidence of customers, creditors, regulators and the general market place. The development of a wide array of products, has put pressure on the interpretation of accounting and tax rules, and, in turn, has given rise to significant concerns about the legality and appropriateness of certain transactions. Involvement in such transactions may damage an institution's reputation and franchise value.

The importance of the first form of reputation risk is apparent throughout the history of banking and was a dramatic feature of the 2007-9 crisis. At a time of crisis, when rumors spread fast, the belief in a financial institution's soundness is the key to maintaining market access and being able to continue serving customers.

The second form of reputation risk, for fair dealing, is also vitally important and took on a new dimension around the turn of the millennium following accounting scandals that defrauded the shareholders, bondholders and employees of many major corporations during the late 1990s boom in the equity markets.

- **Operational risk** should refer to potential losses resulting from a range of operational weaknesses including inadequate systems, management failure, faulty controls, fraud, and human error. Cyber risk *is a special form of operational risk. Human factor risk* is also a special form of operational risk. It relates to the losses that may result from human errors such as pushing the wrong button on a computer, inadvertently destroying a file, or entering the wrong value for the parameter input of a model. Operational risk also includes fraud, for example, when a trader or other employee intentionally falsifies and misrepresents the risks incurred in a transaction. Technology risk, and principally computer systems risk, also falls into the operational risk category. Legal and regulatory risk arises for a whole variety of reasons, and is closely related to operational risk as well as to reputation risk. Legal and regulatory risks are classified as operational risks under Basel Capital Accord.

- **Valuation risk** should refer to the unique challenges that occur in the valuation process. Accrual accounting in certain cases may suppress the reporting of losses and reduce the incentives for voluntary disclosure. As we pointed out earlier, fair value accounting is particularly relevant for products originated by fintech companies since they do not have a sufficiently long performance history through different market cycles. Regulators should encourage supplemental disclosure for fair value disclosure to avoid discouraging actions that may be necessary to resolve a crisis.

- **Systemic risk** should refer to the concerns the potential for the failure of one institution to create a chain reaction or domino effect on other institutions and consequently threaten the stability of financial markets and even the global economy.

  Systemic risk may be triggered by losses at an institution. However, simply the perception of increased risk may lead to panic about the soundness of an institution, or to a more general "flight to quality" away from risky assets and towards assets perceived to be less risky. This may cause serious market disruptions to propagate across otherwise healthy segments of the market. In turn, these disruptions may trigger panicked "margin call" requests, obliging counterparties to put up more cash or collateral to compensate for falling prices. As a consequence, borrowers may have to sell some of their assets at fire-sale prices, pushing prices further down, and creating further rounds of margin calls and forced sales.

The many interconnections and dependencies among financial firms, in both the regulated and unregulated sectors, exacerbate systemic risk under crisis conditions. The failures and near-failures of several banks during 2007-2009 all contributed to systemic risk through creating massive uncertainty about which of the key interconnections would transmit default risk.

The size of an institution that is in trouble can lead to panic about the scale of the default, and this may be perceived a relatively remote issue given the size of most fintech companies. However, market participants may fear that large-scale liquidations will disrupt markets, break the usual market interconnections, and lead to a loss of intermediation functions that then may take months, or years, to rebuild.