



HIGHER SCHOOL OF ECONOMICS
National Research University
(Moscow, Russia)
<http://www.hse.ru/en/>

October 31, 2017

Basel Committee on Banking Supervision
Email: baselcommittee@bis.org

Dear Colleagues,

Basel Committee on Banking Supervision Consultative Document
Implications of Fintech Developments for Banks and Bank Supervisors

On behalf of The National Research University Higher School of Economics we would like to thank The Basel Committee on Banking Supervision for the opportunity to deliver our opinion on the Consultative Document '*Implications of fintech developments for banks and bank supervisors - consultative document*' issued by the Basel Committee on Banking Supervision on August 31, 2017 and available at the following URL: <http://www.bis.org/bcbs/publ/d415.htm>.

In order to deliver a representative opinion of the Russian Federation banking community we have arranged a workshop on October 25, 2017 within the Institute of Control Sciences of Russian Academy of Sciences. More than 60 colleagues attended the workshop from both academic community and credit institutions. We acknowledge participants for their active discussion and expression of their opinions.

Our key message is that fintech progress is mere new form of already known processes that have not indeed paid back the return on investments; fintech projects being similar to 'noisy traders' concept may lead to significant losses economy-wide when critical mass of people is involved. This does not imply the need for more regulation - economic agents should take the responsibility for their own actions, and profits may be shared only when losses are also shared.

Please, find attached additional comments of general and granular nature below.

Do not hesitate to contact us if additional comments are needed.

Yours sincerely,

Fuad ALESKEROV

Email: alesk@hse.ru;

URL: <https://www.hse.ru/en/org/persons/140159>

Henry PENIKAS

Email: penikas@hse.ru;

URL: <https://www.hse.ru/en/staff/penikas>

General Comments

1. Observation 1 (p. 22) states that fintech adds value as enables approaching under-served clients. Nevertheless, modern fintech projects, namely those related to lending, suffer from the problems in debt collection.
 - Credit risk has increased – though not properly understood by everyone – as now one has to collect from a lot of retail borrowers. This is much harder comparing to collection from several large corporate borrowers. Particularly, marginal retail debt collection costs may often exceed debt notional making it non-reasonable to even sue the debtors.
 - There are arguments that borrowers still pay when having borrowed at fintech projects. For a debt to be redeemed there might be two main reasons. First, a borrower is willing to create sustainable credit history to be able to borrow later in potential hope not to pay back. Second, there might be some incentives for a borrower to pay on its loan. Those incentives may be related to previously not introduced term of “fixed-price-free economy”, i.e. the economy where there are no predetermined fixed prices and the consumer pays upon consumption as much as she is willing to. Such effects may be observed when the agents are rich enough or have high intellectual potential; otherwise there might be incentives of exclusion from the community in case the obligation is not fulfilled.
 - One may add that obligations in “fixed-price-free economy” is a symbol of trust for that system, i.e. high degree of trust (induced either by intellect, richness or exclusion enforcement) is needed to promote voluntarily debt redemption. When overall the degree of trust in modern society decreases, it is non-reasonable to expect trust to rise in such a sensitive area like finance.
 - Lending fintech-projects are de facto “fixed-price-free economy” examples as only borrowers decide whether to pay back or not as no efficient collection mechanism can be utilized. Those lending fintech projects focus on mass retail market. That is why wealthy individuals do not have a reason for debts to be paid back. Internet-nature (or location) of most lending fintech-projects also does not permit any enforcement of the sort of community exclusion (social networks are frightened to block personal account say when debt is past due only because the user is to switch to alternative network; same issue was observed prior to subprime crisis of 2007 when credit rating agencies were so to say forced to assign AAA-ratings as otherwise bond and CDO issuers were to switch to competing rating agencies).
 - Thus all that rests for the lending fintech-projects as the reason for debt redemption is the intention to borrow more later and potentially not pay that larger amount back. This is the core mine of the recently observed boom and prosperity driven by fintech activity.
2. Observation 2 (p. 27) mentions inter alia that the intermediation business model is to completely change, i.e. from retail funding and wholesale lending to wholesale funding (particularly, from institutional investors) and retail lending. This is to bring significant losses from interest rate risk perspective.
 - Conventional intermediation business model was driven by the upward-sloping yield curve. Retail funding is mostly short and is assigned low interest rates. Wholesale lending is on opposite long and results in interest rates higher than those for short funding. This produces positive interest margin of high interest rates on loans and low interest rates on deposits (funding).
 - Deflation scenario (e.g. for the EU and Japan) is characterized by an inverted yield curve with higher interest rates for shorter maturities and lower interest rates for longer maturities. Shift in intermediation model is fully in line with that

inverted yield curve as wholesale funding as well as lending is mostly longer in maturity, than the retail lending. Thus, the interest margin is also positive as funding is assigned low interest rates and lending scores high ones.

- Nevertheless, inverted yield curve is typical for an economy in recession or stagnation, but not a growing one. This means when the yield curve is to shift back to upward slope (e.g. when QE programs are abandoned), the interest margin is to become negative for lending fintech projects as longer wholesale funding would be assigned higher price and short-term retail lending would start delivering low yields.
 - This would be a second significant blow to fintech projects.
3. Observation 9 (p. 35) proposes that regulation should not be a constraint for innovations. To promote ones and to provide sustainability one should not ensure the efficiency and soundness of regulation, but to simplify and reduce one.
- Long discussions dating back to 1980s cover the issue of proper credit and market risks regulation; trading and banking books definitions; options to prevent regulatory arbitrage. Nevertheless, due to the complexity of recent regulation (total number of documents published by the Basel Committee in 43 years equals 635 with page volume of 21'269), much more room for arbitrage is in fact possible as it becomes mostly impossible to verify bank computations.¹
 - That is why for proliferating financial soundness one has to abandon differentiation of credit and market risk regulations. In case one wishes to have a prudential ratio, one may limit herself to a ratio of equity to balance and off-balance sheet assets (leverage ratio is not mentioned due to complexities of capital and exposure computations, which are simpler still than that for a risk-weighted ratio). We should not forget that corporates also raise debt and also face bankruptcies. It is the responsibility of management, shareholders and counterparties as well as clients and consumers to decide whether they wish to transact with an entity.
 - If one wishes to keep option for regulatory step-in, as Peter Cooke announced in 1980s, regulation should switch to prudential ratio targeting, not flooring. Operationally one should penalize banks not in case when the minimum is breached, but when then bank deviates X% from its target Z% ratio. The important point is that a bank is to announce X, Z% to regulator. Those may vary from bank to bank, but it should be personal responsibility. Another point is that regulatory actions may be activated not only in case of downward breach, but an upward breach also (scoring profit too fast might be a signal for a financial pyramid).
 - Thus overall regulation has to be simplified and abandoned in most cases. Basel paper "Bank Failures in Mature Economies" (2004) postulates that exactly regulation relaxation led to crisis. The statement is incorrect as in all the described cases of real estate bubbles bursting no one forced banks to accelerate risk-taking. That was only the intent of banks that knew they were only to meet prudential requirements. When no requirements are in place, one starts thinking over what its optimal capital and liquidity ratio levels should be.
4. The whole document is focused on banks. Though nothing is said about fintech applications for insurance (i.e. *insurtech*) as insurance activities are often included as a

¹ For more information, please, refer to Penikas, Henry, History of Banking Regulation as Developed by the Basel Committee on Banking Supervision in 1974-2014 (Brief Overview) (2015). Financial Stability Journal of the Bank of Spain, May 2015, No. 28, pp. 9-48. Available at SSRN: <https://ssrn.com/abstract=2623739>.

branch or subsidiary of a bank holding company. This means that risks are higher than expected.

- Lending fintech projects focus on credit risk on the asset side of a balance sheet. There are other risks, including liquidity, interest rates ones and others, but credit risk is the predominant.
- Insurance activities result in liability-side risks, i.e. underwritten premiums. There are also other risks, including market or investment, liquidity ones etc.
- Thus from risk aggregation perspective the tail exposures significantly increase when one combines asset-side and liability-side risks. One may imagine an Internet project that is not limited to lending, but also underwrites insurance contacts. In that case risks of such project insolvency are underestimated today.

Technical Comments

5. Observation 1 (p. 23) mentions that technology may help in finance inclusion proliferation on the basis of the fact that only 6 out of 10 people on average have bank accounts, but the number of mobile phones exceeds humankind population. The comparison is incorrect.
 - The majority of devices mentioned corresponds to developed countries. Some smartphone producers enable connecting up to 15 devices per one person e-account.
 - That is why high number of devices does not imply the potential for financial inclusion in developing countries.
6. Observation 8 (p. 35) mentions supervisor website where data anomalies were identified. It would be good to share URL for the website for the possibility to analyze in greater detail the experience mentioned.