UK Finance Response – BIS Consultation: Implications of FinTech developments for banks and bank supervisors

15 September 2017

Introduction

1. Innovation in financial services is not new. Banks and other financial institutions have been introducing innovations for years. However, the speed of that innovation has accelerated in recent years as the application of new technologies allows for new products and processes to be rolled out quickly. The use of technology has also reached new levels of integration in the financial system.
2. The attention of regulators has turned toward the role of technology in financial services in response, with a number of initiatives underway to both better monitor technology use, but also to encourage technology enabled financial innovation. The industry welcomes the intervention of the Financial Stability Board (FSB) in its paper in April 2017 as well as the ideas put forward in this consultation document from the Basel Committee on Banking Standards (BCBS).
3. FinTech, as defined by the FSB, remains nascent. Robust regulatory regimes exist in many jurisdictions and it is the view of the industry that these remain sufficient for ensuring the proper management of the risk generated by FinTech activities. What is most needed both in order to better manage risk, but also to facilitate and encourage innovation, is the harmonisation of those regulatory regimes as they apply to FinTech. In so doing, it must be remembered that the goal should be to find a proper balance that allows innovation to flourish while not adding undue risk to the system.

Detailed response:

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 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 minimising 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.

Industry Response 1:

4. The industry welcomes the focus on achieving a balance between regulating against risk and allowing for beneficial innovation. It has been observed that the tendency to focus on risk at times obscures the benefits of technological innovation, especially its ability to assist in compliance in the areas of regulatory reporting, cyber security and AML/CTF activities. Such is the potential of new technology that it could be argued that failure to innovate and transform poses a larger risk to the financial system and its participants than the technologies being used to achieve that transformation.
5. The industry is also concerned that innovation is being driven outside of the regulatory purview and that firms using technology innovations are seeking to arbitrage regulations. This is a concern for the broader

industry because any damage to consumer confidence in financial services delivered through digital channels will ultimately hinder the ability of firms to bring innovation to their customers, both consumers and businesses.

6. The BCBS has correctly identified the need for flexibility in regulation and standards to allow for innovation (p.24). The industry agrees that often outdated rules are too prescriptive, creating barriers or frictions to the use of new technology. We believe that it is possible to allow the required level of flexibility without compromising consumer protection, which, were it violated, could erode consumer trust thereby damaging the ability of FS firms to introduce new technology enabled innovation. We maintain that regulators should consider a programme of revision in order to ensure that flexibility is embedded in existing regulations and standards (e.g. the EBA's revision of its CEBS outsourcing rules expected in 2018). Future reviews of regulation should focus on outcomes and services provided as well as harmonisation with approaches taken in other jurisdictions. This will require cross-border cooperation, including with non-financial services regulators.

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.

Industry Response 2:

7. The industry agrees with the risks identified, namely strategic, operations, cyber and compliance. We also agree that these risks apply to all firms including new market entrants. However, technology holds not only risk, but potential solutions to these challenges. For instance, the use of advanced threat analytics to help firms counter cyber risk. Regulators must be sure to balance the responsible exploration of technology solutions, while also ensuring risks are properly addressed.

8. Banks have different risk appetites that underpin or allow for different business models. These are part of their differentiation strategies in a competitive market and will affect what technologies they use and how they choose to use them. To support this, banks have well-developed governance structures and risk management processes for new technologies, and are working to improve these on a continuous basis. However, the variation in regulation across jurisdictions remains a major challenge for technology risk. For instance, diverging cloud computing requirements make it difficult for banks to set a group policy that would more effectively allow them to control and monitor risk. The Basel Committee should consider how it can encourage harmonisation of regulation in this area, including IT Risk.

Observation 3: Banks, service providers and fintech firms are increasingly adopting and leveraging advanced technologies to deliver innovative financial products and services. These enabling technologies, such as artificial intelligence (AI)/machine learning (ML)/advanced data analytics, distributed ledger technology (DLT), cloud computing and application programming interfaces (APIs), present opportunities, but also pose their own inherent risks.

Recommendation 3: Banks should ensure they have effective IT and other risk management processes that address the risks of the new technologies and implement the effective control environments needed to properly support key innovations.

Industry Response 3:

9. We agree that technology offers both opportunities and risks. These vary based on the market in which a company is operating, the technology being deployed, and the purpose for which it is being deployed. The level of variation means that there is no one-size-fits-all means for managing risk. The best approach will be proportional to the risk incurred. Flexibility needs to be embedded in regulation to ensure that risk-based approaches can be used. It is also essential that international regulators monitor jurisdictional regulation to ensure there is no conflict in requirements that could ultimately increase risk.

10. On demand computing resource is becoming ubiquitous not just in financial services, but in business and society generally. The BCBS is thus right to identify cloud as a key FinTech enabling technology. However, should the BCBS consider further attention to supervision in this area as suggested on page 32, we would emphasise the importance of harmonisation across jurisdictions. The nature of cloud computing, which transcends national borders, means that the only truly effective way to regulate its use without hindering FinTech innovation is to take a harmonised approach.

Observation 4: Banks are increasingly partnering with and/or outsourcing operational support for technology-based financial services to third-party service providers, including fintech firms, causing the delivery of financial services to become more modular and commoditised. While these partnerships can 6 Implications of fintech developments for banks and bank supervisors arise for a multitude of reasons, outsourcing typically occurs for reasons of cost-reduction, operational flexibility and/or increased security and operational resilience. While operations can be outsourced, the associated risks and liabilities for those operations and delivery of the financial services remain with the banks.

Recommendation 4: Banks should ensure they have appropriate processes for due diligence, risk management and ongoing monitoring of any operation outsourced to a third party, including fintech firms. Contracts should outline the responsibilities of each party, agreed service levels and audit rights. Banks should maintain controls for outsourced services to the same standard as the operations conducted within the bank itself.

Industry Response 4:

11. Regulators in the UK and the EU have recently updated or are in the process of updating their guidance for outsourcing, specifically in the context of cloud computing. Although these updates have been welcomed by the industry and are a positive step forward, they remain targeted at all forms of outsourcing and not specific enough to the realities of cloud computing. In addition, the lack of harmonisation at the international level makes efforts on a regional or individual jurisdiction basis only partially effective.

12. The BCBS correctly identifies outsourcing risk as a key area of increasing importance. However, there is a need for proportionality to be more firmly embedded into regulatory approaches, especially in regard to reporting requirements. We recommend that materiality is the key distinguisher as to whether an outsourcing needs to be recorded or reported. **The definition for materiality in this context could usefully be set by the BCBS in consultation with industry in order to encourage a harmonised approach internationally.**

13. As an example, consider the case of a PDF editing programme downloaded by an employee at a global bank. This outsourced tool is non-critical, easily replaceable and may even be free or of negligible cost. According to recently proposed rules in a certain jurisdiction, a firm would need to keep a register of all outsourced products to be reported to a National Competent Authority (NCA) upon request. We believe that such an approach creates frictions in the adoption of technology in financial services out of proportion to the risk they represent.

Observation 5: Fintech developments are expected to raise issues that go beyond the scope of prudential supervision, as other public policy objectives may also be at stake, such as safeguarding data privacy, data and IT security, consumer protection, fostering competition and compliance with AML/CFT.

Recommendation 5: Bank supervisors should cooperate with other public authorities responsible for oversight of regulatory functions related to fintech, such as conduct authorities, data protection authorities, competition authorities and financial intelligence units, with the objective of, where appropriate, developing standards and regulatory oversight of the provision of banking services, whether or not the service is provided by a bank or fintech firms.

Industry Response 5:

14. The industry recognises that technology raises risks in AML/CTF compliance. However, we believe the benefits that technology can bring to this area exceed the risks. Automation and technology solutions to AML/CTF compliance as well as to other areas of regulatory reporting and monitoring have the potential to make processes more efficient and effective for both regulators and firms.
15. The industry believes there is an urgent need to ensure coordination across regulatory bodies, particularly between financial regulators and data protection authorities. This is necessary to control risk, but also to ensure that firms are enabled to bring forward technology enabled innovation which, as identified, will increasingly touch on regulations outside of the traditional scope of financial services regulators.
16. In addition, regulators may not be able to continue to accept the activity of firms that operate outside of financial regulation. The scale of some large technology businesses, commonly referred to as BigTech, means that even minor financial services activity undertaken by these companies should be of the highest interest to regulators. From the perspective of both prudential risk and consumer protection, this is a topic that deserves immediate attention.

Observation 6: While many fintech firms and their products – in particular, businesses focused on lending and investing activities – are currently focused at the national or regional level, some fintech firms already operate in multiple jurisdictions, especially in the payments and cross-border remittance businesses. The potential for these firms to expand their cross-border operations is high, especially in the area of wholesale payments.

Recommendation 6: Given the current and potential global growth of fintech companies, international cooperation between supervisors is essential. Supervisors should coordinate supervisory activities for cross-border fintech operations, where appropriate.

Industry Response 6:

17. Financial services firms support efforts to coordinate regulatory activity in this area. Given the cross-border nature of technology and that many of the benefits of deploying technology can only be achieved at scale, we consider that this is a particularly important area for regulatory cooperation and, ultimately, harmonisation. The Basel Committee should take a leading role in addressing some of the key concerns around IT regulation, notably the definition of materiality, concentration risk and best practices for IT risk. There exist a number of models through which harmonisation could be pursued, for instance supervisory colleges, international bodies and the Single Supervisory Mechanism in the EU.

Observation 7: Fintech has the potential to change traditional banking business models, structures and operations. As the delivery of financial services becomes increasingly technology-driven, reassessment of current supervision models in response to these changes could help bank supervisors adapt to fintech-related developments and ensure continued effective oversight and supervision of the banking system.

Recommendation 7: Bank supervisors should assess their current staffing and training models to ensure that the knowledge, skills and tools of their staff remain relevant and effective in supervising new technologies and innovative business models. Supervisors should also consider whether additional specialised skills are needed to complement existing expertise.

Industry Response 7:

18. Business models will continue to change rapidly as the result of technology innovation. Regulators will need to respond by adapting their supervision models. However, more important will be for supervisors to have access to the correct skills. Given the competitive landscape for expertise in FinTech this may not be easy for even the largest and most well-resourced regulators to accomplish. Therefore, effort should be spent on developing skills and talent among existing staff or offering training as a way to make the regulator a more desirable place for those looking to develop relevant skills in this area.

19. In addition, regulators should be prepared for business models to not simply change to a new model as the result of FinTech, but for business models to become more fluid across the market. Therefore, principle based regulation focused on outcomes will be increasingly important to allow regulators to exercise effective oversight across a range of entities they supervise.

Observation 8: The same technologies that offer efficiencies and opportunities for fintech firms and banks, such as AI/ML/advanced data analytics, DLT, cloud computing and APIs, may also improve supervisory efficiency and effectiveness.

Recommendation 8: Supervisors should consider investigating and exploring the potential of new technologies to improve their methods and processes. Information on policies and practices should be shared among supervisors.

Industry Response 8:

20. Supervisors should actively explore the potential of technology to make regulatory reporting and monitoring more efficient and effective. Establishing best practice and ensuring the diffusion of learnings among other regulators is also vital. This is important not only to strengthen global regulation and achieve harmonisation, but also to avoid regulatory arbitrage that hinders the growth of FinTech solutions and effectively excludes some consumers.

21. It is also important that regulators work with firms in these developments. Many global firms will be able to provide insight into practices in other jurisdictions which will be valuable to regulators looking to develop compatible solutions.

Observation 9: Current bank regulatory, supervisory and licensing frameworks generally predate the technologies and new business models of fintech firms. This may create the risk of unintended regulatory gaps when new business models move critical banking activities outside regulated environments or, conversely, result in unintended barriers to entry for new business models and entrants.

Recommendation 9: Supervisors should review their current regulatory, supervisory and licensing frameworks in light of new and evolving risks arising from innovative products and business models. Within applicable statutory authorities and jurisdictions, supervisors should consider whether these frameworks are sufficiently proportionate and adaptive to appropriately balance ensuring safety and soundness and consumer protection expectations with mitigating the risk of inadvertently raising barriers to entry for new firms or new business models.

Industry Response 9:

22. The industry welcomes the move toward ensuring that there are no unintended regulatory gaps that can be exploited by new business models to offer banking activates outside the purview of the regulated environment. There are specific activities that do warrant careful attention by regulators, regardless of who is engaging in the activity – namely payments, lending activities, and data storage – as the risks associated with these activities have far reaching impacts to consumers and the broader financial system. We believe that the existing regulatory framework, especially as bolstered in Europe through the Payments Services Directive 2, the General Data Protection Regulation and the Network and Information Security Directive, is appropriate for the majority of FinTech activities.

23. However, we would also like to emphasise that beyond the risk of regulatory gaps and potential barriers to entry, insufficient regulatory scrutiny of new firms raises the risk of hurting consumer trust in financial services delivered through digital channels. Trust is vital in the digital world and therefore it is essential for the future of these services that activities being conducted in this space are supervised by regulators to ensure positive outcomes for consumers.

24. Finally, we believe that it is important to avoid a two-tier regulatory approach. Given the pace of technology change and the likelihood that business models will continue to evolve, divergent regulatory approaches would in fact create opportunities for exploiting unintended regulatory gaps. For further discussion of this topic please see UK Finance's forthcoming response to the ECB's guidance for FinTech credit institution licence applications.

Observation 10: The common aim of jurisdictions is to strike the right balance between safeguarding financial stability and consumer protection while leaving room for innovation. Some agencies have put in place approaches to improve interaction with innovative financial players and to facilitate innovative technologies and business models in financial services (e.g. innovation hubs, accelerators, regulatory sandboxes and other forms of interaction) with distinct differences.

Recommendation 10: Supervisors should learn from each other's approaches and practices, and consider whether it would be appropriate to implement similar approaches or practices.

Industry Response 10:

25. The industry would welcome greater cooperation between National Competent Authorities in this area. There is a risk that in the effort to encourage innovation some jurisdictions will create the opportunity for regulatory arbitrage. At the European level, the EBA is considering how to avoid this outcome within the EU. However, FinTech is global and the risk of regulatory arbitrage is perhaps greatest inter, rather than intra, regions. The Basel Committee could contribute to ensuring strong standards are in place globally by producing a best practice for regulators operating such initiatives as those listed in observation 10.

26. One practice that the industry wishes to encourage is the use of FinTech bridges; connections between regulators that facilitate the movement of firms or regulatory ideas between jurisdictions. We believe these are a good way to encourage the growth of FinTech, both in the form of start-ups active in this area, but also new products and services provided by banks and other financial institutions. However, it is essential the regulatory learnings are passed through these bridges in a meaningful way. To show this and to encourage harmonisation, we recommend that annual reports be produced by the various sandboxes which lay out the regulatory learnings gained from exposure to new business models or products and how these have been shared with other regulators.

27. In addition, it is important that regulators within jurisdictions coordinate their innovation facilitating activities. FinTech innovations are unlikely to be subject to only one supervisory body and many will need to consider the regulatory regimes relating to, for example, consumer protection, data privacy and prudential at the same time. A current limitation in the facilitation of innovation in a number of different jurisdictions is that isolation to a single regulator limits the kind of products or the scope of testing that can be undertaken. This is especially the case for established firms supervised by multiple regulators.