Asociación Española de Banca

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AEB Response to BCBS Consultative Document on Sound Practices: Implications of fintech developments for banks and banks supervisors

General Comments report

The Spanish Banking Association (AEB) appreciates the opportunity to comment on the consultative document published by the Basel Committee on Banking Supervision (BCBS), *Sound Practices: Implications of fintech developments for banks and bank supervisors*.

We acknowledge this document provides a valuable description of the challenges facing current banking models in relation to technological innovation. In addition, we value positively the recommendations issued to banks and supervisors so that they can address the opportunities and risks of this new environment, taking the necessary measures to ensure a balance between ensuring the safety and soundness of the banking system with minimising the risk of inadvertently inhibiting beneficial innovation in the financial sector.

We also support the adoption of the FSB definition of a "fintech institution", since this broad definition aims to promote a level playing field holding fintech banks accountable to the same standards as other banks. However, in the description of the fintech landscape, the BCBS seems to identify fintech firms with smaller new entrants, without encompassing banks or big technological companies (BigTech). This seems inconsistent with the definition of fintech and may result in an overestimation of the short-term impact of start-ups and an underestimation of that of BigTech companies.

One of the relevant sections of the consultative document focuses on describing forward-looking scenarios. In our view, the combination of scenarios or situations that may arise in the future will depend on the banks' capacity and agility to implement the necessary transformation processes.

While some of the success will depend on the strategic decisions made at individual basis – potential changes in organisation and internal structures, not only from the point of view of modernising IT infrastructures, but also regarding new talent and internal culture -, in our opinion the role of banking regulation is crucial to overcome the challenges introduced by the new fintech environment.

The process of transformation of banks cannot be carried out efficiently if no measures are taken to:

- guarantee a level playing field, either by eliminating unnecessary barriers to traditional players or by regulating and supervising all participants according to activities and risks;
- apply the principle of technological neutrality in all regulations.

- to encourage innovation and the creation of fintech ecosystems by developing environments where supervisors and market players can establish a continuous and open dialogue on the evolution of technologies and their impact on businesses.

Of the scenarios described in the Consultative document, the scenario 1 is undoubtedly the most desirable for the banking industry, which would be able to use the maximum potential offered by new technologies to improve efficiency in its processes and adapt its product offering to new customer needs. Nevertheless, as mentioned above, it should be considered the contribution of the regulatory framework to the greater or lesser flexibility of the banking industry to deal with opportunities offered by emerging technologies in an effective manner.

The process of bank transformation needed to adopt the new fintech challenges must necessarily be accompanied by a review of the role that banking prudential regulation and supervision play in explaining the main asymmetries between bank and non-bank players. European Banks, as deposit-taking institutions, are subject to prudential regulation (under the framework of the CRR/CRD) and supervision, which affect any activity within their consolidation perimeter. In many of these activities, regulated institutions now compete with non-bank players that are only subject to activity-specific regulation and supervision, at best, or are not even regulated, as seen in the mapping exercise conducted and published by the European Banking Authority (EBA) in their Discussion Paper on its approach to financial technology (FinTech).

Therefore, fintech activities are usually subject to more stringent regulation when they are performed within a banking group than if they are provided by other types of institutions. Some examples can be found in the European remuneration rules under the Capital requirements Directive and other rules on internal governance or in the banks' outsourcing approval processes that leave European banks in a situation of competitive disadvantage in terms of cost, time-to-market and talent attraction and retention.

We don't see very likely scenarios 2 and 5. While neo-banks of Scenario 2 are born without legacy systems and therefore may be more agile and cost efficient, they also face the same regulatory obstacles that prevent them from taking advantage of the full potential offered by new technologies. We therefore believe that these new banks are unlikely to completely replace traditional banks. Scenario 5 is also highly unlikely because it is difficult to think of a financial system fully disintermediated, not only because of the level of development and maturity of the DLT needed, but also because of the assumption that all financial clients prefer a full disintermediation.

Comments to specific recommendations

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.

We agree on this recommendation. As the Fintech world evolves at a high speed, banks and supervisors should monitor the emerging risks and act when needed. The financial innovations help to improve the quality and variety of banking services, complete the market and improve allocative efficiency. Therefore, given its expected gains, it is necessary to create a framework that enables innovation to reach consumers. In this strategy it is necessary to open a dialogue and collaboration between the industry and the supervisory agents. The active involvement of the various private providers, regardless of their size or nature (i.e. banks, technology companies, service providers or start-ups) should be promoted. This conversation, that must take place before any regulatory measure on emerging uses of technologies, will lead to a learning process where all stakeholders will be able to understand the needs and requirements of each other, allowing them to better manage the new types of risks that might arise in the most efficient manner, while preserving financial stability and ensuring customer protection.

This regulatory approach should be holistic (i.e. going beyond the financial sector and including non-financial regulators such as data protection, cybersecurity, etc.); risk-based (following the principle of same activities, same risks, same regulation) and flexible to adapt in the changing ecosystem.

We also agree with the need not to hamper innovation in banks. The regulatory framework should not be a barrier to this. It should allow banks to undertake their digital transformation. The main risk for financial stability is not that banks become digital, but that they don't.

Some of the barriers that banks currently experience on undertaking digital transformation relate to use of digital identity and digital onboarding processes, use of cloud services, prudential rules in some geographies such as the EU capital frameworks that apply full deduction to software, unbalanced requirements in access to data (obliging banks to open their data without similar requirements for other sectors), complex cybersecurity frameworks (with multiple authorities involved), unbalanced responsibility frameworks in payment services rules or consumer protection. These barriers are explained in the *European Banking Federation Vision for banking in the digital single market*[1] with an EU perspective, but are common to banking digital operations in many other jurisdictions.

We agree with the FSB that another driver of financial innovation has been changing financial regulation, in the sense that the reduction of bank's activities due to these rules has open a gap in the market that is increasingly being filled by new entrants. However, after-crisis financial regulation had an additional effect: being extremely detailed, it is now creating barriers for regulated entities to undertake their process in different ways. An example would be the PRIIPs regulation in the EU, where the exact format of the information document is mandated by authorities, avoiding the entity to adapt the communication means to each customer preferences.

[1] http://www.ebfdigitalbanking.eu/

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 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;*
- *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.*

We agree with BCBS Recommendation 2. At the same time, we understand that digitalization is creating a new reality and banks should be able to respond to their customers' new expectations. For this, a flexible framework from the point of view of supervisors is needed. The creation of experimentation frameworks such as sandboxes would be very helpful in this regard.

In this new ecosystem, the approach should be same activities, same risks, same rules, same supervision. We believe the framework would not be complete if third parties are not monitored.

Technology and digitalization allows to provide financial services in a new way, but also compromises the banking intermediation to channel funds from savings to investments. New participants only provide part of these services and for this reason are not subject to the whole set of rules applicable to universal banking. This, at its turn, means that they can provide the services at a more competitive pricing, compromising the capacity of the banks to compete in these segments. The risk is that in the future the most profitable services will be provided by specialized players, and customers will not find the possibility to access an integrated (universal) banking service, which is very valuable for customers and the economy.

We believe it is worth referring to the FSB report on Fintech[2]: "*FinTech innovations can potentially have an adverse systemic impact on the financial system, although there is no evidence of such an impact at present. An adverse systemic impact implies a risk to the provision of critical financial services. A major disturbance in these services, or a disintermediation of regulated entities providing them, can have potentially serious negative consequences for the real economy".* It also refers to the fact that *"Other oligopolies or monopolies may also emerge, for example, in the collection and use of customer information, which is essential for providing financial services*".

We support both FSB remarks and would like to point especially at the risk of systemic impact implicit by the disintermediation of regulated entities. The increased openness of bank's data without similar regulatory requirements for other players will mean that an

[2] http://www.fsb.org/wp-content/uploads/R270617.pdf

important value is being drained from banks assets. This will not only be in the benefit of small new entrants providing financial services but for BigTech companies that have the potential to replace banks, creating new oligopolies outside the supervisory perimeter. We believe that action should be taken by supervisors in two ways:

1. Widening the scope of their supervisory perimeter. As the FSB points out, the shadow banking framework could be useful for credit and lending service providers. However, there is no such monitoring framework for non-banks providing payment, clearing and settlement services and investment management services (as per BCBS classification)

2. Facilitate supervised entities to innovate at digital speed by streamlining the authorisations regime: limiting the cases where authorisations are required and favouring the adoption of innovative ideas (i.e. for the use of clouds, the evolution of risk models to artificial intelligence and innovative data use, the use of big data and biometry for AML purposes, etc)

We support the BCBS's approach to use the Principles for sound management of operational risk (PSMOR) framework to control for the operational risks arisen by technological developments. These are well established within banks and this will help introduce any additional monitoring needed in a more efficient way. At some point in time, digital transformation will happen across the whole organization and the integration of any risk in the PSMOR will also allow for a more holistic approach. PSMOR principles are covered by an advanced operational risk management that identify the principles related to governance, risk management framework (full cycle of management, resilience and business continuity) and the disclosure role related to our management. PSMOR also establish the roles of the supervisor, operational risk assessments that have to be performed periodically, possible actions needed for follow-up and incident resolution. It also includes the need to have an independent operational risk function and the existence of a third-line of defence controlling in an independent manner within the organization.

Considering proportionality and the risk we have noted, we believe that non-banks should also need to apply PSMOR principles in their functions, especially BigTechs that have the potential to spread the consequences of an incident to an important number of consumers and businesses.

Policies on management processes and internal governance should be applied proportionally. A risk-based approach that considers specific activity risks regardless the type of legal entity (i.e. banks, startups or BigTechs) is needed. Otherwise, there will be not promoted the same level playing field nor the adequate risk control at those institutions without these governance structures.

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*

The BCBS recommendation is welcomed, although it does not take into account the very different level of maturity of the enabling technologies analysed (AI/ML/data analytics, DLT and cloud).

DLTs are still at a very early stage of development, where banks are experimenting with them and their possible use cases. It is extremely difficult to assess thoroughly the impact of the blockchain/DLT in financial institutions services and processes and therefore, the need to "*implement the effective control environments*" as suggested by the document. It seems clear that such new technology may have a strong impact on costs in technology renew and it can lead to a deep reshape of training, processes, standards and business models. There will also be many regulatory challenges ahead. However, at the moment banks are testing these new technologies in controlled environments, and in many cases, the beta phase has not yet been reached.

In the case of cloud, the rate of adoption of this technology in the banking sector is significantly slower than desired and it is far away from the one taking place in other sectors. One of reasons is due to the different approaches from national financial supervisors and regulators that impose national barriers on data localisation and/or a burdensome process for financial outsourcing approval and therefore prevent to fully reap the benefits of this technology, especially for banks acting cross-border. Obstacles that are not faced by new non-bank entrants. Adoption of cloud computing among financial institutions is not only an opportunity, but it has become essential for their survival as these other players that have constructed their business on cloud continue to gain market share. Therefore, to support and facilitate the necessary adoption of cloud computing within the banking industry, financial regulators and supervisors should harmonize and clarify regulatory requirements in relation to cloud.

We agree that effective risk management processes are required to address this new technology. A common methodology to assess IT and Cyber Risk would simplify the compliance with all the emerging regulations (i.e.: NIS, SREP ICT Risk Assessment, Guidelines on the security measures for operational and security of Payments service under PSD2, GDPR, etc..) and grant that new risk are homogenously identified and managed.

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.*

We support the need to ensure that the increased openness to third-parties and outsourcing should be monitored by authorities.

In these regards, we support the FSB following remark[3]: "*Third-party service providers to financial institutions are quickly becoming more prominent and critical, especially in the areas of cloud computing and data services. The fact that many third-party providers may fall outside the regulatory perimeter places increased emphasis on the importance of managing*

[3] http://www.fsb.org/wp-content/uploads/R270617.pdf

related operational risks, which could ultimately undermine financial stability. In this regard, authorities should determine if current oversight frameworks for important third-party service providers to financial institutions are appropriate, e.g. in cloud computing and data services, in particular if financial institutions are relying on the same third-party service providers. This may entail greater coordination globally across financial authorities, and with non-traditional partners such as authorities responsible for IT safety and security".

We believe a different paradigm is emerging in this area, whereby infrastructures providing services which are considered critical for bank's digital transformation belong now to BigTechs. These base their services in economies of scale and standard offerings and banks don't have any more the bargain power needed to negotiate the specific contract clauses that financial supervisors are used to see (i.e. audit rights, subcontracting clauses, etc). Banks are not any more in the position to ensure full due diligence of all kind of third-parties. We believe the FSB is right to consider that more coordination from the side of supervisors is needed, to understand cross-sector implications. Also, we believe that a proactive role should also be taken, in requiring that such infrastructures should abide by certain rules to facilitate the financial supervisors' duties, instead of trying banks to push by themselves in this direction, which is only creating a real barrier for banks to access clouds and other services.

Therefore, international authorities should work on the promotion of harmonisation across jurisdictions to ensure a common approach by regulators/supervisors regarding procedures and methodologies and outsourcing projects process approval and at the same time ensure that outsourcing in the banking industry does not face unjustified requirements that impose burdensome requirements on banks, not faced by other players (e. g. the right to physical access to data in the cloud is not consistent with its global and decentralised nature).

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.*

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.*

Recommendation 7*: Bank supervisors should assess their current staffing and training models to ensure that 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.*

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.*

We fully agree on these recommendations.

A holistic approach to understand the impact of the new technologies in business is needed to be adopted by regulators and supervisors, which requires efforts in terms of cross-

sectorial coordination and collaboration of the different official bodies in charge of the relevant issues (e.g. data protection, competition, AML/CFT, consumer protection, etc.) and investment in human resources, training and own technology.

At the same time, it is also welcome the development of discussion forums to convey and share knowledge among the different market participants, experts, and regulators and supervisors to share practices and discuss regulatory and supervisory concerns. With these kind of initiatives, it is not only possible to know in more depth the potential implications of the new technologies in areas as relevant as data protection or cyber-risks, which are common to all financial innovations, but also to get to understand how certain new technologies, such as DLT, work.

International cooperation between supervisors is also essential given the global nature of fintech solutions and for the search of efficiency and interoperability.

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.*

We fully agree with this recommendation. Currently there are differences between regulatory, supervisory and licensing requirements for banks and new entrants, as well as between countries.

Regulators should try to create a level playing field, namely by reducing unnecessary regulatory restrictions applicable to incumbents, in some cases, or by ensuring the new Fintech firms undertake their activity with the same level of requirements than incumbents according to their activities and risks. The provision of any financial service must be subject to a license that ensures the services are being provided with certain characteristics and level of quality and security.

We support FinTech licenses for specific activities as they would ensure a balanced framework and security in areas that are unregulated (e.g. digital assets), or that are currently using licenses that are not really adjusted to their activities (e.g. crowdlending). This way, the effective supervisions of the risks can be ensured. These licences should be activity and risk specific and banks should be allowed to perform any of the activities regulated under narrow fintech licenses. This is particularly useful in areas where market developments have not been followed by a thorough risk analysis and, the case being, appropriate regulation (such as crowdlending, financial services marketplaces or virtual asset management).

What is crucial is that players are subject to the same regulation because of the products or services they offer, and not because of their nature or size. The regulatory, supervisory and licensing frameworks should focus on how to best manage stability, integrity and consumer protection risks while encouraging innovation and healthy competition.

***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.*

We agree with the suggested recommendation. To the extent that there is an urgent need to strike a balance between the necessary financial stability and the promotion of innovation necessary for economic development, many jurisdictions are deploying different instruments to facilitate innovation, such as those mentioned in the document (innovation hubs, accelerators, regulatory sandboxes).

The Spanish banking industry agrees with this proactive approach towards innovation, as we believe these initiatives bring benefits to all market participants. But as the document mentions, while the objectives may be broadly similar, the implementation of the different initiatives remains jurisdiction-specific.

Thus, we welcomed the way forward proposed by the EBA in its Discussion Paper on its approach to Fintech, about the need to assessing the features of sandboxing regimes, innovation hubs and similar regimes to avoid regulatory arbitrage.

In our response to the EBA we convey the opinion that it is of utmost importance to pursue a common EU framework for sandboxes, to avoid the increasing fragmentation and at the same time, to widespread the benefits of those successful innovations tested across the different jurisdictions.

This requires, first, collaboration among the different institutions, as each of them has different legal powers and goals. Secondly, a coordinating authority should unify these efforts and provide guidance to individual authorities. This authority could ensure that all different national initiatives have the same approach, provide the same service and allow the same exceptions. Otherwise an uneven playing field will arise among different jurisdictions. Moreover, this authority would help to:

- Share information on the typology of the areas or projects studied by the different national sandboxes;
- Identify test cases, with clear benefits for the market, and scale their use.
- To promote the establishment of agreements with external innovation ecosystems, which might benefit all stakeholders.