Financial Services Management

Fintech and the Future of Banking

Cite

Basel Committee for Banking Supervision, Final Paper,
Implications of Fintech Developments for Banks and Bank Supervisors

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Impact Assessment

- Basel has backed away from even tentative recommendations on fintech in this paper's consultation and specific, binding standards proposed in other actions.
- Basel thinks banking could be redistributed, relegated, or even disintermediated altogether, but it does not offer an opinion on whether this may indeed happen or what policy actions should be taken if so. Resulting risks are sometimes cited, but actions to address them are described, if at all, in general terms.
- Supervisors are told to ensure that new technologies are risk-managed in the same way as old ones are under post-crisis standards. Basel does not make clear whether this approach is well suited for different types of fintech or how applying this bank "policy-and-procedure" governance model would affect the future of banking vis-à-vis non-bank competitors.
- New "enabling" technologies (e.g., AI) are seen as largely opening finance to new distribution models in which benefits outweigh risks. The FSB has been more concerned about this trend due to potential "natural monopolies."

Overview

Finalizing a 2017 paper pondering the future of fintech for global banks,[1] the Basel Committee has concluded that innovations in this sector will make it increasingly difficult for them to maintain their current business model. Basel has nonetheless demurred from conclusions that banks will be out-competed in the franchise-value struggle for retail-customer relationships. It also avoids specific regulatory proposals. In the consultation, Basel proposed a lot of policy

1 See **FINTECH13**, *Financial Services Management*, September 20, 2017.

recommendations, but these are now turned into "considerations" following lengthy and largely fact-based presentations of specific fintech implications. Basel has also pulled back from specific recommendations in an earlier paper addressing fintech's financial-inclusion impact.[2]

Impact

Although Basel notes that venture investments in fintech have flagged in recent years and that banks have also invested heavily to compete in this arena, it nonetheless concludes that the industry is facing potential disintermediation and that this will pose an array of critical questions for bank regulators and supervisors. As noted, Basel does not now tackle what should be done to anticipate, avert, or respond to these challenges, instead laying out broad implications for future consideration.

As noted, these are more equivocal than the consultation. Differing national approaches are described and the implications of different innovations are addressed, sometimes in detail. However, Basel has pulled back from concerns such as conflict of interests raised in the earlier inclusion policy. The final statement thus offers few, if any, positions on which national or global regulators could base any actions.

For example, Basel looks at transaction infrastructure in areas such as artificial intelligence (AI) and machine learning (ML). Although the Financial Stability Board (FSB) raised significant concern about potential downsides if platform companies use their technical prowess to disintermediate banks,[3] the Basel report is generally agnostic about these risks and supportive of innovation. It mentions policy impact of complex issues such as determining who owns consumer data, but does not side with the EU's "open-banking" approach or a like-kind but more limited strategy laid out by the CFPB.[4]

What's Next

The Basel Committee released this final paper on February 19. Because there are no specific regulatory recommendations, there is no timeframe for future action. Indeed, although Basel says it will continue to study fintech, it lays out no specifics on when or how it will do so.

Analysis

Basel lays out the following scenarios without saying which it thinks most likely. Aspects of the scenarios are also inter-dependent:

- Incumbent banks simplify and modernize. In the proposed set of principles, Basel was very dubious this would occur; in this paper, it offers it as a scenario without forecasting its likelihood.
- Incumbents are replaced by challenger banks. These challengers may be

2 See **INCLUSION2**, *Financial Services Management*, October 14, 2016.

3 See *Client Report* **FINTECH15**, November 1, 2017.

4 See **FINTECH14**, *Financial Services Management*, October 24, 2017.

fintech firms establishing their own banks or partnering with incumbents as well as new banks with a fintech-only delivery model without ancillary non-bank technology operations. As in the proposal, Basel sees no evidence that the challenger-bank scenario will prevail.

- Distributive banks replace the current business model. Here, banking services fragment across incumbent and challenger institutions, with banks carving out enough of a business to survive. In this scenario, many entities enter the banking business with "plug-and-play" and similar models in which no one seeks to be a universal or integrated-retail bank. This scenario is already evident in "open banking," innovative payment systems, compliance and lending platforms, and robo-advice.
- Banks are relegated to commoditized services (e.g., processing, risk management), with customer relationships owned by new intermediaries. Front-end platforms are particularly important entrants that lead to this scenario. Basel says this scenario may seem unlikely but then lays out how it might occur and where it is already evident.
- Banks are disintermediated and become irrelevant, replaced by more agile platforms and technology. Basel says this scenario may seem "far-fetched," but it again also lays out instances in which it is already evident.

Basel then lays out the following implications for regulators and supervisors:

- Risk: There are numerous implications not only for risk, but also for beneficial rewards in terms of new offerings, financial inclusion, and operational efficiency. New competition could also enhance financial stability. Although supervisors are told to ensure that innovation comes with risk controls, Basel also notes that current standards may unduly impede innovation.
- Specific Risk Considerations: Risks of particular concern despite all the benefits described above are strategic, operational, cyber, and compliance. Here, Basel details risk controls analogous in most ways to those already required of banks. However, broader business-model risks are also to be anticipated and contained (how is not made clear).
- "Enabling" technologies (e.g., AI) pose numerous challenges as well as provide opportunities. Both are detailed and banks are again told to manage risks much as they do current operational ones. The Basel paper also details the pros and cons of technologies such as AI, big data, and cloud computing.
- Vendor Risk: Supervisors are told to ensure that banks properly manage vendor risk when the bank is likely to end up with it. Complexity risk also arises with reliance on modular third parties, a risk not necessarily managed even if banks apply operational-risk standards to each vendor comparable to those applicable to the bank for the relevant product or service. Although Basel mentions its operational risk-management standards, it does not also

deal with the extent to which only banks are capitalized for operational risk[5] or the effect this asymmetric treatment has on both competitiveness and vendor resilience.

- Supervisory Considerations: The relationship between traditional supervisory concerns and those germane to fintech is uncertain, with Basel thus recommending coordination with other regulators and national-security authorities.
- Cross-Border Considerations: Cross-border supervisory cooperation is also necessary for cross-border fintech services (e.g., remittances, wholesale payments).
- Supervisory Model: Given the above, Basel suggests supervisory models may need to change (e.g., by ensuring technology competence). The Basel paper is generally favorable to the use of "regtech."
- Supervisory Authority: In many cases, this is outmoded and does not appropriately address fintech. Supervisors for example should ensure jurisdiction over third-party vendors to banks. Licensing regimes also require re-examination, although Basel does not necessarily endorse "sandboxes."

5 See *Client Reports* in the **OPSRISK** series.