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Federal Deposit Insurance Corporation (FDIC)
550 17th Street NW
Washington, DC 20429
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Via Email: Comments@fdic.gov

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Regarding Information on Standard Setting and Voluntary Certification for Models and Third-Party Providers of Technology and Other Services

Ladies and Gentlemen

M|E|W Consul strongly supports Federal Deposit Insurance Corporation (FDIC) initiative regarding Standard Setting and Voluntary Certification of among others Third-Party Providers of Technology and Other Services. We believe, such program will

- Promote true innovation, and its faster and wider implementation
- Create level playing field between major banks and smaller or regional institutions
- Create level playing field between established market participants and new entrants
- Create level playing field between financial institutions and other market participants, especially non-financial corporations (NFC)
- Makes financial system in its entirely more shock resistant, cost efficient and customer focused, therefore of greater value to the economy and tax payers as a whole

Background

It is noticeable, that a lot of new products and especially innovative business models never make it to the market, and never get offered to potential customers. In the manufacturing world and digital sector major corporations and market participants often acquire new technologies, start-ups and patents only to terminate further developments. Sufficient data is available, but often below the radar of authorities and general public. Due to early phases, innovators are small, they have little to no revenue stream and/or customer base. Only recently have competition authorities started to look into take-over practices by major digital companies to get a better understanding.

The situation in financial services is worse, because major financial institutions (FI) are controlling access to financial market infrastructure (FMI). While in other sectors such as automotive small and new manufacturers are allowed to use general infrastructure such as roads and bridges same as established and major manufacturer, in financial services the necessary FMI is privatised, e. g. central counterparties and clearing, depot banks, etc. For a new product or new business model or a new market participant to get access one depends on sponsoring by an established FI. Naturally, established FI have no interest in supporting stronger competition or even replacing own existing business models and thereby potentially loose sources of revenue.

In general, innovation and digitization can be divided into two lines:

(1) Technical Progress – helps improving existing business models, raises cost and/or time efficiency, etc.

(2) Disruption – development of new business models: opening new business areas or replacing existing business models

We observe that established FI are cooperating more frequently with FinTech, RegTech, InsurTech, etc. But solely as part of (1) Technical Progress.

Regarding (2) Disruption, major digital companies (DC) are driving change, while established FI are obstructing. DC expertise is on the technical side, while their problem is the shortage of financial and regulatory experience. That has implications particularly with regard to corporate business.

The potential of corporate business is anticipated to be as huge as retail business, but the structure is different: the number and frequency of transactions often is lower, while the size of individual transaction much higher. As a result, it only makes sense economically if no additional FMI has to be established. Unfortunately, as mentioned above, existing FMI is privatised, and the most important existing clients are major FI, which lag economic interest in replacing existing business models by much more efficient and customer focused digital alternatives.

Currently we know only of three ways to break the market access bottleneck:

(1) public sponsoring of true innovative and disruptive business models; that already happens to a minor degree by for example central bank accelerator programs or going forward BIS Innovation Hubs

(2) sponsoring by major digital corporations; DC so far are focussing mainly on retail business, that is changing slowly

(3) sponsoring by non-financial corporations (NFC); this alternative is the most underdeveloped one, NFC are very diversified and lag necessary coordination and expertise in the financial sector, infrastructure, regulation

A new standard setting organisation (SSO) and voluntary certification can help to unloosen the bottleneck on all three levels, and thereby promote innovation, which not only can be used to raise the level of efficiency, but also to close existing gaps in the financial market safety architecture, make the financial system more shock resistant especially with instant FMI.

Because one does not know the final outcome of any true innovation, it often is an ongoing process, there should be no pre-limitation of the projects, areas or ideas that can apply for voluntary certification.

Digitization and cloud based business model regularly obliterate national borders, national and international applications should be accepted.

<u>With reference to Question 1</u>

M|EW Consul has developed strategic corporate liquidity & collateral back-up insurance, called **KLF**. In case of major disruption of financial system or bank credit market, such as COVID-19, KLF provides insured corporation access to HQLA as per BIS definition at predefined terms & conditions.

The main beneficiaries of KLF beside insured corporations are small, regional banks, which are providing financing to smaller firms. Plus employees and local communities, who are often dependent on local corporations as employers and key tax payers.

The problem of "The Credit Line Channel" for smaller firms for example, as outlined in recent working paper (2020-26) by the San Francisco Fed's Economic Research Department, will be significantly moderated.

According to Governor Lael Brainard during a FedNow Service Webinar on August 04, 2020, instant payment requires additional liquidity management tool to cover outflows, "… especially during hours when existing payment services are not open and funds cannot be transferred into Federal Reserve accounts to cover intraday overdrafts. …" Naturally, KLF structure has been further developed to also cover instant payment challenges if desired, following earlier analyses by among others Bank of England.

KLF is platform based, and part of digitization of corporate treasury. As mentioned above, access to private FMI, such as CCP + CSD, is essential.

<u>Banks refuse to cooperate with KLF, therefore FMI providers also do not cooperate out of concern to loose major FI business, and KLF contracts don't get settled so far.</u>

In addition to KLF another version has been developed by M|E|W Consul to guarantee insured FI, asset mangers, FMI providers, etc. access to additional regulatory capital, called RCR – Regulatory Capital Reserve facility.

<u>Well received by various regulatory authorities, RCR currently blocked by FMI and major FI as well.</u>

<u>With reference to Question 2</u>

We expect, the first major advantage of establishing standard-setting and voluntary certification is cost efficiency:

(1) Instead of every potential customer having to collect information and execute individual testing procedure, one independent, reliable and transparent public program would be sufficient

(2) Same argument goes for third-party providers, who only have to go through the process ones

(3) As a result, roll-out of new products and to a wider client base will be faster and wider

But biggest beneficiary will be regulatory authorities and strengthened financial market safety architecture. In general, with slow innovation and implementation speed authorities have sufficient time to adapt, slower speed of legislation no problem. But, if it takes significant less time to develop and implement new financial products or business models, as it is the case with digitization, the time consuming process of legislation, especially international standards, means regulation and safety architecture is always lagging behind. If legislation is time-wise too far behind, the situation is similar to self- or unregulated financial sector.

Certification process helps authorities to be informed earlier about latest developments, have a better understanding of coming innovation. They can give guidance about objectives of future regulation, during the development process of innovative business models, etc. already, "manage" the direction of innovation.

We can already observe that in today's digitized and automated financial system historic rules of thumb no longer work. See for example diversification across asset classes or regions. Dislocations are spreading much faster than experienced in the past. Hedging strategies via diversification lost its basis. Authorities have to understand how innovation changes financial system, to take the right action in a timely manner. This argument gets even more important with the transition to instant payment.

With reference to Question 6

We expect the answer to all three groups to be lower cost of due diligence and on-boarding for:

(1) Third-party provider

(2) Certified technology

(3) Potential smaller user

In general, economic rational behind certification process to us looks similar to other centralised services provided in the financial sector, such as research, credit analysis/rating or platform economy, subject to comprehensible procedures.

Especially third-party provider offering services to smaller and less sophisticated clients in general should benefit from certification. It allows offering higher value but more complex products, which otherwise would be rejected because clients cannot vet them on their own, or at too high costs. That is why today third-party providers concentrate too often on major FI and bigger market participants. As a result, products and solutions offered do not address the specific needs of smaller IDI, etc.

For SSO to validate third-party provider/new technology, they have to provide certain on-boarding standard. Assuming standard is proven, stable and reliable, plus easy to introduce, then smaller ICI, etc. will apply similar standard. As a result, on-boarding will be easier and cheaper.

For reference we advice a look at the experiences re implementation of Payment Service Directive 2 (PSD2) in Europe:

- In the Netherlands the Ministry of Finance organised the National Forum on the Payment System (NFPS); with contribution by potential users and service providers an API standard was developed; transformation was swift, without major disruptions, and new third-party providers know the standard they have to adhere to

- In Switzerland PSD2 implementation made little progress, until the government ordered Swisscom to develop an API platform - open for all. After that a second one was developed by SIX Group, owned by private banks; today on-boarding is relatively easy and cost efficient, new entrances can chose between two alternatives

- In Germany by contrast authorities only defined general PSD2 framework, relied on market and competition, each FI developed own standard; the result, on-boarding is unreliable and time consuming, hence expensive; safety standard is low, technical failures happen on a daily basis; general perception, FI are using complex technical standard as additional hurdle for new market entrants and to reduce competitive pressure

For community banks as a whole innovation will be of higher importance than major FI, but benefits on individual basis are limited. Therefore, every measure that raises cost efficiency, lowers necessary upfront investments, lowers the hurdle to adapt new technologies and new safety standards, should be beneficial.

With reference to Question 7

The benefit of innovation for the general public is very widely spread, not necessarily quantifiable. For example, innovation can raise the safety standard in financial sector, close gaps in regulation/financial market safety infrastructure. The benefit, future crises will be limited, maybe not develop in the first place or stay local. That has to be taken into consideration when setting up and financing new SSO.

Additionally, true innovation defined as disruption generally will be developed by start-ups or new entrances in a certain business areas. Certification as mentioned earlier could be an important prerequisite for gaining market access. The potential might be huge, but client base and revenue stream are initially limited or none existent. Upfront fees would act similar to other hurdles to market entrance, and therefore might be counter productive.

Innovation is a dynamic process. Technology and business models are changing continuously. Hence, certification is also unlikely to be a one-off event, but ongoing. Part of the cost of SSO and certification can be covered via certification updates/renewals, once a client base and revenue stream is established. Naturally the situation is different with already established market participants, with existing revenue stream. Here a regular certification or member fee might be appropriate.

Otherwise, we believe SSO should be treated like a public good, same as other regulatory authorities, and funded by the financial service sector as a whole and the tax payer.

With reference to Question 8

At M|E|W Consul we do not believe that a voluntary certification process will undermine innovation. We expect a similar development to the derivatives markets:

- Standardised and simplified products will get certified, and in general these are products offered mainly to less sophisticated clients such as retail, SME, etc., who deserve extra protection from regulation

- Tailor made and complex products will not get certified, because certification process won't be cost and time efficient; in general these are products offered mainly to more sophisticated clients such as other FI, big NFC, HF and PE firms, etc.

We do not believe that IDI's will feel constrained if a product is certified or not, but they will pay more attention to the decision which products suits which objective and which customer base better. What so far is more an informal process will likely become more formal and transparent one – internally and probably also externally. And higher transparency means lower uncertainty, means external market participants and regulatory authorities can make a better decision about appropriate supervision, risk management or therefore financing costs.

A voluntary certification process raises transparency in the financial system, and that by itself definitely is not a hurdle to more innovation.

With reference to Question 10

We already observe various agencies internationally taking action to understand and promote innovation/digitization in the financial sector. See for example FedNow Initiative by Federal Reserve, Accelerator program by Bank of England or Innovation Hubs by BIS. The objectives and execution procedures differ, but all have in common to raise the financial sector safety standard.

What we have not heard about so far is close cooperation or coordination between all these efforts. Strong integration and cooperation of FI supports an international, cross-border approach. We believe cooperating and exchanging information at an early stage will be to everybody's advantage, and is more cost and time efficient.

It also prevents any kind of regulatory or technical standard arbitrage, which itself can already be highly dangerous.

With reference to Question 11

Innovation by definition is unpredictable, an ongoing process. It is therefore not possible to determine in advance which area, technology or market participant will apply for certification, or when certification will bring the biggest benefit.

As a result, SSO mandate we believe should be as open as possible. Let the market and market participants decide, and allow the market and market participants to change their minds. SSO mandate should be flexible enough to allow certification of technology, services and business models not developed, and not even in the pipeline jet.

If SSO is set up in an open, cost efficient and relatively easy to apply way, we expect significant surge in innovation. We believe new innovative projects will be launched because independent certification is available, knowing that established market participants will less likely be capable to block market entrance.

Summary

Wirecard default is the latest prominent default in the fintech sector. Although it is the result of cumulated minus developments, and not all details are known so far, at the very beginning a fatal error was made regarding regulation. German regulatory authority Bundesanstalt für Finanzdienstaufsicht (BaFin) had to decide how to classify Wirecard: financial holding or Technology Company. It was decided at that time that Wirecard is a Technology Company, subsequently only the banking subsidiary was regulated. BaFin lagged a close understanding of Wirecard business model and its execution. As a result the case could develop over several years.

Assuming SSO or voluntary certification had been in place at the time BaFin had to decide about classification, either Wirecard applies for voluntary certification, because it makes economic sense in the retail sector, or BaFin knows they should take a very close look why the company rejects the advantages. Level of transparency and understanding would have improved, independent of the decision by Wirecard management regarding voluntary certification.

At M|E|W Consul we strongly support implementation of additional SSO and voluntary certification. The benefits to smaller FI, on corporate level and to general public seem obvious to us. The biggest advantages are probably financial disruptions, volatility events, minus developments and disasters which do not happen in the first place.

We believe SSO and voluntary certification will help closing the last gaps in financial market safety architecture and give authorities a better and faster understanding of latest developments and newest innovation.

Naturally, procedures and costs should be set-up in a way to allow as many innovators to participate as possible:

- new entrances with low to no budget
- with financial and technical background
- nationally and internationally based

Let the market and customers decide which product and which business model is attractive, instead of major FI, who are focussing foremost on their own, short-term profitability.

Application for voluntary certification

Once SSO is established and allows international applications, M|E|W Consul will seek voluntary certification of:

(1) **KLF –** corporate liquidity & collateral back-up insurance

(2) **RCR –** Regulatory Capital Reserve facility

Kind regards
Manfred E. Will
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M|E|W Consul