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The innovation sandbox

They have huge advantages but there has to be some regulatory supervision

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Innovation in the banking, insurance and capital markets space has been critical in supporting the growth of the economy, penetration of financial services, financial inclusion and ease of doing business. The digital revolution and innovation in the payments landscape has been supported by regulation. In order to continue to support innovation in financial services, balanced regulation is critical to make sure the integrity of the financial system is protected while encouraging new and disruptive technologies.

This column is a discussion about the feasibility and practicalities of developing a regulatory sandbox for fintech that is a 'safe space' in which new businesses can test innovative products, services, business models and delivery mechanisms without immediately incurring all the normal regulatory consequences of engaging in the activity in question.

Sandboxes are not a new idea. The first sandbox-like framework was set up by the US Consumer Financial Protection Bureau (CFPB) in 2012 under the name Project Catalyst (CFPB 2016). In 2015, the UK Financial Conduct Authority (FCA) coined the term "regulatory sandbox" (FCA 2015). Since then, the concept has spread across more than 20 countries from Abu Dhabi to Sierra Leone.

The primary objective of a sandbox is to promote a rich ecosystem of players in the financial system and the capital markets by supporting innovation. The potential benefits of a regulatory sandbox could be significant. The first being reduced time-to-market at potentially lower cost. Delays driven by regulatory uncertainty disproportionately affect first-movers and discourage innovators. By deferring these after the proving of an idea, innovations can be tested and tweaked more quickly and at a lower cost. Second, a regulatory sandbox approach could result in better access to finance. Financial innovation relies on investment, much of it through equity funding. Regulatory uncertainty at a crucial growth stage means that fintech firms find it harder to raise funds. Third, a sandbox approach could result in more innovative products reaching the market. Due to regulatory uncertainty, some innovations are abandoned at an early stage.

The benefits of the sandbox should lead to better outcomes for consumers through an increased range of products and services, reduced costs and improved access to financial services. The sandbox also ensures that consumer protection safeguards are built into new products and services before these reach the mass market.

Regulators should also consider the potential benefits and risks of having a sandbox policy. A standardised and publicised framework for dealing with innovations that promote an open and transparent communication between regulator and the sandbox entity to facilitate learning from each other are the potential benefits.

Let us now look at the risks of a sandbox policy. The first, potential competition issues that stem from advantages sandbox entities may have, both in regulator advice and in being first to market. The latter may be especially unfair if the selection criteria are defined vaguely or there is a lack of transparency leading to selection bias. The second risk is poor selection of sandbox firms because of the limited capacity of the regulator to assess the technology. Third, liabilities issue in case of failed testing that results in harm to customer or other market participants, which may threaten the reputation of the regulator and trust of the customers.

So what are the mechanisms that a sandbox approach can adhere to? The following options can help manage this risk by giving certainty that the regulator will not take enforcement action at a later date in relation to testing activities, provided firms abide by the conditions agreed with the sandbox unit. These options may also be used by technology companies when they find authorised firms that are interested in testing their products or services. There are three options. One, the regulator could issue a No Enforcement Letter stating that no enforcement action will be taken against testing activities where they are reasonably satisfied that the activities do not breach our requirements or harm our objectives. Two, the regulator can issue individual guidance to a firm on the interpretation of applicable rules in respect of testing activities the firm may be carrying out. And thirdly, Waivers, where it is clear that testing activities do not meet the regulator's current rules, a waiver or modification would allow what would otherwise be a temporary breach of rules.

A successful test may result in several outcomes. To date, the most commonly sought outcome is either full-fledged or tailored authorisation of the innovator/innovation. As an exception, regulators could initiate changes in the legal and regulatory framework to enable legal implementation. Sometimes, a sandbox firm may be allowed to continue its operations outside the regulatory perimeter. If testing fails, the sandbox firm is required to cease running its innovation.

Sandboxes should be limited, transparent and also time bound to ensure they do not cause uncontained damage. They must also comply with mandatory rules because regulators cannot waive criteria set forth by law. It may be difficult for the regulators to set up an appropriate sandbox but it is a need of the times, for sure.

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