MODERNIZING DIGITAL FINANCIAL REGULATION

THE EVOLVING ROLE OF REGLABS IN THE REGULATORY STACK

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"The adoption of new metaphors is said to be the signature of transitions between paradigms."

John G. Daugman, *Brain Metaphor and Brain Theory*

Regulatory sandboxes or RegLabs are tailored regulatory environments or "safe zones" for conducting small scale, live tests of new FinTech products and delivery models. Likened to clinical drug trials or new drivers' learning permits, FinTech RegLabs have been hailed as the *ne plus ultra* of financial regulation: an evidence-based tool for fostering innovation while allowing regulators to remain vigilant to consumer protection and financial stability risks.

RegLabs share many characteristics of high-flying Silicon Valley start-ups – a rich and compelling narrative, an outstanding use case or two, and an almost viral quality to their recent adoption by financial regulators. On the heels of the UK Financial Conduct Authority's (FCA) Regulatory Sandbox, more than fifteen jurisdictions around the world have announced their own RegLab initiatives.

Popular enthusiasm drives the belief that RegLabs benefit innovators and regulators alike through mutual learning and engagement. For innovators, RegLabs can help reduce regulatory uncertainty for new products or business models. The "move fast and break things" mantra of Silicon Valley is fine as far as it goes but dangerous in the highly regulated financial sector. RegLabs provide innovators an opportunity to build regulatory acumen, and to identify regulatory challenges early, before building costly compliance infrastructures for products that ultimately may be deemed unviable.

For regulators, RegLabs provide a venue for developing evidence-based insights on specific financial technologies. Bringing regulators into the innovation process early provides an opportunity for the watchers to tailor regulatory approaches that foster innovation while maintaining allegiance to regulatory objectives. Making those trade-offs explicit is itself an important regulatory innovation, particularly for risk-oriented bank regulators who typical focus on stability and soundness.

With the support of Omidyar Network, the Aspen Institute's Financial Security Program (FSP) conducted a comprehensive (and ongoing) analysis of the global RegLab landscape to identify and advance regulatory design lessons relevant to the FinTech policy debate here in the United States. We analyzed the legal and regulatory frameworks of proposed RegLabs around the world, and interviewed dozens of regulators, financial institutions, and innovators. ***Across countries and continents, we heard a familiar refrain: the urgent need for regulators, innovators, and industry to collaborate on the creation of a new digital financial architecture.***

The RegLab phenomenon is still in its infancy. As such, it is still too early to tell what impact, if any, RegLabs will have on the trajectory of financial innovation or regulatory modernization. To date, Abu Dhabi, Malaysia, the UK, Singapore and Thailand have publicly announced RegLab participants – a total of 53 companies globally, with the vast majority (42) participating in the FCA's Regulatory Sandbox. Most of these companies remain in the very early stages of product testing.

The reaction to RegLabs has not been uniformly sanguine. In addition to the familiar critique that RegLabs inappropriately allow regulators to pick winners in the marketplace, some regulators express concern that RegLabs have inspired a "wild west" approach to FinTech policy, allowing companies to launch untested products with little or no oversight. To the extent we have observed a concerning trend, it is the temptation for regulators to prioritize RegLabs – a shiny new thing – over other infrastructure-oriented initiatives to broadly enable digital finance, such as clear guidance on cloud computing, data standardization, and digital identities.

But regardless of the future of RegLabs per se, they unambiguously serve as a harbinger of a new, collaborative, evidence-based approach to digital financial regulation.

The Global RegLab Landscape

Global interest in RegLabs was sparked by the pioneering work of the UK's FCA. Emerging from the embers of the financial crisis and eager to affirm London's position as the leading global financial center, the FCA launched Project Innovate. Initially styled as a regulatory hub for FinTech innovation, Project Innovate opened its doors in 2014 to an immediate outpouring of demand by FinTech start-ups and financial institutions eager for guidance on navigating novel products and business models through the regulatory landscape. To date, Project Innovate has worked with hundreds of innovators, service providers, and financial institutions on new FinTech products and technologies.

To build upon this work, the FCA launched its Regulatory Sandbox in late 2015. The purpose of the Sandbox is to “create a place for businesses to test new ideas to ensure they meet regulatory requirements [and] accelerate the development and testing of novel products which benefit consumers.” Acting pursuant to a broad competition and innovation mandate, the FCA made clear the Sandbox was intended to:

- Remove unnecessary regulatory barriers to innovation;
- Reduce the time and cost of bringing new, consumer-friendly ideas to market; and
- Ensure that appropriate consumer protection and security safeguards are built into new financial products and services.

In part because of the FCA’s highly facilitative approach, a recent EY Report on FinTech ecosystems ranked the UK as the leading global jurisdiction for FinTech innovation.

Those efforts struck a chord. In recent months, jurisdictions around the world, including Abu Dhabi, Australia, Bahrain, Brunei, Canada, Dubai, Hong Kong, Indonesia (OJK and Bank Indonesia), Malaysia, Netherlands, Russia, Singapore, Switzerland, and Thailand, have announced or launched their own financial regulatory sandboxes or RegLabs. Others are being developed in Brazil, India, Kenya, Mexico, Nigeria, Sierra Leone, and elsewhere.

For better or worse, the basic structure of the FCA’s Regulatory Sandbox – described above – has served as the blueprint for regulators around the world launching their own FinTech innovation initiatives. Many jurisdictions have announced RegLab initiatives which, if implemented as designed, would closely resemble the FCA’s Regulatory Sandbox by offering application-based testing programs to facilitate the design and adoption of new financial products and business models.

But it would be a mistake to paint the RegLab movement with single broad brush. Country-level initiatives are textured and varied in design, and often intended to serve very different purposes. Across this dynamic landscape, several high level themes have begun to emerge.

1.Informal regulatory innovation initiatives significantly outpace RegLab activities

Before the concept became synonymous with FinTech regulation itself, RegLabs were deployed as niche testing venues to provide deeper regulatory insights on specific technologies or business models. These early RegLab initiatives emerged as by-products of more comprehensive regulatory engagement efforts to support and learn from innovative firms attempting to launch new financial products and services.

Programs such as the UK FCA’s Project Innovate, Singapore’s national FinTech Office and Looking Glass @ MAS, Canada’s Launch Pad, and Australia’s Innovation Hub provide opportunities for a robust exchange of information between innovators and regulators to identify potential regulatory frictions that are shared across the ecosystem. Collectively, these ecosystem-building efforts have involved hundreds of companies, effectively dwarfing the scope of sandbox activity.

Consider:

- **UK FCA's Project Innovate** received requests for support from 585 companies over the eighteen month period ending in March 2017. By contrast, only 42 companies currently participate in two cohorts of the Regulatory Sandbox.
- The **Monetary Authority of Singapore** has advised hundreds of companies through informal channels and its innovation lab, Looking Glass @ MAS. To date, it has admitted only one company to its Regulatory Sandbox (a 2% acceptance rate, according to local authorities).
- **Australia' Securities and Investment Commission** provided informal assistance to 109 FinTech startups from March 2015 to November 2016. During this period, FinTechs that received assistance from the Innovation Hub before applying for a license were approved on average 95 days or 45% faster than those who had not engaged with the Hub. At least until very recently, not a single company had applied for ASIC's Regulatory Sandbox framework.

Confirming these statistics, financial regulators privately say that the vast majority of companies eager to participate in their sandboxes typically require little more than informal guidance in navigating applicable legal requirements. Perhaps more important, these informal engagement activities provide a broader knowledge base for regulators to identify policy frictions and opportunities created by emerging technologies.

2. RegLab models continue to evolve

The UK FCA's Regulatory Sandbox has served as a model for many global FinTech RegLabs: a cohort-based live testing program with regulatory relief tailored to the unique risks presented by the product in testing. Applicants are evaluated based on eligibility criteria, including whether the product constitutes a "genuine innovation," offers a "consumer benefit," and is ready for testing. Admitted companies then work with the FCA to craft appropriate testing protocols and consumer safeguards. At the end of the test period, participants either "graduate" to full licensing, or are released from the sandbox without market access. Similar cohort-based programs have been launched in Abu Dhabi and Malaysia, among others.

But variants of the RegLab concept have begun to emerge over the past year, presenting different formal and informal design features, benefits and drawbacks for regulators to consider when pursuing their mandates. For example:

- **Australia** has a statutory waiver framework, which allows companies with a limited number of customers and/or low financial exposure to operate for up to one year without a full license.
- **Indonesia's** OJK has a hybrid sandbox, with tiered registration requirements that provide participating companies up to a year to apply for full licensing. In the interim, the OJK provides informal coaching to participants to help them graduate to full market access.

- **Singapore** informally refers to its RegLab as a "sandbox process." This approach situates the RegLab as the final step of a regulatory continuum which begins with clear guidance on infrastructure issues (such as cloud computing and data access), transitions to informal guidance to resolve regulatory uncertainties, and culminates with a sandbox test to refine the business model prior to launching into the Singapore marketplace. **Canada's** Ontario Securities Commission has adopted a conceptually similar approach, offering live testing as an option for companies seeking licensing determinations for novel products or business models.

- **Thailand**'s SEC is launching a series of regulatory sandbox "verticals" to focus on different aspects of the marketplace: investment advisors, trading platforms, and clearing and settlement.

Each approach offers distinct costs and advantages. For example, the cohort-based approach provides a mechanism for broadly publicizing and generating interest in the regulatory collaboration process, and provides the sponsoring regulator with concentrated exposure to a broad cross-section of innovative companies. Statutory sandbox frameworks lower regulatory barriers to entry for new firms and eliminate regulatory discretion to "pick winners." At the same time, however, statutory waivers reduce the need for collaboration with regulators and therefore eliminate some of the learning benefits of cohort-based RegLabs. RegLab models will continue to evolve as regulators navigate these trade-offs in their home jurisdictions.

3. <u>RegLab impact will depend on regulatory mandates and jurisdiction – and coordinating among regulators in multi-peak jurisdictions.</u>

Broad international and domestic competition mandates in Abu Dhabi, the UK and Singapore allow those jurisdictions to actively promote the development of specific technologies through the curation of companies admitted to their RegLabs. But not all regulators enjoy such wide discretion. Narrower regulatory mandates – focused on consumer protection, market integrity, or financial inclusion – necessarily limit the scope and structure of RegLab activities.

RegLab activities may be further constrained by the jurisdiction of the sponsoring regulator. While the Abu Dhabi Global Market, UK FCA and Monetary Authority of Singapore each have broad authority to regulate across the entire financial system, regulators in more fragmented, multi-peak systems are limited to actors and conduct within their regulatory perimeter.

These distinctions are important for understanding the potential for RegLabs in the United States. ***Although the UK FCA is typically held out as a model, there is no U.S. financial regulator (state or federal) with comparable authority to provide regulatory relief for the purpose of encouraging innovation across the financial system.*** As discussed further below, our multi-peak regulatory system highlights the importance of coordinating any RegLab activities (and any associated technical knowledge and insights) across financial regulators. Other multi-peak jurisdictions are coordinating RegLab activities through joint working groups or formal MOUs to facilitate information sharing, particularly around products which are supervised by more than one regulator.

4. Designing appropriate safe harbors to balance risk and innovation remains an ongoing challenge

RegLabs may serve as a policy tool for helping regulators more finely balance the policy trade-offs between innovation and risk. By toggling the regulatory obligation to match the anticipated risks of new products or business models, RegLabs introduce a welcome flexibility for companies attempting to innovate within a highly-regulated sphere.

This is not to be confused with a "free pass" for RegLab companies to operate without regard to consumer protection. Most global RegLabs require participating companies to maintain basic consumer safe guards during the testing period, including risk disclosures, data protection standards, dispute resolution mechanisms, and compensation programs. Even statutory sandbox jurisdictions, such as Australia, which provide licensing exemptions for companies with a limited number of consumers, mandate compliance with certain consumer protection protocols.

Notwithstanding this attention to consumer protection during the testing period, important design questions remain on how best to link RegLab activities with prospective safe harbors and formal regulatory guidance. In this respect, the U.S. Consumer Financial Protection Bureau's No Action Letter (NAL) policy and Project Catalyst program provides instructive case studies. A No Action Letter provides a narrow, non-public statement that the CFPB presently has no intention to recommend an enforcement or supervisory action regarding the particular financial service or product. Critics say the NAL policy provides insufficient legal protection for firms experimenting with new products or business models, and point to the fact that no firm has been granted NAL relief as evidence of this policy failure. On the other hand, Project Catalyst is viewed as a broad success, both in terms of providing informal guidance to thousands of individual companies and incorporating insights from these interactions into the policymaking process. For example, the Bureau's recent information requests on alternative data and consumer access to financial records both reflect friction areas for the FinTech community identified through Project Catalyst consultations. While the current scope of NAL policy may discourage companies from seeking formal regulatory relief, the Project Catalyst consultations are helping to drive positive change in Bureau policy.

5. RegTech is underrepresented in early RegLab cohorts

RegTech – technologies designed to facilitate compliance with regulatory requirements – might seem like a fruitful topic for evidence-based collaboration between regulators and innovators. These technologies have enormous potential to reduce compliance burden, improve compliance efficacy and free up scarce regulatory resources to focus on higher-order supervision and examination activities. RegLab testing could not only accelerate market adoption of efficiency-enhancing RegTech solutions but also help catalyst corresponding modernization of the regulatory process itself.

At the time of this writing, however, only a single RegTech firm has participated in a RegLab test: Tradle (a block chain-enabled Know-Your-Customer (KYC) solution, selected as part of the FCA's first cohort). By contrast, however, a handful of jurisdictions have announced less formal initiatives focused specifically on RegTech, including the UK FCA, Australia's Securities and Investment Commission, the Hong Kong Monetary Authority, and the Monetary Authority of Singapore. As a practical matter, we suspect that this trend will continue, with RegTech advancing primarily via informal regulatory collaboration, which presents less risk of inferring a regulatory imprimatur on particular compliance technologies.

Considerations for the U.S. Financial Regulatory Architecture

Despite the tremendous global interest, the current U.S. financial regulatory structure is not conducive to the iconic, cohort-based RegLabs launched in the UK, Singapore, Abu Dhabi, and elsewhere. Given the complex web of U.S. state and federal financial regulators – with at times overlapping and redundant authority depending on jurisdiction, provider, and product type – there is no single regulatory entity that can provide certainty for new FinTech companies attempting to scale on a national basis.

For U.S. RegLabs, then, the most promising near-term opportunities may lie with the states – the original laboratories of social and economic experimentation. A key concern for many consumer-oriented FinTech products in the U.S. – particularly in the credit and insurance sectors – is the uncertainty associated with conflicting approaches by regulators with overlapping jurisdiction. Rather than a threshold barrier to the introduction of a novel product, it's the uncertainty that divergent views of regulators with overlapping jurisdiction may preclude efficient scaling across state lines.

RegLabs may be helpful in reducing these frictions by supporting *de jure* or *de facto* passporting of state regulations. A *de jure* passporting system would provide reciprocal licensing protocols to allow companies to operate across multiple jurisdictions by complying with a single licensing regime. A shared RegLab platform tied to formal reciprocal licensing protocols – or as a basis for developing shared approaches to risk management and supervision – could benefit regulators and innovators alike by reducing costs and improving outcomes for both sides. Several New England states are currently considering this type of shared, multi-state sandbox as the basis for a *de jure* passporting framework.

Regulators also have an opportunity to lend their support to *de facto* passporting – that is, enabling technology solutions to reduce the licensing and compliance burden of operating across multiple jurisdictions. The State Regulatory Registry, LLC, a nonprofit subsidiary of the Conference of State Banking Supervisors which runs the National Mortgage Licensing System, is a current example of a shared services platform for reducing regulatory burdens. The Austrian Reporting Service, a third-party shared services platform sponsored by the largest banks in Austria to facilitate real-time data sharing with the Austrian Central Bank, likewise demonstrates the opportunity for efficiency and efficacy gains through technology-enabled supervision platforms. A RegLab might play a useful role in bringing together innovators, financial industry incumbents, and regulators in designing and implementing these solutions.

A somewhat bolder recommendation might be to use RegLabs to accelerate testing and adoption of potential solutions to the major drivers of household financial insecurity. For example, there is emerging evidence that hybrid financial products – those that combine elements of credit and saving, or saving and insurance, for example – may help individuals and families more efficiently manage short-term income and expense volatility. The slow development and roll-out of these solutions has been attributed, in part, to uncertainty over how competing regulators might approach products that do not neatly fit into a specific regulatory category. A multi-regulator RegLab designed to test hybrid product solutions to vexing financial security problems might help catalyze socially beneficial innovation.

But even if RegLabs per se fail to gain traction in the United States, they offer important insights on the future of regulatory innovation. As discussed above, early global experiences suggest that RegLabs are neither necessary nor sufficient to advance collaborative, evidence-based FinTech policy and innovation ecosystems. ***While RegLabs have grabbed the headlines, the vast majority of regulatory innovation activities around the world are happening through informal engagement and market infrastructure initiatives.***

On this score, U.S. regulators are keeping respectable pace with their international peers. The Consumer Financial Protection Bureau, Office of the Comptroller of the Currency, Commodities Futures Trading Commission, and Treasury Department each have established initiatives for studying emerging technologies and facilitating informal exchange with innovators and incumbents. State banking and insurance regulators likewise have launched technology innovation-related initiatives.

Of course, these initiatives in isolation cannot solve for the extreme complexity of the U.S. regulatory architecture. More attention is needed to developing formal and informal channels for collaboration and knowledge sharing not only between innovators and regulators, but among regulators themselves. Industry sandboxes or other education-oriented testing services could help facilitate evidence-based discussions of new approaches to digital financial regulation and augment precious regulatory capacity to stay current on emerging technologies.

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Regulatory sandboxes have generated tremendous interest among financial regulators and industry participants alike. In so doing, they have exposed an underlying demand for a different approach to financial regulation – one that embraces a greater role for regulatory collaboration in the innovation process, while providing tangible benefits to entrepreneurs and incumbents through reduced cost and uncertainty. Whether or not RegLabs ultimately become a feature of the U.S. financial regulatory architecture, they provide a powerful metaphor for a new, collaborative approach to digital financial regulation.

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