

The case for an EU Regulatory Sandbox

Georg Ringe

5th Luxembourg Fintech Conference
10 October 2019

The topic

Main points

- How to regulate financial technology?
 - Financial technology and the speed of innovation
 - Regulatory uncertainty
- Proposal for sandbox, implementation within the EU framework

I. Challenges for fintech regulation

“Uncertainty”

- EU consultation (2016): **regulatory uncertainty**
 - Mifid etc: “written for a different age”
- EBA 2017: very different regimes across EU, 35% of fintechs under no regulatory regime at all
- Zetsche et al (2017); EU Commission (2017): MS interpret pieces of EU law very differently

“Uncertainty” no 2

Uncertainty for the regulator

- Risks and promises of fintech
- Lack of regulators’ sophistication and expertise in technology
- Many facts not yet apparent, to be monitored – e.g. consumer risks, market stability issues
- Fast-moving developments – EU legislation slow

Consequences

- barrier to entry
- barrier for potential investors & consumers
- may increase “time to market” by a third, at a cost of 8% of product lifetime revenue (Stern et al 2014)
- Problem for regulators, arbitrage possibilities.

II. How **should** regulation respond?

Starting point

Assessment of new technology frequently ambiguous

- Promises and risks of new business model
- Regulatory uncertainty; shortcoming of the framework; some unaddressed risks; high barriers to entry
- Dynamic solution needed that responds to immediate need – yet safeguards against risks
- Case for “**regulatory sandbox**”



Sandbox

Regulatory sandbox

- “controlled space” where firms can test and validate innovative products, regulation relaxed
- special safeguards for consumers
- limited period of time
- support and monitoring by authority
- “mutual learning” idea

Sandbox

Sandboxes in operation (inter alia):

- UK and NL, DK, Switzerland
- East Asia (incl. Taiwan, Japan)
- Australia, Canada

Common features

- **Entry requirements:** innovation factor, stability concerns, individual need; sectoral limitations
- **Consumer protection:** redress, ombudsman, compensation scheme
- **Time limitation**
- **Relaxation of regulatory burden:** waivers, no enforcement, discretion, guidance
- **Exit:** remove privilege, consumer exit

Advantages

- **Reduces market barriers**
 - shorter “time to market”
 - Addresses regulatory uncertainty problem
 - Lowers regulatory burden, encourages entrepreneurship -> fuels innovation
 - Greater incentives for start-ups, lower risk of being copied by larger rivals

Advantages

- **Institutionalised dialogue** between firm and regulator (mutual learning)
 - Regulatory learning – risks and benefits
 - Collection of data and experience
 - Creates culture of dialogue and cooperation
- **Signalling effect** – communicates regulatory flexibility and open-mindedness towards new technologies and innovative firms
 - UK sandbox contributes to London's pre-eminence as a fintech hub

Advantages

Benefits for regulators

- Better monitoring of market and individual firms
- Data collection, learning process
- Experimentation with RegTech/SupTech
- will inform macroprudential issues

Advantages

Benefits for consumers

- More innovation and competition – lower prices
- Regulatory uncertainty improved and consumer protection in place
- Increase “trust” in innovative products
- Increased competition – higher diversification – fosters stability

Advantages

Advantages over changing traditional regulation

- Experimentation character, overcoming regulatory agnosticism and knowledge dilemma (difficulty of cost-benefit analysis in financial regulation, Gordon 2014)
- Speed – in particular in the EU context
- Flexibility / possibility of subsequent change

But:

Disadvantages

- Costly, resource-intensive
- No panacea, no ultimate solution
- May not be credible if no strong regulatory expertise (Zetsche et al 2017) or sufficient staff
- Lack of transparency?
- Rule of law problem?

III. Specific proposal

Implementing the Sandbox

Additional problem in EU

- Multiple layers of legislation / regulation
- Sandboxes operating on Member State level cannot set aside EU legislation
- No true EU regulator who could undertake sandbox on EU level

Implementing the Sandbox

**Olivier Guersent, DG for financial stability
(September 2016):**

“We think we should dedicate a bit of thought to how we can have a sound regulatory sandbox approach in Europe that allows markets to develop, that allows innovation to flourish, that allows those companies that innovate to go across borders in the single market while being consistent with our framework”.

Implementing the Sandbox

Two possibilities

- (1) Introduce a genuine EU sandbox, either
 - fully operated at EU level, or
 - executed by Member States
- (2) “Guided sandbox”: sandbox at Member State level, coordinated by EU

Implementing the Sandbox

(1) Genuine EU sandbox

- Apparently some support by EU Commission
- Respondents to fintech consultation
- But: politically unrealistic
- Legal barriers (*Meroni*)
- Treaty change required? Long period of implementation versus time constraints

Implementing the Sandbox

A more realistic option

- European Banking Federation (EBF) 2016; Banking Stakeholder Group (BSG) 2017
- recommend harmonised framework for experimentation (with harmonised tools)
- i.e. establishment of level playing field for MS and participants, but execution within the power of national authorities
- Easier to implement yet still time consuming
- One-size-fits-all?

Implementing the Sandbox

(2) “Guided sandbox”

- MS sandboxes, coordinated by EU
- “guided policy implementation”: experimentation with sandbox concept itself
- ESMA could serve as
 - Monitor
 - Forum of exchange with experiences
 - Institution adopting guidelines and recommendations
- MS have incentive to experiment and compete

Implementing the Sandbox

Advantages

- Speed of adoption and flexibility
- ESMA's role initially – highlight where room for flexibility exists already now
- Future legislation may deliberately leave more room for manoeuvre
- Smaller MS would benefit disproportionately from ESMA guidance
- More sophisticated regulators may experiment themselves

Implementing the Sandbox

Multiple-level feedback process

- MS report back to ESMA
- ESMA's feedback to MS
- Market and competition as a source of feedback
- More sophisticated regulators may experiment themselves

Race to the bottom?

- If executed properly, market failures will be addressed
- EU law setting minimum standards
- Expect market learning process, MS specialisation

Follow-up regulation

Regulatory Trajectory

(1) Maintaining dialogue

- Build on positive relationship from Sandbox
- Maintain information and data exchange
- Increasingly monitor macro issues

(2) Addressing barriers *within* the market

- Identify inadequate obstacles and address them
- Accompanied + supervised scaling up
- Cooperation with other regulators (MoUs)

Conclusion

The case for a sandbox

- Helpful regulatory tool for uncertain, new phenomena
- Particular EU context – challenges
- Pragmatic proposal to implement on the MS level with EU guidance

Follow-up Trajectory

- Maintaining dialogue & information exchange, while addressing barriers to scaling up

Professor Georg Ringe
Director, Institute of Law & Economics
University of Hamburg
Johnsallee 35 | 20148 Hamburg | Germany
georg.ringe@uni-hamburg.de
<http://ssrn.com/author=836081>
www.ile-hamburg.de