Desciption of the issue

As new digital technologies emerge, opportunities are rapidly opening up for the financial sector to deliver better products and services for customers across Europe. Novel digital solutions – from mobile applications and electronic signatures to blockchain and machine learning – can enable banks and insurers to help customers in a more efficient, easier to use, transparent and supportive way. However, whilst technological change is fast paced, current regulatory and supervisory approaches in the financial sector usually lag behind innovation, and changes take a long time to develop and implement.

Regulators need to explore how to gear up in order to support innovation across its activities, working with industry and wider stakeholders. A more innovative approach should allow regulators to better understand the benefits and risks of new services before they assess the validity of the current regulatory framework. A first step on this journey is to consider the creation of regulatory sandboxes. In the information technology world, sandboxes are isolated environments used to test new or untrusted programs. Similarly, regulatory sandboxes are ‘safe spaces’ in which businesses can test innovative products, services, business models and delivery mechanisms without immediately incurring all of the normal regulatory burden of engaging in the activity in question. If appropriately implemented, they can make a significant contribution to innovation in financial services to the benefit of consumers.

The accelerated and low-risk learning process could serve as a compelling reason for regulators to provide well-structured, light-touch regulation in the sandbox. Authorities will be afforded an opportunity to learn alongside sandbox firms (financial and non-financial institutions alike) and better understand emerging risks. This approach enables a more forward-looking risk assessment, instead of regulators playing catch-up. Furthermore, increased regulatory understanding could streamline regulatory approvals and guidance, which would have a positive impact on innovation.

Regulatory sandboxes can indeed be of real benefit for both the industry and its clients. Testing new solutions or business models with real customers allows innovative firms to quickly learn, improve their value propositions, get more access to funding or, conversely, give up on non-viable ideas at an early stage. Real market testing is common practice in innovation ecosystems across industries, but it is particularly hindered in financial services due to the greater regulatory burden in terms of prudential requirements, consumer protection and financial integrity. Having to comply from the beginning with stringent requirements increases the time and cost to market and prevents some innovations from even being commercially tested. Moreover, as new services and business models sometimes challenge the existing regulatory framework, innovative businesses face regulatory uncertainty, which increases the risk for investors and thus makes it harder for these companies to raise funds. By providing regulatory flexibility and certainty at early stages, regulatory sandboxes have the potential to foster innovation in financial services and benefit both providers and consumers through increased efficiency and competition.
There are some initiatives aiming to introduce Regulatory Sandboxes that are currently taking place in different countries:

- The pioneer project was launched by the UK Financial Conduct Authority (FCA)\(^1\). Firms – small and large – could apply for the first cohort of the regulatory sandbox until 8 July 2016.
- The Monetary Authority of Singapore released a Consultation Paper on FinTech Regulatory Sandboxes Guidelines\(^2\) on 6 June 2016. Although the Singaporean approach is similar to the UK’s, MAS has also asked larger financial firms to provide ‘problem statements’ which then could be tackled by start-ups.
- The Hong Kong Monetary Authority recently announced the creation of a “fintech supervisory sandbox” as well as “Fintech Innovation Hub” to promote new technology.
- Finally, the latest consultations were launched by the Australian Securities and Investments Commission in its document “Further measures to facilitate innovation in financial services”\(^3\) and “Regulatory sandbox licensing exemption”\(^4\).

**Regulatory status**

The EFR welcomes the establishment of a regulatory sandbox by the UK FCA and urges the Commission/the ESAs to closely follow its development and look into the viability of creating a similar structure at the European level.

The need for a Europe-wide approach on sandboxes stems from the ongoing harmonisation of national frameworks, which is clearly against significant differences between national regimes. Moreover, national initiatives within Europe are bound by EC regulations that restrict the application of certain regulatory waivers that are also needed to develop early-stage innovation with certainty. This is the case of data protection regulations, which will be further harmonised and strengthened once the General Data Protection Regulation (GDPR) (Regulation (EU) 2016/679)\(^5\) enters into force. There is little doubt that this cannot be done in detriment of consumer protection, hence explicit consent from customers participating in sandbox experiments should still be required. Moreover, companies willing to innovate in a regulatory sandbox would still be liable for data breaches that might arise during the experimentation phase.

**Challenges**

- Regulatory Sandboxes are intended to allow testing of innovative financial products or innovative regulatory solutions, but should not be considered as a shortcut for any type of project. An assessment process must be established to determine that there is genuine need for a Regulatory Sandbox. It is also of interest to determine the feasibility of the project, its potential benefits for consumers or for the system as a whole, and its uniqueness.
- Since innovation projects often face regulatory uncertainty, one of the objectives of sandboxes is to provide clarity. This requires that each project must be reviewed on a case-by-case basis as participants needs might differ. One of the key challenges for regulators is how to leverage all participant needs with a minimum common framework in order to avoid arbitrariness and to be flexible enough to provide useful answers.

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1. [https://www.fca.org.uk/firms/project-innovate-innovation-hub/regulatory-sandbox](https://www.fca.org.uk/firms/project-innovate-innovation-hub/regulatory-sandbox)
• There is yet another challenge for regulators, related to setting basic measures that must be followed by companies already authorised and by new entrants that want to test their services, but are not authorised yet. The sandbox must be open to all innovators, but a minimum set of requirements must be established for all players to ensure a level playing field without stifling innovation.

• How to set up clear exit criteria is another concern. Within the sandbox, some regulatory requirements might be relaxed. However, once the project enters the market, it must comply with all applicable regulations.

• The Commission/the ESAs should work on aligning the guidelines with other regulators globally, to ensure the start-up environment is not unlevel globally and that there are no opportunities for arbitrage.

Proposed solutions

• Given the need to define the concept of regulatory sandboxes and to limit its scope, a common position in the European space is advisable. Therefore, the European Commission should issue a first document in which it states the need and potential benefits of Sandboxes for European citizens and firms, as well as how to address the coordination challenges linked to different regulatory and supervisory bodies being involved. There is a need to regulate the digital transformation of Europe and regulatory sandboxes can be a key tool to encourage this. We recommend that the final output of this process be harmonized tools that avoid national divergences in implementation and establish a level playing field for all countries and participants. A harmonized sandbox approach additionally would foster innovation in cross-border services, in the spirit of DG FISMA's Green Paper on Retail Financial Services.

• Regarding the process, clear and harmonized criteria for projects to enter the sandbox have to be defined and made publicly available, to avoid discretionery decisions. These criteria must define the requirements of eligibility for the applicant, and some key issues that the project must meet prior to application, such as: previous research and a testing plan that includes milestones, how to measure its success, testing parameters, customer and general safeguards (for data protection, security and confidentiality measures, eg. data anonymisation, limited and monitored access to the sandbox environment, etc.), risk assessment and exit strategy, as it is likely to enter the market. It must also include a check of ethical purposes, exclude certain particularly sensitive data and identify the volume of data that will be concerned. And, finally, the proposed project must be innovative with a short duration and verify that are not similar products or services already in the market where the sandbox operates. Multi-stakeholder projects should also be considered.

• The expected outcome of the sandbox from a regulatory standpoint should be a learning process in which a company successfully delivers an innovative new product or service while working with the regulator on how to apply existing rules in a novel area – which in some cases could lead to new regulatory or supervisory approaches. However, prior to accepting the project, it is important to analyse that the project’s success does not rely on changes of regulations beyond the authorities in charge of the jurisdiction. Otherwise, it would be impossible for the project to enter the market, where it will have to meet the whole existing regulatory framework.

• The approval process must be able to accept authorised companies and non-authorised companies. The latter will be able to test their projects but must accomplish a minimum set of guarantees to ensure a level playing field with established players. As soon as those companies enter the market, all players, must follow all the rules that apply to them.

• The scale of the activities carried out within the sandbox has to be limited to avoid additional risks to the financial system and for consumers.
• Each project must be analysed on a case by case basis. However, to avoid arbitrariness, a list of regulations that cannot be relaxed will be useful. These exceptions might be necessary because the authorities in charge of the sandbox are not empowered to create exemptions or because of consumer risk issues. This issue is of special interest because uncertainty could deter both companies and customers from entering sandboxes.

• The authorisation process has to be simple and transparent, with requirements that are proportionate to the activities the firm is going to conduct, and coordinated between all relevant authorities.

• There have to be waivers or modifications to particular rules if testing activities would otherwise breach them. If there is not a clear breach involved, the sandbox can give certainty by:
  - Issuing ‘no enforcement action letters’ by which the regulator commits not to take enforcement action during the testing as long as the firm follows the conditions agreed, while reserving the right to close the trial.
  - Providing individual guidance to firms on the interpretation of applicable rules in respect of the testing activities they aim to carry out.

• Once the sandbox is running, a clear supervision process must be established to guarantee that the testing company addresses the agreed milestones and to otherwise apply appropriate penalties.

• Success and failure for a project’s testing should be clearly defined before testing begins. Failure is an important part of testing in order for firms to adapt and continue to innovate without fear of enforcement action, and/or potential shutdown. Firms may be hesitant to participate in a sandbox if regulators are quick to shut down a project. Also, what happens if such an event occurs? Clarity on the consequences of such a halt and future testing of the project should be made available before testing begins.

• Finally, there have to be appropriate consumer safeguards, since real market testing involves risks of consumer detriment. These safeguards could include limiting testing activities to customers who have given informed consent to participate, providing customers of sandboxing firms the same rights as customers of other authorised firms, requiring firms in the sandbox to have the resources to compensate any losses to customers or agreeing on a case-by-case basis the disclosure, protection and compensation appropriate to each testing activity. It is also essential that customers are aware that they are in a test environment, have been informed of the risks and level of protection they are subject to, with the option to opt out upfront if they do not agree with those terms.

The European Financial Services Round Table (EFR) was formed in 2001. The Members of EFR are Chairmen and Chief Executive Officers of international banks or insurers with headquarters in Europe. EFR Members believe that a fully integrated EU financial market, a Single Market with consistent rules and requirements, combined with a strong, stable and competitive European financial services industry will lead to increased choice and better value for all users of financial services across the Member States of the European Union. An open and integrated market reflecting the diversity of banking and insurance business models will support investment and growth, expanding the overall soundness and competitiveness of the European economy.