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Regulatory sandboxes are going live

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Executive Summary

Regulatory sandboxes are gaining popularity as a framework for promoting financial innovation by cordoning off a sort of "safe space" for testing new business ideas within an existing regulatory regime. Regulatory sandboxes are expediting the financial sector's shift toward more consumer-responsive business models in the aim of better serving customers.

Regulatory sandboxes in the limelight

A regulatory sandbox is a safe environment for testing innovative financial products and services. While in the sandbox, the product/service being tested is granted forbearance from regulations that otherwise would apply. The regulatory sandbox framework is seen as a vehicle for public/private cooperation to promote innovation under the aegis of the government.

New entrants to heavily regulated industries typically lack certainty about whether their new ideas or business models fully comply with existing regulations. New entrants consequently tend to incur more costs and take longer to succeed in tightly regulated industries than in lightly regulated ones. The financial realm is indisputably one of the most heavily regulated sectors. In recent years, however, regulatory authorities seeking to strengthen their financial sectors' competitiveness in response to the FinTech boom have started to create a sort of "test drive" business environment (a.k.a. sandbox) to reduce regulatory uncertainties and, in turn, facilitate new entrants' market access. Against such a backdrop, the regulatory sandbox has emerged as a feasibility testing ground for new ideas and business models.

Overview of UK FCA's regulatory sandbox

The regulatory sandbox concept originated in the UK as one element of Project Innovate, a program of the Financial Conduct Authority (FCA). Launched in October 2014 to promote competition in the interests of consumers, Project Innovate was reportedly modeled after the US Consumer Financial Protection Bureau's Project Catalyst, which dates back to 2012.

Project Catalyst is tasked with addressing concrete issues facing consumers, including improving unbanked consumers' financial access (financial inclusion) and making payment services more consumer-friendly. The means by which it does so include data-based decision making and a flexible pilot testing process. These two features are shared by the UK's Project Innovate also. Project Innovate further refined the pilot testing process in the form of the FCA's regulatory sandbox. The regulatory sandbox process comprises the following steps.

First, a company files an application that presents a new business idea, discloses any concerns vis-à-vis the idea's regulatory compliance, and details anticipated improvements to the status quo. Upon receipt of the application, the FCA reviews its content and assesses whether it meets the regulatory sandbox's eligibility criteria (regulatory concerns are sometimes fully resolved at this stage). If the application is approved, the applicant and FCA jointly decide how to conduct the trial and agree on the scope of regulatory forbearance, the customer segment(s) to be served during the trial, the trial's duration and at least one key performance indicator (KPI) for measuring the new product/service's benefits. The FCA requires a quantitative target to be set for each KPI. The KPI for a new service to, for example, facilitate saving might be the extent to which low-income consumers' saving rate increased during the trial. A blockchain settlement system's benefits might be measured through daily monitoring of the percentage of transactions settled correctly and on time.

Once the trial begins, the KPI is periodically measured and evaluated. After the trial has reached its agreed-upon completion date, FCA staff assess whether the product/service yielded as much improvement as initially envisioned. If it did, the FCA starts working on deregulation to specifically accommodate the applicant. Meanwhile, the applicant decides whether to officially launch the trialed product/service.

If the product/service fails the FCA's assessment, the trial is terminated at that point. To avoid inconveniencing trial participants who have been actually using the trialed product/service, the applicant arranges in advance with an incumbent financial institution to provide the participants with a similar product/service in the event the trial ends in failure.

The FCA recently announced its regulatory sandbox's first cohort of trials. The first cohort comprises 21 business ideas being tested in the sandbox. They include blockchain-enabled financial services and a new prepaid-card payment network.

Interest in regulatory sandboxes spreading globally, even to Japan

Many countries are joining the regulatory sandbox bandwagon. Those that have announced their own regulatory sandbox initiatives include Singapore, Abu Dhabi, Hong Kong, Australia, Malaysia and Taiwan. In Europe, the European Banking Federation has notably called for legislation that would permit any EU-member country to adopt the regulatory sandbox framework. The Bank of Tokyo-Mitsubishi UFJ and Hitachi have announced that they are testing a blockchain-based check digitalization platform through the Monetary Authority of Singapore's regulatory sandbox program.

Even in Japan, government ministries and agencies have been talking about launching a regulatory sandbox program as they work on crafting policy responses to FinTech. In response to these discussions, the Industrial Structure Council in November 2016 published a detailed roadmap toward adoption of a regulatory sandbox. In 2017, the government reportedly plans to incorporate the regulatory sandbox concept into its national growth strategy for multiple applications, including financial services, artificial intelligence and community development (according to a January 6, 2017, Nikkei article).

Historically, financial regulation in Japan has been predicated on the status-quo financial system and has placed priority on objectives such as consumer protection, prevention of wrongdoing and operational stability. While Japanese regulators have inarguably been highly successful at achieving these objectives, the regulatory environment was not conducive to innovation driven by new entrants seeking to better serve consumers. In recent years, however, the Financial Services Agency has shifted to a more consumer-oriented policy stance. For instance, its policy objectives now include making the financial system more user-friendly for consumers. I hope Japan also embraces the regulatory sandbox model as a means of effectively promoting financial innovation.

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