5 Innovation and regulation

The need for a balanced framework

To take up the advantages of innovation, there is a need for a holistic approach that promotes new digital value propositions while protecting consumers and the financial system against the risks involved.

The digitisation of the financial sector is an opportunity to improve the efficiency of the system and to offer new value propositions to the customers. However, this digital revolution also raises new challenges for the stability and integrity of the financial system and for the protection of consumers.

Regulation and a more intensive supervision (compared to other sectors) are necessary in the financial sector, to achieve four main objectives: i) promote the stability of the financial system, avoiding systemic risk, bank runs and the malfunctioning of payment services; ii) maintain the safety and solvency of banks; iii) protect consumers of financial services, and iv) improve the efficiency and competition of the system. However, the promotion of innovation has often been a subsidiary objective for the authorities, if not completely disregarded. This means the digital transformation of the financial system often faces regulatory obstacles. In some cases these obstacles are explicit prohibitions, but in many others it is precisely the absence of a specific regulatory and supervisory framework which is stifling innovation. There are projects that do not fit easily into the existing regulatory framework, meaning they face an uncertainty which is either delaying projects (awaiting the approval of the authorities) or blocking them before their launch onto the market to avoid regulatory risks, because of the legal uncertainty and lack of trust being generated.

To take up the advantages of innovation, there is a need for a holistic approach that promotes new digital value propositions while protecting consumers and the financial system against the risks involved. This requires a breadth of vision on all interested parties, both public authorities and the private sector, that could exploit these opportunities, overcoming the obstacles that currently exist.

Communication between the authorities and the private sector is a key pillar of the process. For this to be effective, the mechanisms for dialogue need to be simple and agile. Thus, one could coordinate a service for companies provided by the authorities to guide them in their dealings with the regulatory and supervisory framework. A kind of *regulatory hotline* would thus be set up that would allow entities to understand how regulation affects a particular activity or business model, resolve specific questions or receive help with filing applications or meeting requirements. This service would involve formalising a specific channel for the resolution of regulatory uncertainty in a defined period of time which is consistent with market innovation cycles.

In addition, the authorities need to have appropriate environments for experimentation (increasingly known as "*regulatory sandboxes*"). These would be used by the authorities, traditional operators and new entrants to test new technologies and business models with real customers, without having to bear the full weight of regulation from the outset or wait for it to be defined. This means that the authorities would provide some flexibility and regulatory certainty in a controlled environment in which the tests are limited in terms of substance and time and there are special forms of consumer protection. This would help both players. On the one hand, companies could try out innovative solutions earlier (and with lower costs), and on the other, the authorities could get to know these innovations better, understand their benefits and risks, and identify any necessary changes in the regulatory and supervisory framework.

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