POLICY SPOTLIGHT

Fintech Sandboxes: Promoting Innovation, Encouraging Competition

BRIAN KNIGHT | MAY 2021

Innovation and competition in lending helps improve access to credit, especially for borrowers poorly served by the traditional market. However, regulatory burdens and uncertainty in the financial sector can cost companies money and make them risk averse. For innovators, regulators, and consumers, fintech (financial technology) "sandboxes" can potentially offer a win-win-win solution.

Sandboxes provide an experimental environment for companies to test new products or services in a laxer regulatory environment—and to pass the benefits on to the consumer. This can be extremely valuable in financial services, given the high levels of regulation and high barriers to entry. Furthermore, sandboxes offer regulators an opportunity to get a better understanding of where markets are going, rather than forcing regulators to play catch-up when something breaks down.

WHY SANDBOXES ARE AN INCREASINGLY COMMON FEATURE IN GLOBAL REGULATION

The United Kingdom is credited with creating the first regulatory sandbox for financial services, with other nations such as Australia and Singapore following shortly thereafter. In this country, states such as Arizona, Utah, and Wyoming have been leaders in the establishment of fintech sandboxes.

Requirements for regulatory sandboxes can vary, but they generally share these features:

- They are temporary.
- They are for a limited number of consumers.
- They contain provisions for consumer protection and compensation.
- Sandbox participants are required to share information with regulators regarding their operations

The benefits of sandboxes include the following:

- Innovators have a place to test whether their products and services work before deciding to launch on a large scale while limiting their regulatory uncertainty.
- Regulators get the advantage of increased transparency and insight into the cutting edge of financial services and can help innovators design with compliance in mind.
- Consumers stand to benefit from increased competition and innovation.

BUILDING A BETTER SANDBOX

One concern about sandboxes is that relaxing regulatory standards will increase the chances of harm to consumers. However, a well-executed sandbox would require participating firms to be able to compensate consumers in the event of failure. Likewise, the agency administering the sandbox must be able to adequately vet and supervise participants.

Another concern is that sandboxes could grant an unfair regulatory advantage to firms that manage to gain admission. For example, those firms might have greater access to funding and greater exclusive access to the expertise provided by regulators. In addition, regulators might develop a practice of being stricter on firms that do not participate in a sandbox.

The risk that sandbox access becomes a "golden ticket" can be reduced by doing as follows:

- Grant relatively broad access.
- Make sandbox administrators justify their decisions to reject applications.
- Provide maximal transparency with regard to any legal or regulatory guidance provided to sandbox participants.
- Do not regard nonparticipation as evidence of bad faith on the part of firms.

KEY TAKEAWAY

Regulatory sandboxes aren't lawless wastelands—they're laboratories for developing commonsense approaches to regulation. To be sure, there are risks, but those can be mitigated with proper design and execution. There is also a risk to doing nothing, especially for those underserved by the status quo. Increased use of sandboxes in financial services can increase innovation and competition to the benefit of Americans.

FURTHER READING

Brian Knight, "Innovation and Competition in Lending Improves Access to Credit" (Testimony before the House Committee on Financial Services, Mercatus Center at George Mason University, Arlington, VA, February 5, 2020).

Brian Knight and Trace Mitchell, "The Sandbox Paradox: Balancing the Need to Facilitate Innovation with the Risk of Regulatory Privilege" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, March 2020).

Brian Knight, "Fintech Regulation Needs to Keep Pace with Economic and Technological Evolution" (Testimony before the House Committee on Financial Services, Task Force on Financial Technology, Mercatus Center at George Mason University, Arlington, VA, September 29, 2020).

Brian Knight, "How to Build a Good Regulatory Sandbox: Four Principles to Help Policymakers Get It Right," *The Bridge*, April 17, 2019.

ABOUT THE AUTHOR

Brian Knight is the director of Innovation and Governance and a senior research fellow at the Mercatus Center at George Mason University. His research focuses on numerous aspects of financial regulation, including the creation of pro-innovation regulatory environments, the role of federalism in fintech regulation, the use of digital assets for financial transactions, the role of regulation for credit markets and consumer protection, and the provision of capital to businesses.

MERCATUS CENTER
George Mason University

WWW.MERCATUS.ORG