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Regulatory Sandboxes for the (Single) Market in Financial Services: A Need for a More Coordinated Approach?

By Egert Juuse & Ringa Raudla ¹

Introduction

Global financial markets have witnessed drastic changes in the recent past. One of the major changes has been the emergence of **FinTech**² industry, which has significantly blurred the boundaries between traditional financial activities and institutions. Moreover, the surge of FinTech has had revolutionizing effects on finance and undermined the underlying foundations of the conventional financial regimes by introducing real-time payment systems, distributed ledger technologies, lending marketplaces, etc. (González-Páramo 2017; Omarova 2020a). Thereby, the growth of the FinTech industry has presented new challenges for the regulators and supervisors at the national level, especially in the context of EU member states, where financial markets are among the most heavily regulated (and supervised) areas by the EU level. One of the recent initiatives among EU member states in addressing FinTech has been the adoption of a **regulatory sandbox**³. To some extent this novel instrument embodies the possibilities to address the most pressing challenges FinTech industry poses to regulators and supervisors – comprehending the functioning of new technologies, addressing systemic risks, protecting consumer/investor interests, and promoting competition and innovation, all at the same time.

That said, as of 2020, six EU member states had adopted a regulatory sandbox, while six others were rapidly moving towards introducing one (Parenti 2020). Heterogeneous adoption of this tool across EU member states reflects a cautious regulatory approach in terms of passive observation followed by piecemeal adjustments, where ‘smart’ regulation calls for a constant ‘contextualizing’ and ‘customizing’ of legal rules to match individual market developments (Omarova 2020a). At the same time, the role of European Union authorities’ amounts to an

¹ The authors retain the copyright to this policy paper.

² FinTech can be regarded as an umbrella term that generally refers to ‘technology-enabled innovation in financial services with associated new business models, applications, processes or products, all of which have a material effect on the provision of financial services’ (FSB 2022).

³ Regulatory sandbox provides a ‘safe space’ for FinTech businesses and financial firms to offer real products to real customers with the benefit of a waiver, or a significant relaxation, of otherwise applicable regulations. Sandboxes are typically justified as a means of supporting consumer-benefitting financial innovation, facilitating financial inclusion, improving the efficiency and competitiveness of domestic financial institutions, and advancing regulators’ own understanding of the emerging innovative technologies (ESA 2018; Omarova 2020b).

‘interested observer’ status rather than that of an active participant, shaping national strategies or performing a coordinative role (Smoleńska et al. 2020), which is opposite to formalization and centralization tendencies in the integration dynamics of the European Banking Union (Eckert 2022; Raudla and Spendzharova 2022). All this implies that regulatory progress at EU member state level is uneven, resulting in a patchy regulatory framework in the internal market across member states (see Ahern 2021). This, in turn, may create regulatory fragmentation and result in inefficiencies when introducing such innovative tools as regulatory sandboxes.

While there are various factors behind the uneven use of sandboxes among member states, the current policy paper⁴ seeks to unpack some of the shortcomings and drawbacks in introducing regulatory sandboxes by the EU member states, which raise the question of the role of the European Commission and call for considering alternative approaches at the EU-level for addressing the emerging challenges.

The World of Uncertainties

The evidence from the international experience provides some insights into the potential pitfalls related to the introduction of regulatory sandboxes. Several studies (see Tsai et al. 2020; ESA 2018; Jenik and Duff 2020) have indicated that the legal system, regulatory culture, and risk-averse tendencies play a crucial role in affecting the adoption of regulatory sandboxes and may impede the capacities to implement them. In particular, it has been observed that competent personnel and adequate resourcing are crucial, since establishing sandboxes is resource-intensive due to complexities in determining the eligibility criteria for the companies, designing a solid exit strategy, and simplifying administrative procedures, while an ongoing maintenance of the sandbox can be costly (see Ahern 2021; UNCDF 2018; UNSGSA FinTech Working Group and CCAF 2019). Based on some country studies and interviews with national policy-makers conducted in the framework of a research project on experimental policy-making, we can observe that smaller EU member states tend to face insufficient staffing as well as lacking competences in relevant public institutions. The interviews suggest that the available time and financial resources are consumed by other responsibilities arising from EU requirements. Thus, in light of the reasoning of utilizing the economies of scale, an argument could be made for a more centralized and coordinated handling of regulatory sandboxes. As stated by one senior civil servant in Estonia, there is a need for “a central agency that knows how things work in theory or has a practical exposure in relevant situations and hence, has skills and knowledge in terms of what input is needed and who should be involved for experimentations.” This is all the more pertinent to the fact that regulatory sandboxes presume strong inter-organizational coordination due to cross-cutting issues that go beyond the direct sphere of a single supervisor’s responsibility (see Appaya and Luskin Gradstein 2020; UNSGSA FinTech Working Group and CCAF 2019).

At the same time, in the context of a meagre interest from the market side or a small number of participants in the existing sandboxes at the national level, there are risks of generating insufficient returns on investment to justify the spending of public funds for that purpose. Here, the report by the World Bank and CCAF already from 2019 was relatively critical about

⁴ The policy paper draws on the published studies about regulatory sandboxes on the international arena as well as findings from interviews conducted with policy-makers in Estonia and Finland.

sandboxes, pointing out that a lot of resources are spent on sandboxes, but they often do not offer more than innovation hub formats (which offer consulting services to FinTech companies). Hence, the biggest challenge of most existing sandboxes – from the point of view of the test environment – is to find a solution that would offer real value to both the participating companies and the regulator.

Another source of intimidation among national policy-makers is a ‘multi-dimensional’ uncertainty. First, as has emerged in the case of Estonia, there is a lacking clarity about the mandate in the existing legal framework in terms of having or not having the authority to run sandboxes as testbeds. The key source of hesitation is the question of legality, which concerns discretionary powers to impose testing constraints, grant temporary exemptions and having powers to adjust regulations (Appaya et al. 2020; Appaya and Luskin Gradstein 2020). The latter, in turn, is related to rigid legislative standards and various layers of legal instruments at the EU level. These layers of EU regulation render the possible scope for sandbox rather narrow and thereby, increase uncertainty about the relaxation of a regulatory burden in a sandbox platform. Moreover, the EU’s financial rulebook appears to be both over- and under-inclusive, as many categories used by it are difficult to match to the activities of the new type of financial players. There is a patchwork of different rules and requirements that apply differently to FinTech businesses, depending on the EU member state they are operating in. This, in turn, creates uncertainty not only among market players, but also for the regulators (Ringe and Ruof 2020). In such circumstances, supervisors may offer tailored arrangements where the national law offers rooms for interpretation or the legislation explicitly provides the scope to do so, which eventually limits the leeway for experimentation by member states (Ringe and Ruof 2018). As acknowledged by one civil servant, “in Estonia, the percentage of our own financial regulations is so small that practically there are a few cases where we could make some deviations.” At the same time, while the majority of established sandboxes in the EU member states do not allow the carrying out of regulated activities by companies without prior authorization and licenses, some countries have bypassed this principle, as acknowledged by policy-makers. As a result, while facing the boundaries set by the EU harmonization, the latitude in waiving certain regulatory requirements or applying them in a flexible way varies among member states (Parenti 2020).

Finally, there seems to be varying perceptions among national policy-makers about the nature and purpose of a regulatory sandbox format. Some conceive it as a testbed, while others see it as a monitoring, consultation or assessment platform for either meeting the objectives of enhancing innovation, or even for serving PR and marketing motives. While these blurring lines entail a conflict between the actual expectations of market participants and the possibilities of supervision, to some extent they reflect the shift in the role of regulators and supervisors in the sandbox from a gatekeeper to a quasi-compliance consultant or an ally (see Ahern 2020). What is noteworthy, though, is that PR and marketing motives tend to pressure national policy-makers to come up with sandbox formats that entail an added value compared to existing sandboxes on the international arena. As stated by a policy-maker in Estonia, “...otherwise, lagging countries might send a signal to the market, or leave an impression of being late with their actions and not being an innovative state.” Such a line of thought is another factor that contributes to a fragmentation in sandbox approaches in the EU member states.

Aside from the factors related to resource shortages and uncertainty, the downside of the regulatory sandbox at the member state level concerns the potential for a regulatory arbitrage

between countries, i.e. market participants weighing between different jurisdictions and opting for the one that provides a more favourable regulatory treatment for doing business (Allen 2020). In addition, one cannot neglect the potential regulatory “race to the bottom” tendencies and costs associated with a government-granted economic privilege to selected FinTech companies that could lead to distorted markets and cronyism (Knight and Mitchell 2020; Omarova 2020b). Furthermore, it has been found that the aspect of trust may impede information sharing among sandbox implementers on the international arena, implying an undermined regulatory learning among policy-makers (see Allen 2020; also Alaassar et al. 2020). The latter issue can be clearly witnessed in the context of the EU regulatory harmonization and the limitations stemming from the peculiarities of small states that tend to be in a policy-taker position rather than policy-makers (Juuse et al. 2019).

The EU’s Approach to Regulatory Sandboxes

Fintech Action Plan⁵ by the European Commission established progressive objectives for the EU institutions back in 2018, but at the same time concluded that “the case for broad legislative or regulatory action or reform at EU level at this stage is limited”. As such, the proposed actions in the plan largely eschewed the establishment of new specific regulations or institutions in favour of a process of mapping the regulatory landscape, establishing best practices, and reviewing the impact of related regulatory frameworks such as the General Data Protection Regulation (GDPR) and Digital Single Market strategy in the context of Fintech. In line with the plan, the European Supervisory Authorities (ESAs) have been asked to map the current authorizing and licensing approaches for innovative FinTech business models, and issue, where appropriate, guidelines on such approaches and procedures. Likewise, their role has been primarily to observe and map FinTech facilitators, such as regulatory sandboxes, in member states and identify best practices about these facilitators. Thus, the competent EU institutions and the ESAs have been addressing different issues by setting up mainly expert working groups and fora, but also by issuing communications, announcements and guidelines. Here, in relation to regulatory sandboxes, the European Forum for Innovation Facilitators (EFIF), facilitates dialogue among supervisors and encourages discussion on approaches within the EU and with third countries on the regulatory treatment of technological innovations.

Thus, in light of an absent legal framework for FinTech at the EU level and as a stopgap measure in the absence of a *sui generis* regulatory regime tailor-made for FinTech (see Ahern 2021), the majority of EU member states have established national facilitator programmes, including regulatory sandboxes, which are envisaged to encourage public–private interaction and information sharing.

Alternative Sandbox Scenario at the EU Level

In light of the above-mentioned regulatory and supervisory challenges at the national level, continuing with a mere facilitation of stakeholder dialogue might give way to further fragmentation and create inefficiencies. Thereby, a more harmonized approach at the EU level (see Ahern 2021, Ringe and Ruof 2020) by issuing soft recommendations or guidelines for

⁵ See <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0109>

operation of national sandboxes or even having fully harmonized rules on sandboxes could be justified. It needs to be noted that a move towards a more top-down, centralized approach by adopting an EU-wide, cross-border regulatory sandbox would not be unprecedented, as on the 14th of February, 2023 the European Commission launched a regulatory sandbox that establishes a pan-European framework for regulatory dialogues to increase legal certainty for innovative use cases involving Distributed Ledger Technologies⁶. The foundation for such a different approach is provided in the above-mentioned FinTech Action Plan that mandates the European authorities to monitor national initiatives and perform a coordinative role. Likewise, the new regulatory initiatives by the Commission such as Enforcement Action Plan or Single Market Enforcement Task have been set up for addressing the uneven enforcement across the member states and hence, for better implementation of the single market (Raudla and Spendzharova 2022). From the EU level, the rationale for paying more attention to the issue of regulatory sandbox is the potential of this instrument to imply a 'win-win-win' strategy for a more efficient EU Single Market in finance. First, companies can be expected to be keener on trying out new products and services that could potentially improve EU-wide competition. Second, the EU regulatory framework can benefit from the use of these sandboxes via better understanding the costs, benefits and risks of new ideas. Lastly, consumers may enjoy the benefits of efficiency gains and obtain access to more competitive financial services (see González-Páramo 2017). All in all, as stated by Raudla and Spendzharova (2022, 2), "the recent EU-wide crises have exacerbated already existing regulatory challenges requiring more supranational harmonization, such as the development of common standards..."

Conclusions

With the advent of FinTech industry during the post-2008 Global Financial Crisis era, the issue of regulatory uncertainty and misfit has sharply come to the surface. This has prompted national policy-makers to react with innovative instruments such as regulatory sandboxes. However, the EU's regulatory landscape and the hands-off approach on governance matters have caused regulatory friction and also increased uncertainty among policy-makers about what is allowed and what not within a sandbox testbed. Moreover, in light of varying legal and institutional contexts of the EU member states, lacking human and financial resources as well as shortcomings in capabilities, the EU level approach, which is confined to supporting the stakeholder dialogue might not resolve the issues of fragmentation and inefficiency. Hence, for the benefit on EU Single Market integration, alternative pathways need to be considered, including the option of a more harmonized and coordinated line of action.

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⁶ See <https://digital-strategy.ec.europa.eu/en/news/launch-european-blockchain-regulatory-sandbox>

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