

More room for innovation in the financial sector

Market access, authorisations and supervision: Next steps *AFM – DNB*

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DeNederlandscheBank

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Introduction

Innovation is a vital ingredient for any healthy market economy. Only by constantly innovating, by reinventing themselves and what they offer, will companies be able to keep meeting the needs of consumers. The financial sector is no exception: in the Netherlands, the industry is innovating and increasingly undertaking new initiatives. The AFM and DNB are looking to help it do just that, and we have spent the past few months exploring the possibilities.

Many stakeholders have shared their thoughts and ideas on our joint discussion document "More room for innovation in the financial sector". Taking on board their input, we have fleshed out a range of options which we present here. Following the launch of our InnovationHub in June 2016, this is a concrete next step in our drive to align our supervision to the new landscape.

Tailored policy options

Our June document outlined three policy options that may facilitate market entry for new and innovative financial services or activities provided by new or established players in the market. We have spent the past few months developing and fine-tuning these options, which can be put into practice from January 2017.

The first of these options is what we have called a "regulatory sandbox", which leverages the scope offered by the law when interpreting the rules. This implies that, from now on, we will take our cue from the purpose of a rule, while we will also review established policies with new (technological) developments in mind and adapt these where necessary. This should allow us to accommodate innovation that actually contributes to our supervision objectives as much as practicable.

For consumers and market operators alike, robust supervision remains a vital prerequisite for sustained confidence in established and new financial services or activities. So we will not relinquish our standards, merely review and fine-tune them to accommodate innovation.

To facilitate access to the Dutch financial sector, banks could also take advantage of partial authorisation going forward, for instance if they do not plan to take on all the activities covered by the authorisation. Opt-in or provisional authorisations might also prove to be options that offer the best solution for some initiatives.

Our sincere thanks

We have received many responses to our discussion document in the past couple of months and would like to thank all who responded for their suggestions and replies. These have provided us with greater insight into common practice, helped sharpen our focus and proved useful when fleshing out policy options.

To read all the responses, go to our InnovationHub at [Reacties marktpartijen en stakeholders](#) (Dutch only).

Continued focus on innovation

We greatly value active dialogue with all our stakeholders and – in addition to this initiative to better align our supervision with a changing financial sector – we are constantly seeking to expand and enhance our knowledge of technological innovation in order to embrace opportunities while closely monitoring risks.

1. Regulatory sandbox: a bespoke arrangement

The AFM and DNB wish to offer a bespoke service enabling market operators to roll out their innovative financial products, services or business models without undue obstacles.

By focusing more on what rules are actually trying to achieve, we can create greater scope to remove unnecessary supervision barriers.

Regulatory sandbox in brief

The core premise of the regulatory sandbox is that supervisors will focus on the real purposes of policies, rules and regulations when assessing innovative products, services or business models. And that if these purposes are met, they will use the scope offered by the law to provide a bespoke solution.

Examples of sandbox supervision include alternative interpretations within the legal framework of open standards or formal dispensation from specific legal requirements.

Here are a few questions and answers to explain our new regulatory sandbox approach.

1. Who is it for?

The regulatory sandbox is available to all financial services companies looking to operate an innovative financial product, service or business model, whether supervised players or newcomers. Such innovations may result from the application of technology (FinTech), but this is not a prerequisite for qualifying for the sandbox, whose scope is decidedly broader than just FinTech. The sandbox is open to all innovations that stand to contribute positively to a stable financial sector, smoothly operating financial markets and the sustainable financial well-being of consumers and investors.

2. When is it put in place?

If a financial services company cannot *reasonably* meet specific policies, rules or regulations, when marketing an innovative product, service or business model, but does meet their underlying purpose, it can take advantage of the sandbox.

Of course, the term *reasonably* is key. Supervisors will be the judge of whether or not companies cannot reasonably meet specific policies, rules or regulations, and this is done on a case-by-case basis. The application of a regulatory sandbox will closely depend on the circumstances, but a few examples may help to clarify this:

If a financial services company has a demonstrably better way of achieving policy aims, supervisors may find that it is unreasonable to impose on the company a strict application of the current interpretation of such policies.

Sandbox example

A financial services company demonstrates that it meets the aim of sound and ethical operational management using blockchain technology, in a different but actually more efficient and better way.

One might also think of an innovation that creates an entirely new situation not envisaged by the law, while it demonstrably meets the law's underlying purposes, such as when market practices change. Supervisors may find it unreasonable to impose a strict application of the law in such a case.

Sandbox example

An innovative type of asset management enables customers to gradually build their wealth through incremental amounts, with the investment company conducting a step-by-step inventory of customers' financial position, knowledge, experience, objectives and risk appetite as time goes on. If supervisors find the investment company to be acting in the spirit of the law, i.e. to be scrupulously observing its duty of care, they may judge that it is unreasonable to demand the same thorough initial intake process as is customary in asset management where initial outlays are substantially steeper and a full profile is drawn up at a first meeting.

3. What criteria apply?

To guarantee the security of the financial system as much as possible, financial services companies must meet a number of criteria and will be eligible for the sandbox if the following preconditions are met:

- i. The innovative product, service or business model contributes to one or more of the objectives of the financial supervision laws:
 - The solidity of financial services companies and stability of the financial system
 - Orderly and transparent financial market processes, clear relationships between market operators and careful treatment of customers¹
- ii. The application of the innovative product, service or business model runs into unnecessary policy or legal barriers that the financial services company cannot *reasonably* overcome, although it does meet the underlying aim of such policies or laws.
- iii. The financial services company's corporate processes include procedures and measures to protect the solidity of the financial services company, the interests of those buying its financial services or products and of any of its other stakeholders.

These procedures and measures ensure that the use of the innovative product, service or business model:

- Is clearly described and defined, and that clear timelines are in place, including when it starts and ends
- Is sufficiently developed to be fit for use in a realistic environment; the financial services company must prove that the product, service or business model is ready
- Does not endanger the sound and ethical operation of the financial services company if it fails. Adequate control measures, including a viable exit plan, should meet this requirement

¹ Pursuant to Section 1:24(1), and Section 1:25(1) of the Financial Supervision Act (*Wet op het financieel toezicht – Wft*).

4. How it works in practice

Applying for the sandbox

The regulatory sandbox will be available from 1 January 2017 and financial services companies will be able to apply to the AFM and DNB at any time. Such requests are confidential and will be treated as such.

For more information and informal guidance, operators may consult the AFM and DNB InnovationHub.
Terms and conditions

The supervisor in charge will determine how and under what conditions the sandbox can be put in place, and how such arrangements are recorded will depend on the type of sandbox agreed. That said, both the financial services company and the supervisor will be clear beforehand on how the arrangement is set up, how long it will remain in place and what terms and conditions apply.

Where the sandbox involves a divergence from a specific regulatory rule, requirements or restrictions may be imposed on the authorisation or dispensation granted to the financial services company.

Suspending or changing the sandbox

The supervisor will monitor the application of the regulatory sandbox and will at any time be able to partially or wholly end, change or constrain the sandbox, or impose additional requirements. It will do so when circumstances emerge or facts become known on the basis of which any tailored arrangement would have been turned down if these circumstances or facts had emerged or been known before the time at which the sandbox was set up.

Evaluating the sandbox

After a pre-set period – the length of which may differ on a case-by-case basis – the supervisor will evaluate the sandbox provided.

Depending on the type of arrangement, the supervisor may find that the sandbox, including any constraints and requirements:

- (1) Needs adapting
- (2) Can stay in force indefinitely
- (3) Should be discontinued

One element of the evaluation is that the responsible supervisor will assess whether the sandbox requires any changes to established policies, rules or regulations. If it does, it may be declared generally binding or enforceable, for instance by adapting a regulatory rule or its application. Obviously, supervisors have more room for manoeuvre when such a change affects the regulator's own policies rather than rules not set by them. In the latter case, supervisors may urge a change in the rules at national or European level.

Supervisors' options for adapting, continuing or discontinuing a sandbox differ per type of arrangement. When granting a dispensation, for instance, the law specifies in detail when this may be cancelled or changed.

Real-world example

In parallel with its supervision of crowdfunding, the AFM has made specific recommendations to lawmakers as to how the law and supervision could grow and develop in keeping with this market.

Charges

The regulatory sandbox will not involve any extra charges, but newcomers will be charged for authorisations and established operators will pay for regular supervision in compliance with the Financial Supervision Funding Act.

Transparency

As the regulatory sandbox applications are confidential, the AFM and DNB will not be able to communicate about them. However, it may be useful for the market to know about examples of sandbox arrangements, in terms of both their actual substance and of developments in the applications process. DNB and the AFM will therefore report regularly on developments in the regulatory sandbox framework, and will do so in a fully anonymised – i.e. non-traceable – fashion.

5. Will supervisors monitor innovations outside the regulatory framework?

Occasionally, innovative company activities do not require authorisation, e.g. when exemptions apply. However, it may still be useful and relevant to get supervisors involved in the experiment, as early involvement adds value for when such operations are brought into the financial legal and regulatory framework following successful experimentation. A rule of thumb: the likelier the innovation is to become part of the financial legal framework, the greater the involvement of the supervisors should be.

Sandbox example

A company is looking to use blockchain technology for trading financial instruments and may draw on virtual instruments representing virtual values to test the technology. While this puts the test outside the legal financial framework, getting the supervisors on board could help identify the benefits and drawbacks of the technology. The added value to the company will be that the supervisors will be familiar with both the company and the initiative should it proceed to an authorisation application.

Examples of legal sandbox scope and constraints

Supervisors will make every effort to make the best possible use of any (legal) scope for the sandbox, but not all situations allow for bespoke arrangements. Read on to find out where we see scope and constraints:

- Supervisors will have most room for sandbox manoeuvre in terms of their own policies, e.g. in the interpretation of open legal standards.
- This applies to a lesser degree to policies set by the European Supervisory Authorities (ESAs). Depending on the nature and detail of the guidance, supervisors may deviate from the guidance, or interpret or impose it in a different way, always providing they are able to demonstrate that legal and regulatory aims (laws, directives and regulations) are being met in an alternative fashion.

- In terms of national legislation, supervisors may offer tailored arrangements where the law offers scope, if it provides for any dispensations from certain regulatory rules, or because some regulatory rules are open standards that offer room for interpretation and allow for different circumstances.
- In terms of laws agreed in a European context, supervisors will only be able to offer tailored options in as much as this legislation provides scope to do so. Innovations that do not meet European rules and regulations at maximum harmonisation are therefore out of sandbox scope.
- Supervisors will only be able to offer bespoke arrangements to financial services companies within their supervisory remit, and the regulatory sandbox is only possible in the framework of prudential issues on which the ECB has exclusive competence if the interpretation is supported by the Single Supervisory Mechanism (SSM).

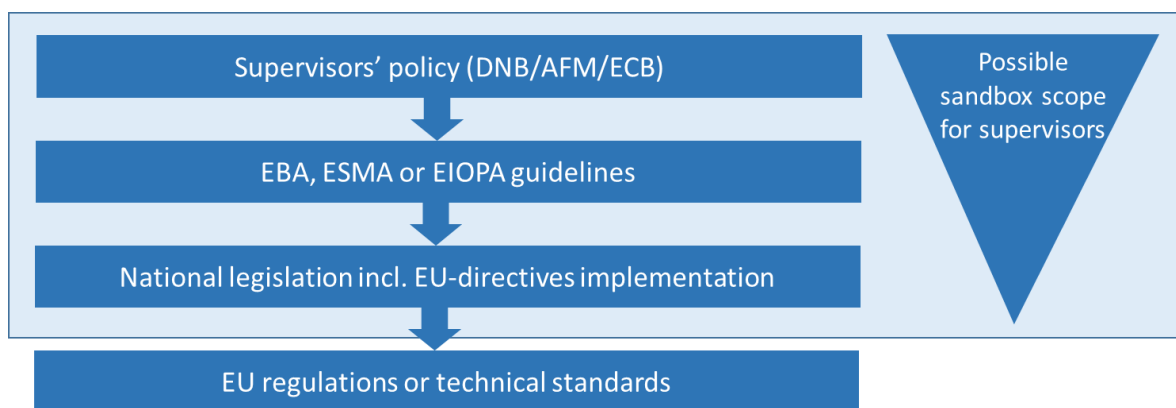


Figure 1. Overview of potential barriers to innovations and sandbox possibilities

2. More room for innovation: Other options

Aside from the regulatory sandbox, rather more orthodox methods are available to offer room for innovation. The discussion document touched on the possibilities of partial authorisation and opt-in authorisation, while “authorisation with requirements” is also a way to create room for innovation that is already in use at the AFM and DNB.

Partial authorisation

Supervisors may grant partial authorisations to financial services companies, in some cases for a predefined period. In fact, the AFM has been consistently applying this method in the real world, while DNB has a similar solution in place for insurers and payment institutions. DNB will now also be more open to granting partial authorisations to banks.

A partial authorisation may be useful if a financial services company does not immediately wish to engage in all operations governed by an authorisation and to which rules apply. This may be a temporary situation, for example if the company’s operations are not yet suited to conducting all authorised activities. But partial authorisations may also be a rather more permanent set-up, when a financial services company is a specialist niche player, for instance. Whenever a partially authorised financial services company wishes to expand its activities, it can always apply for an authorisation pertaining to those activities and so develop towards a universal authorisation step by step.

Partial authorisation in brief

As its name suggests, a financial services company seeking a partial authorisation only has to meet the requirements applying to the specific activities it wishes to engage in.

In practice

The partial authorisation complies with the Dutch Financial Supervision Act (Wft) and applies to institutions for which the law envisages authorisations being granted by activity. In addition to universal banking licences, banks will also be able to apply for partial authorisations going forward.

Authorisation with requirements

The AFM and DNB can offer bespoke arrangements by issuing authorisations with requirements and restrictions. These may differ on a case-by-case basis.

When authorising an investment firm, say, the AFM may specify target customers by issuing a requirement, e.g. that the firm is to serve professional clients only. This is one way to specifically tailor the authorisation to the firm’s activities.

DNB may impose a requirement or restriction on an authorisation to give a company scope to engage in preparatory work. The security offered by such authorisation should make it easier for a financial services

company to invest in its operations and to recruit the right people to help start activities that are not yet operational. This it can typically do more quickly when properly authorised.

Opt-in authorisation

Opt-in authorisation is already set down in Dutch law². This type of authorisation may prove useful in specific cases, in particular for operators that are not banks but that do wish to engage in one or both activities as described below.

Opt-in authorisation in brief

An opt-in authorisation may be the best way to go for companies whose business it is to:

- a. Receive and hold repayable funds from parties other than the public and to grant credits for their own account
- b. Receive repayable funds, not including credits, and to invest these for their own account

In practice

Opt-in authorisation holders are treated as on a par with banks and may use the word 'bank' in their name or when conducting their business. Activities governed by the opt-in authorisation may only be carried out in the Netherlands.

All regulatory rules governing regulated banks also apply to opt-in banks. The business model as described under a. may be set up in such a way that the company has access to the Target 2 interbank payment system.

Although an opt-in authorisation may be the best solution in specific cases, the regulatory sandbox is much more likely to meet companies' needs and offers more scope for innovation than an opt-in authorisation.

² Section 3:4 of the Financial Supervision Act (Wft).

3. Exit strategies

A robust exit strategy is a key element of the regulatory sandbox, partial authorisations and opt-in authorisations for banks.

Supervisors may require the financial services company to draw up an exit strategy envisaging an orderly market exit if market entry proves unsuccessful. If certain risks are well covered, supervisors will be better placed to customise a solution to the authorisation application.

New market entrants are already asked to provide an exit plan. The purpose of an exit plan is to identify how the company can cease business operations without harming others. Adequate exit plans could contribute towards an increase in new entrants, as authorisation may be granted when there are still residual risks. A robust exit plan guarantees that the public will not have to foot the bill and that financial stability will not be in jeopardy if the business fails.

Any exit plan should:

- Identify the possible and most likely causes of the business failing
- Identify triggers that will set in motion the exit plan
- Describe the decision-making process and procedures that will follow once the exit plan is activated
- Identify the team or crisis team that will execute the exit plan
- Describe how the exit plan may be performed in an orderly fashion and offer at least one alternative if the basic scenario proves not feasible for any reason
- Identify essential functions that will need to continue once the exit plan is activated
- Identify contracts that must be upheld and those that must be terminated
- Include a communications plan to accompany activation of the exit plan
- Describe how ongoing customer relationships will be wound up with due care

In conclusion

We look forward to putting all ongoing innovation projects into practice. As supervisors, we will be doing this in close co-operation and we continue to welcome feedback from the market.

We greatly value active dialogue with all our stakeholders and – in addition to this initiative to better align our supervision with a changing financial sector – we are constantly seeking to invest in our technological innovation expertise. After all, any robust assessment of both opportunities and risks requires in-depth expertise in innovation. Going forward, our InnovationHub will be considering matters such as big data, algorithms, customer identification, and duty of care in digital and payment services in 2017.

At international and European levels, we continue to press for responsible innovation in the financial sector. Both the AFM and DNB are active players in this arena through our participation in international working groups and by sharing and disseminating our views.

Lastly, we will try to make sure that future legislation reflects the latest trends and will urge changes to current laws and regulations where necessary.