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# The Freedom to Innovate in Complete Safety: A Regulatory Renewal to Promote Tomorrow's Growth

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The ending of the Bretton Woods accords in 1971 marked the beginning of a long process of financial deregulation and globalisation. The financial system continued to evolve and innovate, enabling banks to improve their profitability and market share. But it remains true that innovation, the source of social progress, is a risky activity that has to be managed at the risk of fuelling instability. The history of the last three decades serves as a testament to the adverse effects of unbridled financial innovation. Faced with this threat, a safeguard proved necessary: regulation.

The banking system is one of the pillars of the real economy, financing individuals and enterprises. However, the multiple risks nestled in the core of its activity are a source of instability when they are underestimated or inadequately managed. Concerned about establishing a high degree of safety, national and international supervisory authorities have developed a regulatory framework aimed at ensuring that banks put in place appropriate risk management systems. Prudential rules have gradually evolved in response to past financial crises in order to take account of the ever-changing economic and financial environment. Since 1988, regulations have been continuously revised in attempts to thwart, with only limited success, the circumvention strategies put in place by banks by means of innovative products. The trilogy of Basel accords testifies to the evolution of the international prudential system whose primary task is to promote financial stability and creditor protection. Adopted in 1988, the Basel I accord introduced the concept of the solvency ratio or the Cooke ratio for the first time. This first regulatory draft was not perfect and certain pitfalls appeared, particularly as regards the scope of the risks covered. The Basel I accord was then revisited, giving rise in 2004 to Basel II, built around three interdependent and complementary pillars. The Cooke ratio gave way to a new capital ratio and we were now in the era of the McDonough ratio. This second accord aligns capital requirements with risk measurements and entrenches best practice in terms of risk management. The first two volumes of the Basel accords relied on a founding principle: a financial system was robust if its individual components were robust. This represented the advent of microprudential regulation.

To circumvent such regulation, banks used all their ingenuity to refine innovative and often complex products whose perception of risk escaped them and contributed to an increase in instability and even helped the next crisis to emerge. This is particularly the case with securitisation, identified as the catalyst of the subprime crisis. This financial crisis reached such a magnitude that the authorities had to intervene to limit its impact on the real economy and bail out a number of financial institutions. The founding principle of the first two Basel accords collapsed like a house of cards: financial institutions might have seemed robust while the system was not. Systemic risk came to the fore and the stability of the financial system as a whole became the priority. The supervisory authorities unpicked global risk in all its dimensions: transversal and temporal in search of an innovative principle based on the fundamentals of the golden rules of the two preceding accords. Relative equilibrium was abdicated in favour of general equilibrium and regulations were enriched with the macroprudential strand through the third chapter of the Basel accords, Basel III. Regulators prepared for battle to promote global financial stability by equipping themselves with dedicated revolutionary tools (contracyclical measures, liquidity ratios, etc.).

The 2008 crisis marked a turning point in the regulatory saga and also a paradigm shift in the financial system. The post-crisis period – characterised by desperately low interest rates, favourable to the erosion of intermediation margins and a frantic quest for yield – also experienced a technological shock. Long regarded as a support function, after 2008 technology became an engine of financial innovation. Careful blends of financial services and technology, fintechs really understood this and profited from an environment of mistrust of banks among the general public, particularly the younger generations, making their appearance on territory often regarded as the preserve of the financial institutions. The transition to the digital era also spelt the end of the banking monopoly, and barriers fell with the entry onto the financial market of new players arousing envy and fear. This new financial ecosystem represented a strategic challenge not only to banks since it revolutionised their business model but also to the supervisory authorities: how were they to ensure that regulations remained appropriate to new entrants?

The positioning of the regulators with respect to fintechs was crucial if innovation was not to be curbed while ensuring safety at the same time. Technological innovation, entailing new risks, some of them operational, necessitated the installation of suitable management. Particular attention had to be paid to the fight against fraud, the risk of money laundering and the financing of terrorism. The recent advances within the European Union have gone in this direction with the May 2016 report of the Economic and Monetary Affairs Committee on virtual currencies and the European Commission's proposal of 5 July to include virtual currencies in anti-money laundering arrangements. However, the regulatory approach used has still to be harmonised and different paths have emerged to deal with technological innovation. In Europe, the new Eldorado for fintechs is to be found in London, boosted by the international influence of its financial centre.

It is, therefore, no coincidence that the UK regulator revisited its framework conditions with a head start over its European counterparts. The FCA  has adopted two-speed regulation, providing a specific approach to fintechs. The sandbox principle, in place since 9 May 2016, enables entrepreneurs to test new ideas without applying strict regulation to them. While favourable to innovation, this initiative raises quite a few questions, particularly that of the frontier between the sandbox and common regulation. Another, more nuanced path, which is preferred in France, aims 'to adapt regulation to the size and risks incurred by players'  with a view to ensuring safety while at the same time assisting fintechs. With regard to Switzerland, an innovation-friendly country, regulatory work has also begun.

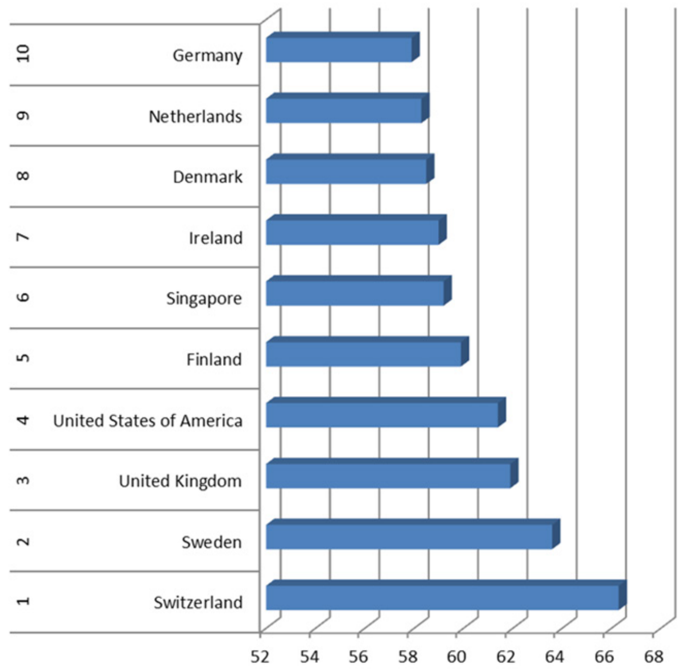


**Exhibit 1: Top 10 Global Innovation Index 2016**
(https://www.globalinnovationindex.org/)

Fintechs in Switzerland are not in a regulatory no man's land but are subject to anti-money laundering requirements and FINMA authorisation depending on their activity. To ensure that all players are placed on an equal footing, the Swiss regulator has been reviewing its prudential framework conditions. In light of this neutral approach as regards technology, FINMA has reviewed its regulation and dropped certain obstacles by authorising in particular video and online identification  and the possibility of concluding an asset management mandate in digital form. FINMA plans to go further by defending the creation of a new category of authorisation for players not conducting specifically banking operations as well as a free authorisation field, sandbox, intended for start-ups not necessitating any authorisation up to a deposit threshold of CHF 200,000. The Federal Council confirmed, in its communiqué of 20 April 2016, an initial exemption concerning crowdfunding platforms. It also tasked the Federal Department of Finance with examining the need for regulation in this area.

Prudential regulation is often criticised on account of its unwieldiness, its invitation to be circumvented and its delayed effect, reforms very often being made only after the crisis. Since 2008 regulators have turned a corner and extolled the motto that says that prevention is better than a cure. Financial innovation has also evolved, mainly confining itself to complex products until 2008 and now focusing on the digitisation of financial activities. Fintechs have penetrated this regulated market, breaking the bank's historical monopoly. This change in the centre of gravity of financial activity has not escaped the attention of the supervisory authorities, who have decided to support them while at the same time maintaining a high standard of safety. However, the proposed arrangements vary from one jurisdiction to the next as fintechs lack frontiers and can easily be relocated.

**Author's Bio**

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Florence Anglès trained in econometrics and is a graduate from the Toulouse School of Economics. Florence Anglès is also a qualified statistician with a diploma from ENSAI (Ecole nationale de la statistique et de l'analyse de l'information). She has been a CAIA charterholder since 2007 and became a certified RGCP (Registered Global Credit Professional) in November 2014, awarded jointly by the ICTF (The Association of International Credit and Trade Finance Professionals) and Thunderbird School of Global Management.

She has spent most of her career in risk management within the banking sector, beginning her career in Paris and participating in a Basel II project for Société Générale. She then worked in risk management for KPMG in Brussels, where she piloted a number of projects for major international banks responding to regulatory changes such as Basel II and Solvency II. In 2009, Florence set up the rating model validation unit, in compliance with FINMA requirements, at Banque Cantonale Vaudoise. She then joined Deloitte Switzerland at the end of 2012 as Senior Manager in charge of Risk Management practice prior to being appointed as Head of Risk Management at REYL Group.

Further to her professional commitments, Florence Anglès is highly active within a number of voluntary organisations. She is a Chapter Executive in Geneva of CAIA Switzerland, ambassador Toulouse School of Economics in Switzerland, Board Member of BPW (Business and Professional Women) Switzerland in charge of Women on Boards and financial innovation strategies, member of "club de lecture" Prix Turgot in Paris and a consultant for the Prix Strategis in Switzerland. She also recently co-founded GIROS, an association of Swiss chief risk officers, which is a working group promoting awareness among risk managers regarding the most pressing topics and enabling members to share good market practices.