

Regulators' Forum

Regulation and Innovation

How can regulators encourage innovation? Several regulators are required, by statutory objective, to promote competition and, in the UK, there will be an obligation for all regulators to promote economic growth. So how can regulatory agencies ensure that innovation enhances competition and consumer choice without being seen to 'pick winners' and risking the downgrading of regulatory standards?

The area of licensing and authorisation is one central area of regulatory activity. How to encourage and promote innovation is, therefore, for some regulators a central activity, especially as they are supposed to fulfil a variety of statutory objectives that include consumer protection, the integrity of markets and systems, as well as the promotion of consumer(s') interests. Soon, UK regulators will also be required to promote economic growth. At the same time, regulators are often faced with large and diverse sets of regulatees, forcing them to make decisions as to how and where to allocate resources in particular activities. How then can regulators develop mechanisms that encourage innovation in the market? Establishing a system that supports innovation has a number of potential benefits; it enhances the relationship between regulators and regulatees, and provides the regulator with additional information as to the kind of technological and business model developments that are occurring, and also enhances the standing of regulators vis-à-vis other stakeholders.

One of the key insights from regulatory practice is that there is usually little complaint about 'regulatory burdens', but that there is concern about lack of communication and contact. The issue, therefore, is how to handle this demand for more interaction between regulators and individual businesses. In the context of supporting innovation, one key regulatory task, therefore, is to support access to the market by reducing potential obstacles arising from a lack of information about regulatory requirements and lack of access to regulatory advice. This requires a good understanding of the 'ecosystem' in which market innovation is taking place. This often demands going outside the usual 'comfort zone' and encountering different types of businesses. The key problem one encounters is that small innovators usually do not know where to start when it comes to regulatory requirements. They lack direct access to advice, and when they receive the 'normal' regulatory advice, this advice is usually framed in risk-averse and 'fence-sitting' terms so as not to jeopardise legal requirements. To encourage innovation, regulators are therefore required to provide spaces in which there can be advice to potential innovators on what they need to do so that they do not struggle with the understanding of compliance requirements. In other words, this is about 'regulatory consultancy' and offering a 'help-desk'.

Such advice cannot be interpreted as a way to undermine legal requirements and regulatory standards. Providing advice cannot (and must not) be used as a 'get out of jail' card in future encounters with regulators. There are, therefore, a number of devices that one can use - such as 'sandbox' where innovation is allowed to be applied in a highly constrained space (by granting a

highly limited authorisation), thus offering the equivalent conditions of a 'controlled trial'. A 'sandbox' to encourage limited trial and error processes needs to be placed in the context of national and EU provisions. Encouraging 'sandboxes' is about maintaining regulatory standards, not about reducing regulation or 'deregulation'. Emphasising the importance of maintaining standards was also critical for ensuring support from consumer protection advocates.

Similarly, it is important to be able to exercise 'informal steers' by giving candid and quick advice that, however, is given on the understanding that innovators have to utilise that advice at their own risk. This bargain between regulators and innovators is critical - the understanding is that there is a trade-off between speed and (legal) reliability of advice and that innovators will value speed in particular. This advice is also given in confidence (backed by criminal sanction) - and permission has to be granted to allow innovators to share the regulatory advice with third parties. At the same time, giving 'informal steers' is potentially tricky for regulators, especially if one has, or is expected to have, a reluctant appetite for risk.

A final aspect is to ensure a smooth handover once the process of advice-giving is over and the process moves into the 'normal' authorisation process. This can be coupled with continued advice and monitoring during the initial launch of the product. Such 'handover periods' therefore included not just authorisation, but also involved supervision functions. The 'advice' function should therefore be seen as a hub-type function dependent on interacting with other parts of the regulatory organisation.

Offering 'regulatory consultancy' to encourage innovation raises questions as to how to handle 'demand' for such activities. It is not always possible for regulators to provide such advice functions to all potential 'innovations'. This requires an evaluation as to whether the proposed innovations are indeed 'plausibly innovative' by offering new products or an interesting re-combination of existing products.

Such choices are inherently discriminatory, and making choices between ideas that have been classified as 'innovation' and those to be treated as 'normal' generates two classes of regulatees. Some regulators do not seek to discriminate between types of innovations, others are more discriminatory. There will always be a need to justify this discrimination in legal terms, but it can be justified by the regulatory objective that such advice 'promotes competition'. There is an argument to be had as to whether the support for innovation should be discriminatory on the basis of the nature of the business (such as size, or background of the innovators) - some regulators focused on the innovation itself at this stage, as other aspects would be identified in other stages of the authorisation process.

When looking at proposals, it is important to have some idea as to how to discriminate: not all proposed innovations are good for consumers and it has to be asked whether innovations support informed customer choices. Furthermore, it is not the job of regulators to pick winners, rather it should be expected that most innovations will eventually fail in the market place. When looking at proposals, it is usually quite easy to discriminate between those that are little more than marketing, others that need to be explained in more detail, and those that offer extensive analysis as to why their proposals represent 'innovation'. Making these decisions would arguably be more problematic if such decisions fell under judicial review. More generally, the inability to offer advice to a larger set of actors placed a burden on offering advice functions to small firms in particular.

It is, therefore, also an issue to decide to what extent the support for innovation raises tensions with other regulatory objectives; for example, it might have implications for customer protection. Some innovations do raise issues about how to regulate these new markets. There might also be tensions between the desire to promote innovation and wider government objectives.

Most of all, the experience of supporting innovation processes was evidence that regulation was usually not seen as a barrier. Instead, engagement with the regulator and being accredited were seen as a status symbol. This demand for advice conflicted with the wider environment that demanded rationing of regulation. In the area of innovation, regulation therefore provided a confidence-building device for emerging markets, but at the same time it could also act as a deterrent for late entrants into markets. This might therefore lead to a shoring-up effect for the initial entrants.

Finally, there is also an issue as to what kind of regulator would be able to provide innovation-supporting advice. There might be questions about the extent to which customer groups were vulnerable or unable to voice concerns, and the extent to which there were established processes at hand that could be utilised.

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