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PROPOSAL

Future Insurance Technology (FIT) Lab, a US regulatory sandbox solution

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1 Introduction

The challenge is the same across many industries globally—how do we address new, innovative ideas in an environment that is strictly regulated? In other less-regulated industries, companies introduce new products and concepts can be discontinued almost as soon as they are launched. The venture capital start-up model is especially precarious—90% of startups fail.¹

Members of the banking and insurance industries safeguard the assets of people and organizations, and therefore do not have the flexibility to experiment as other industries might. Innovation in providing better services at lower costs is a desirable goal, but not at the expense of consumer confidence and protection.

2 Regulatory sandboxes across the world

In an effort to address innovation in regulated industries, other countries have developed an approach called a “regulatory sandbox.” The goal is simple—to lower the barriers for testing of new ideas, and to ensure the risks are not transferred from businesses to consumers.² The form varies from country to country to align to the needs of the market.

2.1 United Kingdom

Announced in the **UK** in May 2015, the Financial Conduct Authority (FCA) offers a regulatory sandbox aimed at providing clarity around applicable rules before testing a

¹ Neil Patel, *90% of Startups Fail: Here's What You Need to Know About the 10%*, FORBES, Jan. 16, 2015, available at <http://www.forbes.com/sites/neilpatel/2015/01/16/90-of-startups-will-fail-heres-what-you-need-to-know-about-the-10/#10bacf8d55e1>.

² Christopher Woolard, Address at Innovative Finance Global Summit (Apr. 11, 2016), available at <https://www.fca.org.uk/print/news/speeches/innovate-finance-global-summit>.

novel idea.³ The sandbox offers participants individual guidance, possible waivers or modifications to FCA rules, and letters of no enforcement action. In return, the FCA closely monitors a pilot of limited duration with defined boundaries.

The FCA sandbox is not for everyone though—out of the 69 companies that applied, only 24 were accepted into the first class.⁴ The FCA evaluates criteria through an application process, including the ingenuity of the innovation, the benefit to consumers, the readiness of the product, and the need for FCA guidance.

2.2 Australia

Australia followed the UK's lead by announcing discussions of a sandbox exemption in March and a formal proposal in June.⁵ As a natural extension of the Australian Securities and Investments Commission (ASIC) Innovation Hub, the sandbox exemption allows ASIC to assist with speed to market issues and organizational competence requirements. ASIC proposed to provide examples of how they assess organizational competence and allow start-ups to test certain financial services for six months.

2.3 Switzerland

The **Switzerland** Financial Market Supervisory Authority (FINMA) announced in March that it would introduce a new licensing category for innovators and a license exempt area, or sandbox.⁶ This would be for businesses which carry out some banking activity, but limited acceptance of client assets and did not allow lending activity. Businesses which accept less money would be able to apply for an innovator's license and would be required to hold a certain amount in collateral. Innovative platforms such as payment systems and crowdfunding would meet these lesser requirements.

2.4 Singapore

In June of this year, The Monetary Authority of **Singapore** (MAS) proposed guidelines for a sandbox that would enable both financial and non-financial institutions to

³ Regulatory Sandbox, Financial Conduct Authority (Nov. 17, 2016), <https://www.fca.org.uk/print/firms/project-innovate-innovation-hub/regulatory-sandbox>.

⁴ JD Alois, *First class: FCA Reveals 24 Fintech Firms Accepted into Regulatory Sandbox*, CROWDFUND INSIDER, Nov. 7, 2016, <https://www.crowdfundinsider.com/2016/11/92162-first-class-fca-reveals-24-fintech-firms-accepted-regulatory-sandbox/>.

⁵ 16-185MR ASIC Consults on a Regulatory Sandbox Licensing Exemption, Australian Securities & Investments Commission (June 8, 2016), <http://asic.gov.au/about-asic/media-centre/find-a-media-release/2016-releases/16-185mr-asic-consults-on-a-regulatory-sandbox-licensing-exemption/>.

⁶ FINMA Reduces Obstacles to Fintech, FINMA (Mar. 17, 2016), <https://www.finma.ch/en/news/2016/03/20160317-mm-fintech/>.

experiment with fintech solutions.⁷ Participants will have regulatory requirements relaxed for a certain well-defined space and duration. The MAS analyzes the applications using criteria such as the innovativeness and the potential for wide-scale deployment across Singapore. The benefits are expected to include a reduction in regulatory friction and a safer environment for experimentation.

2.5 Malaysia

Malaysia followed shortly after the MAS announcement with a similar sandbox discussion, but also focused on the track record of the institution, a preference for start-ups collaborating with current financial institutions, and a preference for cooperation rather than disruption.⁸ Upon the successful completion of the one-year sandbox pilot, the Bank Negara Malaysia (BNM) has indicated it would consider changing regulations to allow for a successfully proven new idea or business model.

2.6 Hong Kong

In a different approach, the **Hong Kong** solution would only be available to banks and not start-up fintech firms. Hong Kong announced a regulatory sandbox in September that would allow companies to pilot “new fintech products without the need to achieve full compliance” with supervisory requirements.⁹ By focusing on testing of the technology, risk management, consumer protection, and monitoring by the Hong Kong Monetary Authority, the Hong Kong sandbox is a suitable solution for one of the top three financial hubs in the world.

2.7 Thailand

Thailand also announced in September that it would be pursuing a fintech regulatory sandbox that would allow commercial banks to apply first, with non-bank financial firms and technology companies applying afterward.¹⁰ The sandbox is not intended for smaller companies which are encouraged to join incubators. The goal of the sandbox is to share information about, and shape, regulation. The sandbox will guide participants on how to shape the products, enabling them to quickly receive licenses.

⁷ MAS Proposes a “Regulatory Sandbox” for Fintech Experiments, Monetary Authority of Singapore (June 6, 2016), <http://www.mas.gov.sg/News-and-Publications/Media-Releases/2016/MAS-Proposes-a-Regulatory-Sandbox-for-FinTech-Experiments.aspx>.

⁸ Nizam Ismail, *A Tale of Two Cities – Regulatory Sandboxes in Malaysia and Singapore*, LINKEDIN, Aug. 2, 2016, <https://www.linkedin.com/pulse/tale-two-cities-regulatory-sandboxes-malaysia-singapore-ismail>.

⁹ Michelle Chen and Michelle Price, *Hong Kong to Launch Banking Fintech “Sandbox” as Rivals Pull Ahead*, REUTERS, Sep. 6, 2016, available at <http://www.reuters.com/article/us-hongkong-banks-regulator-idUSKCN11C0EV>.

¹⁰ Erin Hobey, *Brief: Thailand Finally Pursues Fintech, Preps Regulatory Sandbox*, CROWDFUND INSIDER, Sept. 22, 2016, available at <http://www.crowdfundinsider.com/2016/09/90443-brief-thailand-finally-pursues-fintech-preps-regulatory-sandbox/>.

Although many international authorities have recognized that an inflexible regulatory scheme reduces opportunities in innovation, the authorities who have proposed or implemented these frameworks have the authority to implement a national solution. Financial and insurance regulation in the US involves a complex system of laws and regulations providing no uniform solution to addressing innovation.

3 The banking innovation approach of the US Office of the Comptroller of the Currency (OCC)

Many international authorities have regulatory responsibility over both financial entities and insurers within their jurisdictions. As the prudential regulator of the US federal banking system, the OCC released a paper supporting responsible innovation among national banks and federal savings associations.¹¹ While innovation in an essential system such as banking carries risk, the paper acknowledges that appropriately managed risk should not impede progress. In defining responsible innovation, the OCC stressed that innovation be deployed in a way that is consistent with sound risk management.

Although receptive to a sandbox-type concept in the paper, the OCC comptroller clarified in November that the OCC vision for a collaborative innovative environment does not involve the creation of a “safe space” in which compliance with regulations is loosened as the OCC does not have the authority to waive compliance requirements.¹² Although fintech companies opposed the banking system in the past, there has been a migration toward fintech companies partnering with banks or taking steps to become banks. Even with this movement, the OCC is hesitant to issue national bank charters to fintechs, and has yet to define what conditions a fintech company must meet to receive a charter. The Comptroller assures that fintechs will be held to the same high standards of safety, soundness, and fairness other chartered institutions have met in the past.

The OCC is encouraging an open dialogue between companies and regulators in developing a pilot that is limited in scope and duration and closely monitored. The Comptroller stated that this open dialogue would help product designers to ask the right questions as they design the product and test parameters. Designing the pilot with the regulator also “helps regulators understand the precautions that companies have taken to ensure new products and processes are safe and sound *and* meet consumer protection standards.”

¹¹ SUPPORTING RESPONSIBLE INNOVATION IN THE FEDERAL BANKING SYSTEM: AN OCC PERSPECTIVE, OFFICE OF THE COMPTROLLER OF THE CURRENCY, *available at* <https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-responsible-innovation-banking-system-occ-perspective.pdf>.

¹² Thomas J. Curry, Address at Chatham House “City Series” Conference, “The Banking Revolution: Innovation, Regulation & Consumer Choice” (Nov. 3, 2016), *available at* <https://www.occ.gov/news-issuances/speeches/2016/pub-speech-2016-142.pdf>.

Although the OCC regulates a necessary and complex industry, it is intent on creating a structure for piloting innovation within the boundaries of current regulations. Similar efforts could be made to reduce barriers within the insurance industry approach to innovation.

4 Need for an insurance US regulatory sandbox solution

When introducing a new concept to the insurance industry, many times the concept falls into ambiguous areas of law. Interpretation of statutes and regulations requires deep knowledge of the industry, and can be misinterpreted when applied to new and innovative products. Even for incumbent insurance companies, launching a novel product often falls outside of areas that statutes and regulations explicitly address.

Traditionally, insurers invest many resources in developing a new product to the point where it could be filed with a state department of insurance. When a novel product is first introduced to a department through a filing, the regulator is likely to have questions and concerns about various parts of the product. At this point, the insurer must reform the product or provide further information to the regulator to allay concerns. Would the insurer have formulated the product differently having identified potential concerns at the outset of product development instead of at the completion?

When an insurtech start-up seeks capital to launch a new idea, the start-up generally seeks to improve consumer experience or reduce prices through a novel approach to insurance. New entrants to the insurance market often find the regulatory environment confusing and unnavigable. By not providing a channel through which start-ups can seek regulatory guidance, consumers may lose a novel innovation that would have improved processes or offered services to traditionally underserved markets.

Disruptive and novel innovations surprise not only incumbent companies, but often surprise regulators who were not involved in the product development stages of a new product. A consistent and open dialogue with state regulators will allow them to stay current with the changing insurance industry—and even contribute to innovative efforts.

With the need of incumbent insurance companies to clarify ambiguities around innovation and the requirement that new entrants properly navigate the insurance regulation environment, the industry has the opportunity to create a solution that will encourage open communication with regulators.

5 Characteristics of a proposed US sandbox solution, FITLab

The US has a unique insurance regulatory system and market that makes it difficult to apply the structures of the regulatory sandboxes already present elsewhere in the world. In other regulatory sandbox models, a central authority helps the entity to navigate regulations and in some cases grants exemptions. The US insurance regulatory environment has no central authority, and navigation through the rules and regulations of the numerous jurisdictions is difficult even for an established insurer with a standard product.

The goals of regulatory sandboxes are 1) to lower the barriers for testing of new ideas and 2) to ensure the risks of new endeavors are not placed on consumers. A structured approach to discussing innovative products early in their development would provide protection for consumers while benefitting regulators who help to shape the future of insurance and product developers eager to introduce new innovations.

Many new products proposed within established insurers and start-ups stall internally due to uncertainty surrounding regulator interpretation. The few products that make it to a filing stage may then be delayed due to unforeseen concerns of regulators arising only during a product review. The first stage of lowering barriers for the testing of new ideas is to facilitate an honest and open dialogue between the company creating the product and the regulators who will review the product in the future.

Instead of a regulator sandbox that facilitates the product development and piloting of new products, a US solution such as the FITLab could provide a “safe space” for open communication between industry and regulators surrounding new innovative efforts. Conducted three times a year at each NAIC meeting, the FITLab would allow entities wishing to receive regulator feedback on innovations to “pitch” their ideas and concepts to a small group of interested regulators. The session and discussion would be facilitated by the NAIC through a confidential application and scheduling process, assuring participant anonymity.

In order for honest and open dialogue to occur in the FITLab environment, both the company and the regulators involved would need to agree that no actionable items will result from the discussion—in other words, what happens in the FITLab stays in the FITLab. Regulators will leave with no commitments from the company, and the company will leave with no commitments from the regulators.

The goal of FITLab is the sharing of knowledge. For the regulator, candid and honest discussion will allow the regulator to build knowledge around upcoming innovations in the industry. For the company, discussion will give insight into regulator concerns surrounding the product at the outset of development, allowing the company to address concerns before significant resources have been invested.

While other regulatory sandbox solutions also facilitate the development and monitoring of pilots, FITLab would be a gateway through which interested state regulators may approach the presenting company to discuss piloting the innovative product in their state. In the current environment, it is difficult for the creator of an innovative product to identify states that would be interested in working with the company to launch a pilot. By receiving introductory information about the FITLab proposals in advance, each state may express interest in participating in a specific session—then follow up with the company after the session to discuss moving forward.

Establishing goals of the industry in proceeding with a regulatory sandbox is step one in creation of a solution. All stakeholders must have an opportunity to contribute thoughts and ideas to drive toward an actionable framework that can be implemented in the future.

6 Munich Reinsurance America, Inc. (Munich Re, US) can facilitate the creation of the US regulatory sandbox solution

One of the fundamental elements of a successful venture is the participation of stakeholders in the creation of the program. However, a common difficulty encountered by unsuccessful ventures is delay caused by the lack of a facilitator focused on enabling and expediting the realization of a goal. As an industry leader in innovation, Munich Re has the experience to coordinate and facilitate the creation of a regulatory sandbox solution. Through the collection of ideas industrywide and the coordination of a Design Sprint, Munich Re can facilitate regulatory sandbox initiative leaders in the design and implementation of the first iteration of a regulatory sandbox solution.

An idea campaign is a challenge that organizations set to engage their network on a specific set of questions.¹³ Using an internet idea campaign platform, Munich Re can assist leaders of the sandbox initiative with posing questions to the insurance industry around the pivotal aspects of a regulatory sandbox solution. After receiving ideas, comments, and suggestions around the regulatory sandbox solution, sandbox initiative leaders can identify key stakeholders available to participate in a Design Sprint.

A Design Sprint is a five-phase exercise invented by Google Ventures to reduce inherent risks in implementing a product or process.¹⁴ By clearly defining goals and setting time limits at each step, the Design Sprint has been used to shortcut discussion cycles that can slow the development of a process without significantly improving the final results. With the utilization of industry experts at key points in the Sprint, many stakeholders are able to contribute while a core team drives the Sprint through to completion.

¹³ Idea Campaign, Idea Scale, <https://ideascale.com/service/idea-campaign/>.

¹⁴ The Design Sprint, Google Ventures, <http://www.gv.com/sprint/>.

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Stakeholders identified by the leaders of the sandbox initiative can participate in the Design Sprint either as a part of the core team or as a contributing expert. The core team will commit to the time and space required to conduct a Sprint, and will consult contributing experts remotely throughout the process. Through the five phases of the Sprint, the core team will design the structure of the regulatory sandbox solution using the ideas contributed by the industrywide idea campaign and the guidance provided by contributing experts.

By facilitating a regulatory sandbox solution, Munich Re hopes to lead the effort to lower the current barriers to innovation in the insurance industry. Open communication and feedback between innovators and regulators will drive our industry into the future while protecting the interests of consumers and the industry at large. This will be the first step in forging the future of our industry, and Munich Re looks forward to collaborating with stakeholders to guide the industry through this great achievement.

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