

Fintechs, insurtechs and the mistake of having a sandbox

It is a consensus that currently we experience, in several aspects of the social and economic life, the disruption of the paradigm brought by the new technologies and business models associated with the globalization, the Internet, and the digitalization of the relations.

In this context, the supervisors of the financial system and the insurance market have to understand how and where these sectors are going. And this is happening locally and also within the ambit of associations such as the Financial Stability Board – FSI, and the International Association of Insurance Supervisors – IAIS.

One of the initiatives undertaken by many supervisors is the so-called “sandbox.”

By and large, the sandbox is an environment controlled by the supervisor in which supposedly innovative and/or disruptive projects are subject to specific approvals associated with specific limits.

In the sandbox, the companies operate specific projects after obtaining special licenses, with limitations to their operation areas and subject to a permanent and special attention of the supervisor. On the other side, the supervisor operates in a collaborative fashion, making an effective and safe innovation viable for consumers, stakeholders, and even potential investors in innovative companies.

Indeed, the supervisor’s concern not to upset but rather to collaborate with the innovation environment is excellent news.

All the more so because, due to its responsibilities, the supervisor tends to be conservative and restrain the speed and the intensity of the innovation processes whenever it understands that the desirable level of security is at risk.

As it happens, the conservatism is an inherent aspect of the supervision and cannot be removed from it even in a differentiated environment such as the sandbox.

Additionally, since innovations are a

challenge, to a greater or lesser extent, to the traditional market, the supervisor cannot allow itself to be engulfed by a more conservative view that it may find in the regulated market or, at least, in a part of such market.

In fact, in an innovation environment, the supervisor, likewise a scientist, should try to interfere the least possible, especially when it recognizes, as in the case of the fintechs and the insurtechs, an element for the development of the supervised market.

So, one might ask, what stand should the supervisor take?

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Over the past two decades, the banking and insurance supervisions underwent important transformations, due to very distinct elements such as confidence crises, need to reinforce the control and governance structures of the supervised entities, and the growing collaboration among different jurisdictions.

However, irrespective of this transition effort that involved the supervisors and the companies and consumed time and funds of all of them, the dynamics of the disruptive economic transformation demands a new and more structural reevaluation of the supervision and regulation positioning. This is a condition for the supervisors, without frustrating the innovation processes, to meet the society’s demands for security in the supervised markets.

In truth, the supervision offering depends on the availability of public funds (almost always scarce) to tackle this task of the State. But, because of both the scarcity of funds and the

search for public and private efficiency, the supervision space must be the smallest possible and guided by the society’s demand for supervision.

Thus, when an innovation emerges, the main challenge to be faced by the supervisor is not to find a relevant and proactive way to participate in the process. Differently, the focus must be on the evaluation of the relevance of the formal presence of the state in the innovation environment. Especially if we consider that the main purpose is not to create more difficulties for the innovation and the achievement of the benefits it will bring to the society.

In this regard, given the intrinsically conservative nature of the supervision, a too much active participation of the supervisor in the control of the innovation process does not seem, in principle, advisable.

Let’s think about, for example, in an innovation that, in a sandbox, depends on licenses and security limits for the implementation. In principle, if those innovations would not depend on specific authorizations, the requirement for licenses will be an obstacle and not a facilitator.

In turn, if the innovation is not in compliance with the legislation, a decision that authorizes it with restrictions has the nature of an amendment to the legislation that should, therefore, benefit any innovator.

If a specific authorization is required for a given activity (as it may happen, depending on the jurisdiction, with the peer-to-peer insurance or credit granted on large scale), there is no need to create a sandbox. Instead, the supervisor should change or clarify the rule in effect and be prepared (from the operational and mindset viewpoints) to give such authorization with the most efficiency possible.

Even if the stamp of the supervisor is able to attract investments, it would be difficult for the supervisor to choose the winners, a situation that becomes more sensitive, in regard to innovations, in those frequent cases where the winner

has potential to gain control over the most part or the entire market.

The jurisdictions under the common law, which are used to adopt a decision rendered in a concrete case as a formal basis for a general rule, may attenuate the appointed contradictions but cannot eliminate nor prevent the hyper valuation of the inherent conservatism of the supervisor and the damages caused by the discretionary choice of winners.

The sandbox may be thought as a forum of discussions on innovation. In such case, however, it would not relate to establishing any power to authorize or not, sometimes in a limited way, a given innovation or business model. Rather, it would relate to the creation by the supervisor of a specific channel for internal communication and communication with the society and research groups.

It is worthwhile noting that the name sandbox, which is charming and playful, compares the supervisor with the parents of innovative companies that are children that must be controlled to prevent them from hurting themselves and the others. But, should we really adopt this line of metaphor, the supervisor should be more like parents of adults playing a central role in the conduction of the social life, adults that do not fit in sandboxes.

To infantilize the innovation, limiting it to a sandbox, seems an attempt to cover the reality. In this context, the best scenario is the failure of this mission without making many innovations inviable, spending a minimum of the taxpayer money.

As already said, the best way for the supervisor to participate in the innovation process is to learn about it as a very attentive spectator. The supervision and regulation actions must focus on the definition of clear structural limits and the attribution of the responsibility for the violation of such limits to the supervised entities (the so-called “incumbents”).

It is worth noting that there is a relevant distinction between fintechs and insurtechs.

The main purpose of the financial market is the financial intermediation, which may be, broadly speaking, understood as the receipt, safeguard, management, and transfer of the funds of some persons to others.

On the other side, the insurance market assumes risks of persons and companies, through a mutualistic

structure in which, also broadly speaking, those that suffer losses are indemnified with the funds of the members of the covered group, including the vast majority of members that did not suffer losses, and all participate, since before the occurrence of such unforeseeable losses, in the funding of such indemnities.

In turn, one of the main impacts of the Internet and the digitalization of relations is the “disintermediation”.

Thus, certain activities traditionally performed by financial institutions as a core activity may be effectively performed by the fintechs, also because they are not closely involved in the prudential aspects. The core activity of the insurers, currently, still, more focused on the assumption of risks (as the relevance and the range of the work of the insurance brokers indicate) will hardly be developed by the insurtechs.

We do not intend to lay down a necessary general rule, especially because of the complexity and specificities of the different jurisdictions and the unpredictable future of the innovations. For example, in some scenarios, the insurance will be the smallest link of a chain of risk management services and/or will be based on global structures managed by technology giants, which would ultimately demand the broadening of the scope of the insurance supervisors’ actions and/or a closer cooperation among the supervisors.

Anyway, at this moment, our perspective is that the insurtechs will tend to orbit around the insurers or will transform themselves into insurers, whereas the fintechs will tend to assist the financial institutions clients, at different levels of partnership with the financial institutions or not, even if they do not become financial institutions.

It is too soon to anticipate the repositioning of the supervisors, in view that so many scenarios are possible.

Even the analysis of the risks and benefits brought by the most disruptive innovations depends on the structure and maturity of each market. Whereas in some jurisdictions the great concern will be the resilience of the financial institutions, in others it will be to make the best of the opportunity to reduce the market concentration.

Anyway, the supervisors must take these differences into consideration especially because they are closely related to the need for supervision, to the type of the necessary supervision, to the possibility of attributing

responsibilities to the entities that are traditionally supervised (the incumbents), and the need for the creation of new supervision structures for the entities that will develop activities whose relevance and independence will grow.

The capital markets, whose supervision, in some situations, is demanded to cover not permanently the life of the entities, but rather specific activities and projects, are subject to different dynamics, depending on the structure of the capital market and the supervisor’s role in each jurisdiction. As to this aspect, this may mitigate the negative impacts of the strategies criticized above.

Another interesting characteristic of the innovations is that they do not respect the “former” limits of the specific activities (on the contrary, they challenge them), which, in the case of the jurisdictions where there are specific supervisors for the financial system, the insurance market, and the capital market, make it necessary the alignment and a strict cooperation among them.

In sum, a sandbox that is actually a meeting point for supervisors or sectors of supervisors of the financial system, the insurance market, and the capital market is a good idea. At this moment, it is also essential to develop the supervisors’ understanding of innovation and an efficient communication between them and the society about innovations and their impacts and benefits. However, the supervisor will make a mistake if it believes that the innovation environment may be transformed into a sandbox that it will watch closely or that, should it do so, will productively cooperate with the innovation process.



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