

A journey through the FCA regulatory sandbox

The benefits, challenges, and next steps

Brought to you by the Centre's FinTech Team

Executive Summary

Since its launch in 2016, 89 firms have so far been accepted to test innovative products and services in the UK Financial Conduct Authority (FCA)'s regulatory sandbox. And as the record numbers in the latest cohort¹ testify, firms' interest in applying to the sandbox shows no signs of abating. In fact, the FCA is now considering its next steps, which include leading the efforts to create a Global Financial Innovation Network² and a global regulatory sandbox.

In response to these trends and developments, Deloitte, in collaboration with Innovate Finance³, interviewed several firms which have been, or are still going, through the FCA's sandbox to seek their views on their journey. The majority of the firms were start-ups, and spanned the spectrum of the four sandbox intakes (aka cohorts).

The unequivocal message is that the sandbox has delivered real value to firms, ranging from guidance relating to the application of regulation to innovative propositions, to "kicking the tyres" on the risks relating to their business model. While the FCA has emphasised strongly that it does not "pick winners"⁴, the feedback from our interviews is that being accepted into the sandbox, and proving the underlying technology in a live environment, increased the credibility of firms with both investors and customers alike.

In this article, we summarise the key themes, observations, and views that emerged from our interviews, including firms' reasons for applying to the sandbox; the key challenges they faced through the authorisation and testing stages; the unexpected benefits they experienced; and their views of what the FCA's next steps should be.

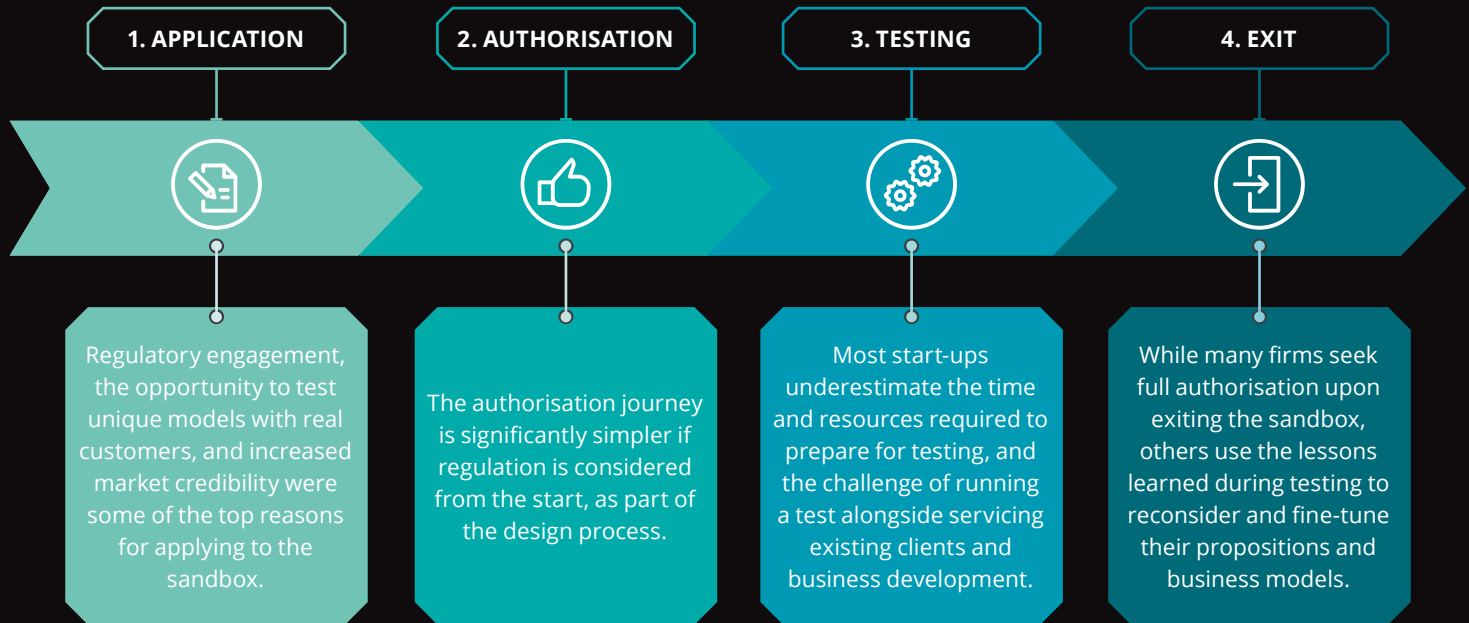
1 <https://www.fca.org.uk/firms/regulatory-sandbox/regulatory-sandbox-cohort-4-businesses>

2 <https://www.fca.org.uk/publication/consultation/gfin-consultation-document.pdf>

3 <https://www.innovatefinance.com/about/>

4 <https://www.fca.org.uk/news/speeches/uk-fintech-regulating-innovation>

The sandbox journey: an overview of the key messages from our survey



Application

The first step a firm needs to take to start its sandbox journey is to submit an application⁴ which sets out its business plan and describes how it meets the sandbox's eligibility criteria⁵. As part of the review process, the FCA will, if necessary, contact firms to obtain clarification or further information before making a decision on their applications. Once accepted, firms are normally given between three and six months⁶ in the sandbox.

The reasons cited by firms for applying were very varied, and not mutually exclusive. Unsurprisingly, several firms wanted to use the sandbox primarily to understand how regulatory requirements would apply to their innovative services or products, and/or what type of authorisation they might need, if any. Others thought that testing in the sandbox would speed up the creation of a minimum viable product; and some others wanted to take advantage of the opportunity to test their product live with real customers to refine their business model.

Whatever the primary reasons, most firms acknowledged a further incentive to apply: getting the “badge of honour” of being accepted in the sandbox, and proving their business model in a live and regulated environment, increased their credibility with both customers and investors.

This raises the possibility of an unintended, yet perhaps inevitable, consequence. While the sandbox may be very successful in enabling FinTech innovation and competition, it can also create an uneven playing field between the start-ups which are accepted in the sandbox and those which are not.

⁴ <https://www.fca.org.uk/publication/forms/regulatory-sandbox-application-form.docx>

⁵ <https://www.fca.org.uk/firms/regulatory-sandbox/prepare-application>

⁶ This timeframe can be extended under some circumstances



Regulatory engagement, the opportunity to test unique models with real customers, and increased market credibility were some of the top reasons for applying to the sandbox.

“*The FCA sandbox levels the playing field between incumbents and start-ups, by allowing smaller firms to get up to speed with financial regulation and think about their business models as much as their innovation.*”

Nuggets, September 2018

Authorisation

Once firms are accepted, they have to complete all the paperwork and set up the capabilities to obtain the necessary authorisation(s) – typically with restrictions such as the number of customers or the volume of transactions.

A clear theme emerging from our conversations is that a majority of firms found the sandbox authorisation process, and specifically navigating and interpreting the FCA handbook, fairly daunting. The level of previous exposure of start-up teams to FS regulation was a clear differentiating factor. Indeed, more regulatory savvy firms – often with founders from FS backgrounds – which had embedded “regulation by design” into their business model, found the authorisation journey much easier.

On the other hand, start-ups whose founders did not have previous FS experience – for example those whose leaders were technology experts – had to invest significant time and money in securing external legal and compliance support. This shows that, if a FinTech start-up is considering performing regulated activities, making an appropriate investment in compliance and legal capability should be a key component of its overall strategy.

Nevertheless, while the FCA does expect firms to do their due diligence and preparation, firms also acknowledged that the regulator was very helpful in signposting (but not helping them to comply with) regulations that were relevant to their business model. In this context, several firms highlighted the importance of the FCA case officer’s role as an informed co-ordinator who is able to offer firms continued support either directly or by obtaining any necessary information from other FCA teams in a timely manner. Significantly, one firm, whose case officer had to change over the course of its testing period, due to turnover, cited the lack of continuity as a major challenge, especially as its business models was particularly complex.



The authorisation journey is significantly simpler if regulation is considered from the start, as part of the design process.

“We used *pro bono* legal support from a law firm. Without this, the process would have been much harder, considering our teams background is in the aid sector, not regulation or legal.”

Disperse, September 2018

Testing

Once firms have received the required authorisation, they can start testing. However, it is important to recognise that there can be a significant lead time between being accepted into the sandbox and the start of any testing. In many cases, it might take a few months to obtain the necessary authorisation(s). And even after a firm is authorised, mobilising capabilities for testing can be time consuming – specifically customer acquisition and opening a business bank account have proven to be common challenges for new entrants.

With respect to customer acquisition, firms testing in the sandbox are responsible for identifying real customers to perform their tests with. Start-ups with few or no customers (and sometimes limited marketing budgets) tend to find this a bigger challenge than more established firms with an existing client base. When appropriate, partnership with other firms can be helpful in overcoming this obstacle.

In addition, for resource-constrained start-ups, running a test alongside business-as-usual activities and existing clients can be a significant challenge. On the other hand a tight testing time has benefitted some firms because it forced them to prioritise and accelerate the development of their innovative products.

While the number of tests and their criteria must be agreed with the FCA at the outset, firms are given a significant degree of freedom in designing their own test plans. Firms are also largely free to choose the Key Performance Indicators (KPIs) used to assess the performance of the test(s). The KPIs (e.g. customer adoption rates or ease of customer journey) are normally intended to measure the business objectives, rather than fulfilment of regulatory requirements. Provided the necessary consumer safeguards are in place, the FCA has been normally very flexible and willing to consider small amendments to both testing plans and KPIs if required.



Most start-ups underestimate the time and resources required to prepare for testing, and the challenge of running a test alongside servicing existing clients and business development.

“Tests and KPIs were designed to address the business success factors of a test solution that was operating within a regulated environment and under real-world conditions. SETL was able to prove their technology which helped to build awareness and credibility for SETL’s technology on its journey to develop other regulated market products for regulated markets.”

SETL, September 2018


Exit

Following the completion of their tests, or the end of the agreed testing period, firms need to transition out of the sandbox. As part of the testing plans, firms will have agreed customer safeguards and exit plans to implement upon the test completion. As a final step, firms need to submit a report to the FCA detailing the outcome of the performed test(s) and next steps.

Transitioning out can take many forms depending on how the firm chooses to proceed.

Firms looking to continue the tested business model have to apply for a “variation of permission” to lift the restrictions imposed during the test. While the majority of firms choose to do so, other options include, upon getting appropriate legal advice, agreeing with the FCA that authorisation is not required, or reconsidering their business model and regulatory position. One firm, for example, decided to become a pure technology infrastructure provider and pared down the regulated activity that was initially part of its original business model.

Of the various stages of the sandbox journey, the point of exit seems the least clear for firms. For example, while many of the firms we interviewed received an official “exit” day, a few had no clear “graduation day” and/or ongoing exchanges with the sandbox team, even after the submission of their final report. This was more common for firms in the initial cohorts, and those whose business models had more “grey areas” in relation to the application of regulation. But there might still be an opportunity here for the regulator to make the process clearer.



While many firms seek full authorisation upon exiting the sandbox, others use the lessons learned during testing to reconsider and fine-tune their propositions and business models.

“*The exit process was much less clear. We submitted the final report, but we are still in touch with our case officer in the sandbox and we have not yet transitioned to the normal authorisation and supervisory teams at the FCA.*”

Blockchain based start-up, September 2018

”

Unexpected benefits

Overall all the firms we surveyed had a very positive experience in the sandbox. While many firms were aware of the benefits of close regulatory interaction with the FCA, and of proving their technologies, some firms also gained a few unexpected benefits.

Working closely with the FCA appears to give firms a greater degree of legitimacy with customers and investors alike. Having the opportunity to discuss details of innovative compliance approaches with the FCA also gives firms increased confidence in their strategic plans, especially if these include applying for full authorisation upon exiting the sandbox. And when a firm chooses to apply for full authorisation, its experience in the sandbox tends to make the process quicker and smoother.

Start-ups wishing to provide services for other regulated firms find that their experience in working closely with the FCA gives them a much deeper appreciation of the regulatory environment in which their prospective clients operate.

Finally, a number of firms found that testing their products and services in a live environment gave them an early view of some of the flaws in their offering, and a chance to fine tune their business models in response. Similarly, other firms realised that, with relatively minor tweaks, they could structure their offering in a way that continued to add value, but did not require regulatory authorisation. More generally, start-ups welcomed the challenges posed by the regulator as they helped them think through the business risks inherent in their models.



“
“It was a very positive experience – intensive, but the benefits are significant. We would not disregard testing something else in the sandbox in the future.”
Wrisk, September 2018
”

Looking ahead

When asked how the FCA sandbox could evolve further, firms highlighted a number of areas for potential improvement or development.



Navigation of rules – An easier way to navigate the FCA handbook was a recurring point of feedback. In particular, several firms suggested that the FCA could develop a “Financial Regulation 101” starter-pack for firms and people with limited financial services sector experience, as well as more guidance on the FCA’s expectation in relation to the sandbox application forms. Some firms also thought that the FCA could consider extending the time firms are allowed to stay in the sandbox, or starting the “timer” after the necessary authorisations have been obtained.



Facilitating cohort interaction – Many firms also felt that the FCA could do more to facilitate the creation of a network, or “cohort feel”, amongst the firms accepted into the regulatory sandbox, especially those participating in the same cohort. While a number of issues may be too confidential to share, several firms would have welcomed the opportunity to discuss broader challenges and approaches with their peers, enabling them to learn from each other.



Sharing lessons learned – Another view was that the FCA should share the lessons learned in the sandbox with the wider industry. Sharing the guidance (in anonymised form) given to the firms in the sandbox more publicly and transparently would also help alleviate the risk which we flagged earlier in this article: that the sandbox could be seen to provide, albeit unintentionally, a certain competitive advantage to the firms that are allowed to participate in it.



Global reach – Firms with international operations or ambitions were very supportive of the FCA’s proposals for a global regulatory sandbox and regulatory network. However, as one firm remarked, in order to be truly effective, a global sandbox would need a very clear structure, including a single application process and, in all likelihood, a central team to manage co-ordination with firms and regulators. Nevertheless, a global sandbox should facilitate cross-jurisdictional referral systems, promote regulatory convergence, and help firms understand the regulatory environment in selected key markets.



“*The application process was quite complex and it would be great to make it more accessible for organisations, especially those from non-financial and non-legal backgrounds.*”
Northrow, September 2018

Conclusion

Now in its third year, the FCA sandbox has evolved over time and is now, as one participant put it, a “slick operation”. While the benefits of going through the FCA sandbox vary, perhaps its biggest achievement has been to break the myth of regulation being a barrier to innovation. On the contrary, it has shown that regulators can play an active and positive role in encouraging innovation by giving unique business models “permission to play” in a highly competitive FS sector. Yet, while the relevance and importance of the sandbox show no sign of diminishing, as our survey shows, there is still room for improvement. Creating a regulatory environment for FinTechs to be truly cross-border businesses is rightly the next challenge for regulators to overcome.



“
“We are humbled to say that without the FCA regulatory sandbox we wouldn’t have been successful. We wouldn’t have had an opportunity to prove our business model in a way that balanced support for new innovation and customer protection.”
Bud, September 2018
”

Contacts



David Strachan

Partner, Risk Advisory

Head of EMEA Centre for Regulatory Strategy

dastrachan@deloitte.co.uk



Suchitra Nair

Director, Risk Advisory

EMEA Centre for Regulatory Strategy

snair@deloitte.co.uk



Valeria Gallo

Manager, Risk Advisory

EMEA Centre for Regulatory Strategy

vgallo@deloitte.co.uk



Morgane Fouché

Assistant Manager, Risk Advisory

EMEA Centre for Regulatory Strategy

mfouche@deloitte.co.uk



CENTRE *for*
REGULATORY
STRATEGY
EMEA

The Deloitte Centre for Regulatory Strategy is a powerful resource of information and insight, designed to assist financial institutions manage the complexity and convergence of rapidly increasing new regulation.

With regional hubs in the Americas, Asia Pacific and EMEA, the Centre combines the strength of Deloitte's regional and international network of experienced risk, regulatory, and industry professionals – including a deep roster of former regulators, industry specialists, and business advisers – with a rich understanding of the impact of regulations on business models and strategy.

Deloitte.

This publication has been written in general terms and we recommend that you obtain professional advice before acting or refraining from action on any of the contents of this publication. Deloitte LLP accepts no liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 1 New Street Square, London EC4A 3HQ, United Kingdom.

Deloitte LLP is the United Kingdom affiliate of Deloitte NWE LLP, a member firm of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"). DTTL and each of its member firms are legally separate and independent entities. DTTL and Deloitte NWE LLP do not provide services to clients. Please see www.deloitte.com/about to learn more about our global network of member firms.