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Stability, Innovation and Growth in the Financial Sector – a Supervisors' view

Good morning. Thank you for inviting me to speak at Point Zero. It is a pleasure to be here today.

I want to talk about innovation and growth in the financial sector – and how to approach these from a regulatory and supervisory perspective.

There still seem to be people who believe that innovation and supervision are conflicting concepts. I can tell you that this is not the case – quite the opposite is true!

Only within a well-defined and sound regulatory and supervisory framework can innovation be successful and sustainably add to growth of the financial sector and the economy.

Let me start by making one thing clear: dealing with innovation in financial regulation and supervision is not "special" in any sense. We have been doing this for decades. And as for all good supervisory practices, it helps to embed them in a clear conceptual framework.

Let me offer you one:

- First, supervision and regulations need to be **technology-agnostic** in a sense that they do not favor one innovation over another based on the technology they are built upon.

- Second, we need to develop **comprehensive and clear 'rules of the road'** to which new business models in the financial space must adhere to.

- Third, the **intensity of supervision and regulation** should be based on the types of services provided and the underlying risks – whether we need prudential, bank-like regulation, whether we look at payments-like services or whether conduct regulation is the primary focus.

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- Fourth, given the pace of innovation and technological progress in the financial space, supervision needs to be able to **adapt swiftly to new situations;** at FINMA, we call this the "functional approach".

You might ask yourself: 'why is there no definition of innovation in this framework?' After all, you need to know what you are dealing with before you can regulate and supervise it.

My answer to this is "yes and no". Yes, supervisors need to be aware of what the innovative idea or business model is trying to achieve and what the underlying risks to customers and the system are. And no, supervisors and regulators are not in the business of assessing whether something is a 'good' or 'bad' innovation. Our mandate is to make sure that whatever financial innovation sees the light of the market is properly risk-managed and does not harm the customer or financial markets at large. In other words, FINMA is very open to financial innovation that occurs on a sound regulatory foundation. This is also the way to fostering a healthy and competitive financial center in Switzerland over the long run.

Technology-agnostic supervision

Financial Innovation often makes use of new technologies – think about artificial intelligence (AI) or distributed ledger technology (DLT). As regulators and supervisors, we should not care about which technology drives the innovation.

Let me use DLT as an example. About five years ago, many regulators, including FINMA, highlighted the potential of DLT to improve the efficiency of key processes in the financial sector, such as settlements. Since then, unbacked crypto assets, so-called cryptocurrencies, making use of DLT, have become a major use case, representing more of a speculative investment product than a means of payment.

So, a fascinating new technology can be put to many different uses – for which the value ultimately lies in the eye of the beholder. We as supervisors and regulators must make sure that the way such a new technology is used by financial institutions – and the risks that are created by this use – are properly understood and managed.

Clear rules of the road

As FINMA, our mandate is to contribute to a competitive and sustainable financial center by focusing on our objective to protect creditors, investors, and insured persons as well as to ensure the proper functioning of the financial market.

This mandate very explicitly states that we are open to innovation and new technologies if the risks associated with them are properly identified and managed.

Innovative new business models based on new technologies need clear rules of the road that create a level playing field and neither penalize nor favor certain technologies over others. They should be, as I said, technology-agnostic.

But why are clear rules so important?

Well, if financial innovations should successfully transform business models and add value to the customer, they need to be trusted – and this trust develops easier and more sustainably if and when the financial sector is well regulated and supervised. Innovators and entrepreneurs need to understand and take into consideration the risks posed by their business models and technologies – in a comprehensive way and with full accountability.

The main role of the supervisory authority therefore should be to provide legal, regulatory, and supervisory clarity and to ensure a strong focus on risk management and adequate controls. After all, every business model, regardless of technology, is exposed to financial risk, market integrity risks – i.e. conduct, money laundering and sanctions – as well as cyber and other operational risks.

Identifying adequate supervision and regulation

Strong governance, and appropriate policies need to cover these risks in a comprehensive and proportionate way, while avoiding a one-size-fits-all approach.

FINMA has consistently communicated clear expectations to the financial industry which also serve as guidelines for companies operating in the fintech sector.

When it comes to innovative business models, many specificities need to be considered. In the case of blockchains, differences such as operating a securities settlement system on a private blockchain versus providing this service on a public blockchain result in a very different risk profile.

There are several tailor-made DLT regulations, such as the Swiss DLT law, which was implemented in 2021, or the EU Markets in Crypto-Assets (MiCA) regulation. While these regulations provide a critical foundation, the sector is very dynamic and new market developments are continuously emerging.

Take for example the implementation of the so-called 'Travel Rule'. This requirement, based on FATF recommendations, obliges financial intermediaries to exchange relevant information about the originator and beneficiary of a payment. The Travel Rule is an important cornerstone in the fight against money laundering and terrorist financing which should also apply in the blockchain space.

FINMA has already communicated its supervisory expectations on how to implement the travel rule on blockchain in 2019. In short, the financial intermediary should not accept to operate transactions from or to anonymous wallets. A transfer from or to an external wallet belonging to the client or a third party is only possible if the supervised institution has first verified the ownership of the external wallet resp. the identity of the third party. In this context, FINMA allows a variety of methods to enable Virtual Asset Service Providers to offer compliant services.

Another example is prudential risk. The intensity of prudential regulation depends on the level of risks posed by the business models. If a business model makes use of maturity or liquidity transformation, that business model will result in prudential risks that must be addressed with the relevant regulations and standards. These risks include not only risks for the clients of this specific service provider, but also stability and contagion risks which are, in this case, typical of credit intermediation and must be mitigated by banking regulation. Corresponding business models may therefore well need to be licensed and supervised as a bank.

If the business model focuses on payment and safekeeping services, without any kind of credit intermediation, the need of prudential supervision could be lower. But risks, like counterparty risk for the clients or operational risks, remain material and must be mitigated by prudential regulation, like the Fintech-license in Switzerland or the E-Money/PSP regulation in the EU.

In all these cases, there will be a need for mitigating conduct risks and therefore, conduct regulation such as AML, sanctions rules or investor protection should apply.

Supervisory clarity helps innovators focus on innovation and value creation without worrying about regulatory and supervisor uncertainty. As for the travel rule mentioned above, some initially saw FINMA's expectations as overly restrictive and stifling to innovation but have now come to recognize the value of having clear rules upfront.

Swift adaptation to new developments

The example of the travel rule is also a good illustration of FINMA's functional approach. Legislation takes time, and supervisors – especially in the field of FinTech – need to react quickly to new developments. The functional approach, which can be summarized as "same business, same risks, same rules" allows FINMA to apply the existing principle base regulation to new developments. Applying a functional approach not only allows FINMA to react in a timely manner, but also ensures that similar business activities are subject to equivalent regulatory requirements, thereby emphasizing fairness and consistency. Technology should adapt to regulation, not the other way round.

The key is always to identify the relevant risks and to mitigate them. Existing regulation provides us with a good framework for identifying prudential and systemic risks, payments and counterparty risks, and risks to consumers and market integrity.

And while existing regulation provides us with many tools to address these risks, there is still work to be done and loopholes to be filled. In Switzerland, for example, one of those areas for improvement would be the fact that issuers of stablecoins are not under supervision by FINMA if the claim of the stablecoin-holders are guaranteed by a bank. This creates follow-on risks to the purchaser of the guarantee as well as to the provider of the guarantee.

Conclusion

My key take away is simple: a focus on risk mitigation and clear and consistent rules builds trust. And trust is key to the sustainable success of innovation in financial services.

Through our transparent authorization and supervisory activities, FINMA helps to ensure that the use of new and innovative technologies in the financial market is in line with the regulatory framework and that the protection and trust of clients as well as the reputation of the Swiss financial center are maintained at a high level sustainably.

This also means that, as long as the risks are adequately mitigated, FINMA is open to new ideas. A good example of this is our roundtable at Point Zero on the use of public blockchains in a regulated environment.

Furthermore, FINMA itself is also actively using new technologies to continuously improve its own efficiency and effectiveness. Our event on the use of AI/ML in supervision (SupTech) provides interesting insights into how FINMA is working to further increase its effectiveness and efficiency. Thank you for listening and I hope that you will enjoy many interesting contributions to the Point Zero Forum.