Fintech Sector Must Do More To Self-Regulate

By **Jonathan Polk** (August 21, 2023)

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Just last month, the White House announced[1] that seven artificial intelligence companies had agreed to voluntary commitments to keep consumers safe from a technology that some have said could pose an existential threat[2] to humankind.

However, AI companies are not the only companies that should be voluntarily putting standards in place to protect consumers and encourage responsible innovation.

Particularly, in the financial services sector, traditional regulatory regimes are not well suited to governing these new market phenomena.

It is time for the private sector to define and adopt strong industry standards for emerging technologies in order to foster the trust necessary for new products and services to achieve scale.

Blockchain

To bring the issue to life, let's consider blockchain technology — particularly cryptocurrencies and digital assets — and examine how the lack of standards has affected the adoption of this potentially game-changing development.

Crypto's potential to facilitate low-friction, low-cost and widely available access to money movement has been well documented.[3] So too have the incidents of bad behavior[4] and frustration among market participants arguing for sound market regulation.[5]

While the volatility of crypto's value is one barrier to its adoption as a medium of exchange, there is no doubt that the lack of supervision and standards has also chilled adoption.

Crypto is also a prime example of how an emerging technology poses novel obstacles to addressing legitimate governmental interests and concerns.

The mechanics of blockchain and the anonymity it provides make it necessary for government anti-money laundering legal regimes to adapt to an entirely new way of moving money.

Perhaps more vexing, the wide-scale adoption of crypto — and the disintermediation of fiat currencies that would come along with it — will critically affect central banks' ability to implement monetary policy.

In the above example, the benefits and risks of this innovation are colossal. The solutions will need to come from the private sector.

The Benefits and Limitations of Financial Services Regulation

Public sector-imposed rules to protect consumers, investors and market participants have yielded undeniable benefits.

Regulations such as capital and liquidity requirements have improved the resiliency, reliability and the integrity of our markets. With that said, even the most effective financial services regulatory schemes are limited in two key respects.

The first is an enduring fact of market regulation: The examiners' understanding of a financial institution is mostly a product of what they are told by the regulated entity.

There is a common misperception that bank supervision includes comprehensive verification of the information collected in the supervisory process. This is simply not the case. While examiners do verify certain points during supervisory reviews, the volume, scope and complexity of the information gathered make wholesale validation impractical.

The second key limiting factor is that consensus is hard to achieve, and it is getting harder.

While driving consensus on financial market regulation has always been difficult, it seems our public institutions have become less and less effective at this in recent years.

This trend is exacerbated by several especially challenging characteristics of the supervision of innovation in finance. First, financial regulatory authority in the United States is extremely fragmented. The sheer multiplicity of authorities is a challenge.

Second, new technologies and the products built on them will, in many cases, require entirely new approaches to rulemaking and oversight. Existing rules and policies are not well suited to these new phenomena and, in some instances, are not relevant. The public sector's capacity for innovation is not on par or pace with the private sector.

Finally, the public sector does not have the technical sophistication to understand and effectively govern this innovation in many cases.

The Bottom Line: The Private Sector Must Be Proactive

Given the limitations on the public sector, there is an urgent need for the private sector to take matters into its own hands.

Further, the private sector needs to provide thought leadership with a keen eye on — and a genuine appreciation of — the risks these technologies pose to governmental interests. That means industry groups need to understand, acknowledge and constructively address the legitimate public interests underpinned in market regulation.

Industry groups need to proactively work with the various relevant authorities to find solutions that serve these interests while preserving the benefit of the innovation they want to bring to market. The market has no choice.

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[1] https://www.nbcnews.com/tech/tech-news/top-ai-companies-agree-work-together-transparency-safety-white-house-s-rcna95406 (last accessed July 27, 2023).

[2] https://www.safe.ai/statement-on-ai-risk (last accessed July 27, 2023).

[3] https://www.imf.org/en/Blogs/Articles/2023/02/23/technology-behind-crypto-can-also-improve-payments-providing-a-public-good (last accessed July 27, 2023).

[4] https://www.soliduslabs.com/research/2023-crypto-enforcement-trends (last accessed July 27, 2023).

[5] https://www.cnbc.com/2022/11/11/op-ed-crypto-markets-need-regulation-to-avoid-ftx-type-situations.html (last accessed July 27, 2023).