

OCC Announces Innovation Framework – Rejects Sandbox

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Editor's note: this post has been edited since the date of its original publication.

On October 26, 2016, the Office of the Comptroller of the Currency (the “OCC”) announced [initiatives](#) to support what it terms “responsible innovation,” including the creation of an Office of Innovation tasked with, among other things, the development of a bank-run pilot program for national banks, their service providers and fintech partners. The industry was hoping for a U.K. FCA-style “regulatory sandbox,” including waivers from licensing and compliance obligations for fintechs, but OCC Comptroller Thomas Curry sharply [criticized](#) that approach yesterday.

The framework also does not address the potential availability of a limited purpose national bank charter for fintechs, commonly referred to as a “fintech charter.” Curry [expects](#) the OCC to issue a separate release “soon” to solicit comments on a potential fintech charter. Watch this space for forthcoming analysis and other insights on the OCC’s highly anticipated charter proposal.

Section I of this post describes the OCC’s responsible innovation framework. Section II discusses key differences between the OCC’s proposed pilot program and existing regulatory “sandbox” initiatives, as highlighted by Curry.

Section I. Framework for Responsible Innovation

On October 26, 2016, the OCC released its [Responsible Innovation Framework](#) following a year-long research initiative that included the release of a [white paper](#) in March, review of public comments on the paper, and a public [forum](#) in June. The framework reflects the OCC’s perspective that recent changes “challenge traditional banking business models” and that banks must evolve and adopt innovation strategies to continue to meet the needs of their customers, businesses and communities (and therefore, to survive). In fact, Curry indicated in his [Chatham House speech](#) that banks must innovate in order to avoid the fate of the taxi industry, whose business model has been trampled by Uber because of its resistance to innovation. Curry argued, however, that the analogy is imperfect since banks function as both the taxis and highways in that banks also provide the underlying infrastructure for the global financial system. Thus, while banks cannot be complacent and must evolve and innovate, they must consider the impact on their own safety and soundness, as well as on systemic stability, when doing so.

Recently, banks’ innovation has often been happening in partnership with startup financial technology companies (fintechs), as reflected in the details of the framework. The framework incorporates the perspective that the benefits of innovation must be balanced against the potential harms to markets, financial institutions and consumers that can result from innovation. In fact, preventing consumer harm is a persistent theme throughout the framework and the white paper. To that end, the OCC defines “responsible innovation” as:

- “the use of new or improved financial products, services, and processes:
- to meet the evolving needs of consumers, businesses, and communities
- in a manner that is consistent with sound risk management and
- is aligned with the bank’s overall business strategy.”

A key component of the framework is the creation of an **Office of Innovation** to implement the framework’s other elements, which are summarized as follows:

- **Outward-Focused** – directed towards regulated institutions and other regulators
 - establishing an **outreach and technical assistance program for banks and nonbanks**, including vendors and fintech partners of banks;
 - encouraging coordination and facilitation, including development of a program for **bank-run pilots**; and
 - promoting **interagency collaboration**.
- **Inward-Focused** – directed towards OCC staff and processes
 - increasing **awareness and training** activities for OCC staff of financial innovations and developing trends;
 - encouraging coordination and facilitation to **improve timeliness and transparency** of OCC decision-making; and
 - establishing an **innovation research function**.

The Office of Innovation will be headed by a Chief Innovation Officer reporting directly to Comptroller Thomas Curry. The OCC expects the office to begin operations in Q1 2017, with its headquarters in Washington D.C. and offices in New York City and San Francisco (financial technology hubs and locations of existing OCC field offices). The OCC's Office of Innovation may become similar to the U.K. Financial Conduct Authority's ("FCA") [Innovation Hub](#), launched as part of Project Innovate in 2015. Curry noted in his [Chatham House speech](#) that understanding the FCA's model has been helpful, but his lack of praise of the FCA approach (including with respect to a regulatory sandbox) spoke volumes.

Outward-Focused Portions of Framework

Banks and their vendors and fintech partners face a dizzying array of complex regulatory requirements. For example, the OCC (along with other banking agencies) has released extensive guidance on how banks and their affiliates must manage their vendor relationships, and in many cases, vendors or fintech partners may be subject to direct oversight by the OCC, FDIC or Federal Reserve under the Bank Service Company Act. In addition, as described in our [recent memo](#), these agencies have just floated a broad cybersecurity approach that would encompass vendors and banking organizations' fintech partners as well.

The framework notes that "[m]any fintechs recognize that to develop successful partnerships with banks, they must thoroughly understand applicable regulatory expectations. Well-informed fintechs also benefit the banks with which they partner." The OCC's research indicated that banks and nonbank fintechs would benefit from clear, direct engagement from the OCC. Thus, the **outward-focused** portions of the framework include:

Outreach and Technical Assistance Program for Banks and Nonbanks

The framework requires the Chief Innovation Office to develop and implement a formal innovation outreach strategy (including, for example, holding office hours, organizing workshops and forums, and creating a [one-stop shop website](#)). Additionally, the framework requires the OCC to provide technical assistance to banks and fintechs, including through "designing 'rules of the road' materials for nonbanks."

Coordination and Facilitation: Pilot Programs

The framework notes that while banks have historically tested products and services "before implementation" without regulator involvement, the OCC has found growing demand and overwhelming support for a process for banks to test innovations in a regulatory "safe place."

The OCC's framework requires the implementation of a program of optional bank-run pilots that fosters responsible innovation by OCC-supervised banks, furthers the OCC's understanding of innovative products or otherwise facilitates OCC policy objectives. Although the pilots must be bank-run, eligible participants would be banks and significant service providers, fintechs in partnership with banks or significant service providers, and other regulators.

While the idea behind the OCC's pilot program may share common roots with regulatory "sandbox" initiatives adopted in other jurisdictions - most notably in the United Kingdom - Comptroller Curry explicitly distinguished between the OCC's pilot program and sandbox approaches taken by other regulators in his [Chatham House Speech](#). Section II of this post compares the OCC's pilot program to other countries' sandbox initiatives.

Interagency collaboration

The framework notes that innovation requires greater collaboration between regulators, such as the Consumer Financial Protection Bureau and the Department of Treasury.

Inward Focused Portions of Framework

In the wake of the 2008 financial crisis, OCC staff were quick to say “no” (or slow to say yes) to national banks’ innovations under the theory that novel approaches presented unacceptable risk. The framework is an implicit acknowledgement that the reflexive “no” must change into a thoughtful consideration of whether innovations are responsible. Thus, the **inward-focused** portions of the framework include:

Awareness and Training

As the framework notes, “[t]he rapid technological and engineering developments in the financial industry ... raise important questions about whether the OCC has sufficient expertise to understand and supervise some emerging developments.” In addition to training initiatives, under the framework, the OCC will expand its recruiting, for example to those skilled in engineering, advanced information technology, systems development, cybersecurity, statistics, and mathematical modeling.

Coordination and Facilitation: Timeliness and Transparency of Decision-Making

According to the framework, “[l]ack of transparency and timeliness in decision-making related to innovative products, services, and processes was a consistent theme in agency research, comment letters, and internal stakeholder interviews. External commenters stated that regulatory uncertainty, lack of transparency, and inconsistency deter innovation.” Thus, the framework requires the OCC to establish “clear response expectations, time frames, and workflows” to “provide more consistent, transparent, and timely processes and facilitate disposition of inquiries and proposals.”

Innovation Research Function

The OCC plans to develop a research function within the agency to collect information on specific innovations and trends and to analyze the effect of such developments on the federal banking system and consumers.

Section II. Regulatory Sandboxes versus the OCC’s Pilot Program

The framework’s language echoes the idea of a regulatory sandbox but instead calls it an optional bank-run pilot program. After Curry’s [Chatham House speech](#) we know why – Curry does not support the FCA’s sandbox approach: “Waiving compliance with consumer protection or safety and soundness never makes sense, nor does our agency have the authority to waive compliance requirements.”

Regulatory Sandboxes As “Safe Spaces”

The idea of a “safe space” was pioneered by the FCA when it launched a [regulatory sandbox](#) as part of Project Innovate in 2015. Licensed and unlicensed firms apply to the FCA to be a part of the sandbox to engage in limited tests of new products and services that do not easily fit into the existing regulatory framework in a live environment. Among other requirements, the applicant must be creating innovation intended for the U.K. market; the innovation must be ground-breaking; there should be consumer benefit; there must be a genuine need for a sandbox; and the applicant must be ready for testing. The FCA usually requires that the test have customer safeguards. Typical sandbox tests have lasted [three to six months](#) and involve weekly reporting to the Innovation Hub of the FCA.

Sandbox participants receive individual guidance from the FCA on how relevant rules would be applied to the innovation. The FCA sandbox also offers waivers from or modifications to the FCA’s rules in cases where they are “unduly burdensome” to the test, as well as relief from disciplinary actions, as long as the participant is actively engaged with the FCA and compliant with the testing parameters.

The draw of a sandbox is obvious for both fintech firms and regulators: young firms are provided greater flexibility to grow and become established players early on in their life stage, when compliance and regulatory costs may disproportionately hinder their ability to scale; regulators adopting a sandbox can establish themselves as competitive in the market for regulation, and growth is promoted within the local fintech sector - all while permitting regulators to still accomplish their supervisory objectives.

Other countries such as Australia, Malaysia, Singapore, Hong Kong and Abu Dhabi have launched or are exploring launching sandboxes to facilitate innovation and promote growth in their national fintech sectors. In addition, the FCA’s Innovation Hub has [signed cooperation agreements](#) with Australia’s and Singapore’s Innovation Hubs, facilitating the experimentation of sandbox firms with cross-border business models.

The OCC’s Bank-run Pilot Program

In contrast to the FCA's sandbox approach, however, Comptroller Curry has expressed strong opposition to providing any waivers from consumer protection or safety and soundness requirements or assurance of enforcement action relief to pilot program participants. As stated in his Chatham House remarks, participants in the pilot program must design products and services to ensure they are "safe and sound and meet consumer protection standards."

In addition, the focus of the OCC's pilot program is on banks and fintech companies with relationships to banks, in contrast to the availability of the FCA sandbox to unlicensed firms, regardless of their relationship with licensed firms. Based on the eligibility criteria provided in the OCC's framework, standalone fintech firms who do not directly or indirectly provide services to banks would presumably be ineligible to participate in the pilot program.

What are the benefits of the OCC's pilot program?

The pilot program would provide a direct channel through which participants testing out new products and services could maintain an open dialogue with regulators. This could help increase regulators' comfort with and understanding of new products and services, speeding any approval or licensing processes down the road.

Moreover, although pilot participants will likely be required to ensure their products and services meet existing consumer protection standards, this still leaves open the possibility of limited "no-action" relief in other domains, i.e., non-consumer protection issues for which the OCC is the supervisory agency. Providing assurance that the OCC would not take action against participating companies would help foster innovation. Moreover, the pilot program could provide a platform through which multiple regulators could coordinate on providing limited relief to participating companies, which would be particularly useful given the complex web of state and federal laws applicable to the delivery of financial services in the United States, and the associated regulators charged with enforcing those laws.

As is always the case, the devil will be in the details, and industry participants are eagerly awaiting the Chief Innovation Office's development of the OCC's pilot program.

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