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A Regulatory Approach to Fintech

We must guard against emerging risks without stifling innovation

Christine Lagarde

IN THE 19TH CENTURY, when Alexander Graham Bell was awarded a patent for the telephone, the only way to communicate rapidly over long distances was by telegraph. The dominant company in that market dismissed Bell's invention as a useless toy and rejected an opportunity to buy his patent. The rest, as they say, is history.

This anecdote illustrates the disruptive and unpredictable nature of technological innovation. Today, some enthusiasts say crypto assets may represent the beginning of a similar breakthrough. Others condemn crypto assets as little more than a fad or a fraud. We should not dismiss them so lightly.

Crypto assets are just one example of how new technologies are being used to deliver financial services—Fintech for short. In Kenya and China, mobile payment systems have brought millions of previously "unbanked" people into the financial system. In Latvia, Brazil, and elsewhere, peer-to-peer lending has opened up a new source of credit for small businesses that have trouble borrowing from a bank.

Around the world, advances in artificial intelligence promise to extract more value from data that is ever more abundant and ubiquitous. Its applications in the realm of financial services include enhancing fraud protection and regulatory compliance, potentially expanding access to financial services, and deepening financial inclusion.

Fintech offers considerable promise, but it also poses risks. Consider distributed ledger technology, which underpins crypto assets. It can enable faster and cheaper transactions, from trading securities to sending money to relatives abroad. It can be used to securely store records such as diplomas and real estate deeds and to automatically execute so-called smart contracts. But clearly the technology has also been used for illicit purposes.

How should regulators respond? Their task isn't an easy one. On the one hand, they must protect consumers and investors against fraud and combat tax evasion, money laundering, and the financing of terrorism, ensuring that risks are thoroughly understood and managed. They must also protect the integrity and stability of the financial system.

On the other hand, they must beware of stifling innovation that responsibly and sustainably benefits the public. By constructively engaging with market participants at the center of financial innovation, regulators can stay abreast of the benefits of new technologies and quickly identify emerging risks. Developing a forward-looking regulatory framework calls for creativity, flexibility, and new expertise.

Crisis lessons

As I see it, the experience of the financial crisis and its aftermath yielded three important lessons that can guide us as we seek answers.

Lesson number one: *trust is the foundation of the financial system, but it is a fragile foundation that can easily be shaken.* How can we reap the benefits of the new technologies while maintaining trust?

Lesson number two: *risk accumulates in unexpected places.* The years preceding the global financial crisis saw the emergence of financial instruments, such as collateralized debt obligations, that were poorly understood by investors. Will a more decentralized financial system be more stable, or less? Will risk be more dispersed? Will the diminished role of traditional intermediaries mean that emerging risks are more likely to go undetected?

Lesson number three: *in a globalized world, financial shocks quickly reverberate across national boundaries.* Responding to a crisis requires concerted action on a global scale; in other words, we are all in this together. Will the evolving global financial system transmit shocks more quickly? How can resilience be strengthened? What can be done to enhance international cooperation?

Global action

So far, national authorities have reacted with varying degrees of regulatory stringency. If this uncoordinated response continues, activity will simply migrate toward more lightly regulated jurisdictions in a “race to the bottom.” Because crypto assets know no borders, a global approach is vital.

Such an approach is taking shape. The Financial Action Task Force, a global standard-setting body, has already provided guidance to its members on how they should address money-laundering and terrorist-financing risks associated with crypto assets. The Financial Stability Board (FSB), which coordinates financial regulation for the Group of 20 (G20) largest advanced and emerging economies, is studying ways to monitor the growth of crypto assets with an eye toward identifying emerging threats to stability.

In March, I flew to Buenos Aires to participate in a meeting of G20 central bankers and finance ministers. The G20 agreed with the FSB’s assessment that crypto assets do not currently pose a threat to stability. They also agreed that crypto assets could pose a threat at some point in the future. They asked the FSB, along with other standard-setting bodies, to continue their work on crypto assets and report on their progress.

IMF’s role

Here at the IMF, we can serve as a forum for the exchange of ideas and a catalyst for forging consensus. It is our job to monitor the economies and financial systems of our 189 members, help them build institutional capacity, and offer advice on improving policies and regulatory structures. That gives us a unique global perspective.

To do our jobs properly, we must understand the innovative technologies, learn from them, and perhaps even adopt some of them to improve regulation, supervision, and surveillance. In some cases, it will be enough to apply existing regulations. In others, new approaches may be required as new risks—including cybersecurity—emerge and as distinctions between entities and activities break down.

One thing seems certain: we shouldn’t put off action until the answers become completely clear. Instead, we must begin to consider the regulatory framework of the future. We must do so in a manner attuned to the rapid pace of change, and with the awareness that unexpected new opportunities and risks may emerge. One approach, undertaken in Hong Kong SAR, Abu Dhabi, and elsewhere, is to establish regulatory “sandboxes” where new financial technologies can be tested in a closely supervised environment.

Above all, we must keep an open mind about crypto assets and financial technology more broadly, not only because of the risks they pose, but also because of their potential to improve our lives. When in doubt, just think of Alexander Graham Bell and his telephone. FD

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