Regulators say they promote innovation, but the opposite is true

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The economist Art Laffer famously drew a graph on a napkin illustrating that beyond a certain point, increasing tax rates lead to reduced tax revenue. Similarly, there is a Laffer curve of financial innovation. More regulation, more regulators and more regulatory uncertainty increase the cost of and inhibit financial services and payments innovation.

Regulators in the United Kingdom, Australia, Singapore and the U.S. have acknowledged this in establishing “sandboxes” that aim to allow promising fintech ideas to develop without the distracting hurdle of heavy enforcement. But despite some success stories, too many regulators merely say they are promoting innovation. Rather, they are making — not enforcing — new laws as they go.

If strict law enforcement hurts the payments industry and isn’t in the public interest, the law should be changed or eliminated, not selectively enforced. That principle has been applied to a limited extent in some jurisdictions.

For example, the U.K. is already Europe’s most favorable jurisdiction for financial services. Its Financial Conduct Authority permits fintechs it rates promising to test their products in a sandbox for six months. The FCA ran 18 fintech firms through the first cohort of its sandbox, and 24 fintechs through its second cohort. The FCA says it does not ease regulations that

would put consumers at risk. If innovation-inhibiting regulation can be safely waived, why keep it?

The Australian Securities and Investments Commission authorizes approved ventures to experiment without a financial services or credit license for up to 12 months and may, as it sees fit, relax additional product-licensing requirements and laws it enforces.

In the same vein, the Monetary Authority of Singapore eases the regulatory burden for approved fintechs for short durations, aiming to make Singapore Asia's fintech capital. MAS also attempts to direct financial institutions' capital allocation by subsidizing up to 50% of approved artificial-intelligence and data-analytics projects.

But in the U.S., the decidedly anti-innovation CFPB has "Project Catalyst." While the program is touted as fostering innovation, in five years it has issued only one "no-action" letter — to Upstart, which uses AI and machine learning to price and approve credit. The letter addresses Equal Credit Opportunity Act enforcement.

Given the CFPB's expansive ECOA enforcement, and pattern of lawless prosecution of ECOA-related and other activities it does not approve of, Upstart's need for the agency's blessing was understandable. Besides, the CFPB has appeared to believe that credit riskiness and approvals must be identical across all races and ethnicities. But, drivers don't need letters from police to know they're within the speed limit. Lenders shouldn't need letters from their overseers to know they're operating within the law.

Heavily regulated banking at its core hasn't been innovative in more than a century. It wasn't always this way.

The golden age of banking innovation was in Scotland, from the tail end of the 17th century through the first half of the 19th century. Lightly regulated Scottish banks invented branch banking, interest-bearing savings accounts, overdrafts, lines of credit, and two-sided and multicolor banknotes.

The most momentous retail-banking innovation in the 20th century was general-purpose payment networks. While bank-owned, they were spearheaded outside banks proper, in barely regulated whitespace, by visionaries such as Visa's founding CEO Dee Hock.

No special regulation governed credit card rewards, cobranding and affinity marketing programs. There was no CFPB when Blockbuster and First Data pioneered prepaid cards.

In recent years, payments innovation has occurred only around the system's edge, in the least regulated domains, such as merchant acquiring. Square scaled and socialized mobile acceptance. The Dutch unicorn Adyen built a single, end-to-end, fully integrated, global acceptance platform.

In China, initially, regulators took a hands-off approach toward nonbank e-commerce payment systems, implicitly endorsing and enabling mobile-payments behemoths Alipay and WeChat Pay to develop and scale.

But in sub-Saharan Africa, banks are heavily regulated and weak. Path-breaking mobile-payment systems M-Pesa, Orange Money and EcoCash developed outside the banking system.

In the European Union, regulators have had too much of a heavy hand when it comes to directing payments innovation. The EU's first Payment Services Directive — known as PSD1 — created a licensing structure for nonbank payments providers competing across the Eurozone. The revised directive, known as PSD2, gives licensed nonbanks the right to initiate free payments against consumers' current accounts and harvest transaction data. But PSD2 is highly prescriptive, mandating strong two-factor authentication for electronic retail payments, rather than permitting parties at risk in the market to determine optimal risk management.

The European Central Bank licenses "fintech banks" defined as having "a business model in which the production and delivery of banking products and services are based on technology-enabled innovation." Lo, all banks rely on technology. Having a separate license for those considered innovative is too clever by a half. Why not have a regulatory regime that doesn't inhibit banks, period, from trying to innovate?

Policymakers should heed World Bank Chief Economist Paul Romer's counsel that, "Simple rules that are easy to follow are a sign that a government treats its citizens with respect. They yield direct economic benefits — more entrepreneurship; more market opportunities for women; more adherence to the rule of law."

More regulation and regulators deter new entrants and innovation from existing players. Ideally, legislatures, not regulators, will ensure that rules are conducive to innovation — that they're few, simple, clear and impartially enforced.

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