Sharon Donnery: Innovation and trust - regulating in the interests of us all

Remarks by Ms Sharon Donnery, Deputy Governor of the Central Bank of Ireland, at the Milano Hub, Milan, 7 February 2024.

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I am delighted to be here in Milan to discuss how regulators can support innovation in the financial sector, in line with our institutional mandates. Many thanks to Alessandra and the Banca d'Italia for inviting me to come, and indeed to the Milano Hub for hosting us.[1]

Innovation and Regulation – hand in hand through history

I am not the first economist or central banker to talk about innovation in financial services, and I certainly won't be the last. Indeed while the topic it is certainly *alla moda*, in reality financial innovation is as old as the system of money itself.

From the invention of coins as a medium of exchange to the paper notes of Kublai Khan (which astounded your compatriot Marco Polo[2])-

From the concept of Interest, as the "price of time", to the advent of fiat money-

From the creation of insurance as a means to pool risks – popularised indeed by Italian merchants[3] – to the invention of private pensions as a vehicle for lifetime consumption smoothing-

All of these were significant – at times extraordinary – inventions.

While I could go on, what is clear is that throughout history, financial services and the financial system has been continuously evolving and innovating.

Interestingly, and indeed necessarily, so too has the legal framework of money – evolving in tandem as a constant and essential underpinning of these innovations.

As such, I would say that innovation and regulation go hand in hand. And while I wouldn't recommend the Kublai Khan approach (anyone refusing to accept his notes were punished by death!), I would argue that rules and regulation have played a crucial role in the safe, and therefore *enduring*, adoption of innovation into the system.

Part of this has been the creation of rules and regulations to enable or to accommodate such innovation; but an important part has also been about ensuring they have appropriate guardrails – in order to maximise their benefits (for consumers, investors and the wider economy) while minimising their risks.

For it is by underpinning trust – the essential currency of money itself – that regulation allows financial innovation to not only survive, but to prosper. Trust improves adoption and encourages use. Trust enables the benefits of innovation to accrue to the system, and so for it to advance.

Put simply, without trust innovation doesn't progress – because it doesn't take.

Innovation in the digital age – the balance of benefits and risks

So if financial innovation is as old as finance itself, and the need for regulation to enable, frame and underpin that innovation has been a constant, what is new about the current phase of innovation in the financial sector – and why is there a need for regulators to take a different approach?

Stating the obvious, the main difference is that the current phase of innovation is primarily a digital one, with innovations in the financial sector taking place in the context of widespread technological advancements in our economy.

This has led to different dynamics in terms of both the nature and pace of change – resulting in a wave of new entrants, new products and new ways of serving customers.

Such innovation is delivering some real benefits for consumers and society; but it doesn't come without risks.

For example, **new entrants** provide much needed competition in the interest of consumers; this can also improve market functioning and is essential to a dynamic system and economy.

But the market only functions when its parts do; and from our own supervisory experience there have been growing pains with some of these new entities – with business models sometimes rushing ahead of control frameworks.

New products are to be welcomed, and are essential to meet evolving consumer demands. With some of these however, there are questions of suitability – not to mention utility. In the digital age rapid adoption of new products by retail consumers can also pose a challenge, in particular for products with a risk profile that may not be suited for such investors.

In this regard, some crypto-assets come to mind. While there is clear potential for distributed ledger technology and tokenisation to benefit the functioning of the financial system, given the volatility of some crypto-assets there are also clear risks to consumers and retail investors – which must of course be a focus for regulators.

New ways of serving customers is not only beneficial but critical to keep pace with wider developments in society; however for these benefits to endure it is essential that they are secure and resilient.

As such financial services firms must invest in digitalising their operations, processes, and offerings while also ensuring they have adequate safeguards in place to limit potential risks. While always true, this is particularly important in a digital world – given complex interlinkages and dependencies outside of the financial system.

Engaging with the challenge-

So while the benefits from financial innovation and the digitalisation of the sector are clear, so too are the risks. And it is only by adequately managing these risks that we can fully benefit from the opportunities.

This is the challenge for us all – regulators, industry and innovators alike. And coupled with the pace of digital development and change, not to mention the volatility and complexity of the wider external environment, it is no easy task.

Having said that, I think it is important for regulators to meet the challenge head on – to be confident in our expectations of regulated entities, be humble about where we need to learn or leverage from others, and to be open – to new ideas and new ways of engaging with innovators.

In the Central Bank of Ireland's case – and in the case of many other regulators – we have embraced this challenge.

This has involved doing things differently and learning new skills. It has also involved a shift in our strategic outlook – to be more future-focused, so to anticipate and support innovation; and to be more open, so as to strengthen our engagement with external stakeholders.[4]

Given this strategic outlook, it will be no surprise that over the last years we have significantly enhanced our engagement with the innovative ecosystem; and indeed this is something we have in common with the Banca d'Italia – given their own three integrated channels of dialogue with the market.[5]

We see this engagement as we a way for us to better deliver on our mission to serve the public interest, in particular by:

- **Deepening our understanding of innovation in the financial services sector** – so that we can better understand the opportunities and risks for consumers and the economy.
- **Better informing our regulatory approach** – allowing us to ensure that our regulation is aligned with a well-functioning financial system based on good levels of competition and innovation.
- **Better explaining to innovative firms what being regulated entails** – so firms can build regulatory requirements and safeguards into their early stage development and are better prepared for the responsibilities that come as a regulated firm.
- **Embedding a regulatory culture in our firms** – as firms with strong governance and risk management foundations are set up well for growth and innovation.

In this vein, our innovation engagement has been very valuable – both for the Central Bank and the innovative ecosystem in Ireland. And since we first launched our own Innovation Hub in 2018 we have been continuously evolving our approach – and are currently consulting on plans to: **Enhance our Hub** to deliver deeper, clearer and more informed engagement; and to **Establish an Innovation Sandbox Programme**, aimed at innovative initiatives which are consistent with our public policy objectives.[6]

The public consultation closes this week, and we are excited to launch the first round of our Sandbox Programme later this year.

Our engagement doesn't end with the market, however. Engagement with peer regulators is also vital – in particular given the rapidly growing and cross border nature of many of these innovations.

This is part of the reason I am here today. It is also why we are actively participating in the supervisory convergence work of the European Supervisory Authorities – and we welcome their efforts to establish common supervisory and regulatory approaches in this area, so that we can take full advantage of the potential of innovative technologies.[7]

-while delivering trust through the cycle

So, our innovation engagement has represented a new approach for the Central Bank of Ireland. It has helped firms better meet our regulatory expectations; and it has helped the Central Bank better understand innovations happening in the system. Two key outcomes for us – for we want to authorise and supervise innovative firms, as we recognise the benefit of them for our citizens.

But while this different approach has shown real benefits, it is important to say that such engagement does not come at the expense of our fundamental roles of regulation and supervision. Rather, as I have said before, our engagement is a complement to these roles – which remain crucial in the face of rapid financial innovation.[8]

For no matter how pioneering the innovation, the basic requirements of adequate risk management remains. Indeed, I would argue that the more complex nature of some of these innovations, and the speed at which they can scale and develop, makes the basics all the more important – and regulation and supervision of them all the more essential.

I have already mentioned the importance of trust – not only for the financial system but for innovations themselves. For me, ensuring there is trust in the financial system is a fundamental part of a regulator's role. And it is through *supervision* that we deliver that trust throughout the cycle:

- Trust that firms we authorise are of a sufficient standard to provide financial services in Ireland and Europe;
- Trust that firms we supervise are well run, and are managing the risks to them and their customers; and
- Trust that should a firm fail, they do so in a way that is orderly and that ensures consumers' funds are sufficiently safeguarded.

While these principles are general, we have found that they have been more acute with new and innovative firms, whose regulatory maturity and risk management capabilities have not always grown in line with their balance sheets; and where the regulatory toolkit is not everywhere as developed as in other sectors.

While it is not something I will focus on today, this has been particularly clear in Ireland's large and growing payment and electronic money institutions sector, where at times significant deficiencies have been identified.

I say this not just to criticise, but to make them better; and indeed they must get better in order to secure their customers funds, and the integrity of the system. Getting it right will also be a good for business; and so addressing these issues should be seen as a key enabler for growth, rather than an afterthought in their commercial strategy.

Conclusion – innovation in the interests of us all

To sum up, innovation and regulation go hand in hand. And while regulators need to adapt in the face of rapid financial innovation, innovators need to recognise that no matter how novel, innovative and ground breaking the product or initiative, the fundamental risks and their fundamental duty to manage those risks remain.

And while some might say that regulators are anti-innovation – I say this couldn't be further from the truth.

The job of regulators is not to be indiscriminately pro-innovation, but our mandate is to deliver in the public interest. And let me be clear that innovation done well is in the best interest of consumers and the wider economy.

But not all innovation is good, and not all innovation is done well. So to protect trust in innovation and the system, risks must be managed – so that the bad doesn't drive out the good.

This is in the interest of us all.

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[1] With thanks to Cian O'Laoide, Steven Cull, and Mary-Elizabeth McMunn for their help preparing these remarks.

[2] See "The Travels of Marco Polo", Volume One Chapter XXIV

[3] See for example The Beauty of Uncertainty: The Rise of Insurance Contracts and Markets In Medieval Europe – Botticini et al, Journal of the European Economic Association December 2023

[4] See Central Bank of Ireland – Our Strategy September 2021

[5] See for example Perrazzelli: The visionary project of a Single Supervisory Mechanism - where do we stand after 10 years? October 2023

[6] See Consultation Paper 156: Central Bank approach to innovation engagement in financial services November 2023

[7] See Campa, Digital finance: Confidence and resilience as a foundation for well-functioning financial markets January 2024

[8] See Donnery, Maintaining stability in the face of volatility – financial regulation in a rapidly changing world November 2023