Financial Services and Markets Bill: Positive Money written evidence

Positive Money welcomes the opportunity to respond to the Public Bill Committee's call for evidence on the Financial Services and Markets Bill.

We are a not-for-profit research and campaigning organisation, working towards reform of the money and banking system to support a fair, democratic and sustainable economy. We are funded by trusts, foundations and small donations.

Contact: Simon Youel, Head of Policy & Advocacy: simon.youel@positivemoney.org.uk.

Our submission makes the following key points:

- The proposed secondary objective for competitiveness and growth will undermine the government's vision for a financial sector that acts in the interests of communities and citizens. Objectives which more specifically target outcomes such as productive investment, employment and the transition to net zero would be more appropriate.

- The Bill should include a new statutory objective requiring regulators to ensure the financial system is aligned with the government's environmental goals. Policymakers should be able to introduce climate-calibrated capital requirements to protect against the high risk of new fossil fuel investments becoming stranded assets.

- The Bill must ensure that if cryptoassets are to be integrated into the payments system, this does not lead to 'tiering' between different monetary instruments. Digital settlement assets must be appropriately regulated as a form of money, to avoid the risks of regulatory arbitrage.

- E-money regulation could be an unsuitable starting point for digital settlement assets as e-money has weaker consumer protections. Instead, it may be more appropriate to amend banking regulation so that stablecoin issuers are regulated by the PRA as 'narrow banks' - deposit takers who process payments but do not undertake lending activities.

- The Bill must clarify free access to cash. The measures the government, the Bank of England and others have brought forward to support cash access are positive steps, but they fall well short of the universal cash provision we need for an inclusive, resilient economy.

Summary of recommendations

Objectives for regulators

→ Recommendation: Remove the secondary objective for growth and international competitiveness.

→ Recommendation: A new statutory objective requiring regulators to ensure the financial system is aligned with the government's environmental goals.

Capital requirements

→ Recommendation: Amend the Bill to enable policymakers to use climate-calibrated capital requirements to require financial institutions to hold a pound in capital against each pound lent towards new fossil fuel infrastructure, to protect the financial system against the high risk of stranded assets (the 'one for one' rule).

Regulatory independence and accountability

→ Recommendation: Reject any amendments that would introduce new 'call in' powers.

→ Recommendation: An additional requirement for FCA and PRA stakeholder panels to consist of at least 50% public interest representatives.

Digital settlement assets

→ Recommendation: The Bill should be amended so that stablecoin issuers are regulated more appropriately by the PRA, as 'narrow banks'.

Financial Inclusion

→ Recommendation: Give the FCA a cross-cutting "must have regard" to financial inclusion.

Objectives for regulators

1. The government's Future Regulatory Framework will determine the shape of the financial services industry in the wake of Brexit. The regulatory objectives and principles set under this new regime are critical to achieving a balanced and stable financial system and wider economy.

2. We oppose proposals to give regulators a new secondary objective to promote the "growth and international competitiveness" of the UK financial services sector. We are concerned that this move will undermine the government's own vision for a financial sector that "acts in the interests of communities and citizens, creating jobs

and supporting businesses”[1], as well as supporting the UK’s climate and nature goals.

3. Promoting “international competitiveness”, particularly for financial services, will mean regulators being pressured to slash regulation in order to compete with other jurisdictions and attract firms to stay in or move business to the City of London, at the expense of the wider public.

4. A focus on competitiveness has been shown to encourage regulators to water-down standards, with disastrous effects for the UK economy. The pursuit of competitiveness by regulators has been recognised as contributing to the 2008 financial crisis by Andrew Bailey while chief executive of the FCA[2] as well as the FCA’s incumbent chief executive Nikil Rathi.[3]

5. The government’s starting assumption that the financial services sector is an “engine of growth for the wider economy” is not borne out by the empirical data, with a large body of research showing a negative relationship between the depth of financial sector activity and economic growth.[4] The government’s approach must reflect this evidence, and not encourage regulators to pursue finance-led growth at the expense of the real economy.

6. The government’s implication that regulators will be required to facilitate the growth of the financial sector is particularly inconsistent with regulators supporting the long-term growth of the UK economy. It is estimated that the large size of the UK’s financial sector may have cost the economy £4.5 trillion in lost growth between 1995 and 2015, due not only to the 2008 financial crisis, but also the misallocation of resources, skills and investment away from the productive real economy.[5]

7. Regulation aimed at increasing competitiveness will likely make the financial sector even less able to serve the needs of the UK economy. The government’s vision for a financial sector which acts in the interests of communities and citizens, creating jobs and supporting businesses would be much better served with alternative measures, such as objectives for productive investment, employment, the net-zero transition, and sustainable house prices - all of which would help reduce the bias towards unproductive and speculative financial activity currently maintained by regulators.

---

[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1032075/FRF_Review_Consultation_2021_-_Final_.pdf&sa=D&source=docs&ust=1666025166903047&usg=AOvVaw1c4dzLo1VLHA-Aiu4V2g0x

[2] https://www.fca.org.uk/news/speeches/future-financial-conduct-regulation

[3] https://committees.parliament.uk/oralevidence/746/html/

[4] See for example: Cecchetti, S. G. and Kharroubi, E. (2012) *Reassessing the Impact of Finance on Growth*. BIS Working Paper No. 381. Bank for International Settlements;
Arcand, J. L., Berkes, E. and Panizza, U. (2015) ‘Too Much Finance?’, *Journal of Economic Growth*, 20, 105–148;
Rousseau, P. and Wachtel, P. (2017) ‘Episodes of Financial Deepening: Credit Booms or Growth Generators? ’, *Financial Systems and Economic Growth*, 52, 52-75.

[5] http://speri.dept.shef.ac.uk/wp-content/uploads/2019/01/SPERI-The-UKs-Finance-Curse-Costs-and-Processes.pdf

Recommendation 1: Amend the Bill to remove the proposed secondary objective for regulators to promote the growth and international competitiveness of the financial services sector.

8. We agree with the government's assessment that the transition to Net Zero should be hardwired into the UK's regulatory regime. However, we believe that the current proposal for a regulatory principle for sustainable growth does not go far enough and risks being undermined by a stronger statutory objective to promote the international competitiveness of the industry.

9. The International Energy Agency[6] and the UN IPCC[7] have made stark warnings that investment in new oil and gas fields and coal supply must stop now if we are to reach net zero emissions by 2050, and estimate that annual global investment in clean energy needs to more than triple to $4 trillion by 2030.[8] Moreover, green financial reform will also need to incorporate adaptation and nature recovery if the UK is to build a sustainable economy.

10. However, ongoing activities within the City of London are undermining these ambitions. The five largest British banks, including many with net zero targets[9], have financed fossil fuels to the tune of £275 billion since 2016[10], risking the long-term stability of the financial sector and wider economy.[11] The Bank of England's recent climate stress test estimates that climate change could cost UK banks up to more than £340 billion in a severe physical risk scenario in which climate action is delayed.[12] There is also increasing awareness of the strong link between nature loss and financial instability[13]: UK banks and asset managers provided a further $16.6 billion to just 20 deforestation-linked businesses between 2015 and 2020.[14]

11. The Climate Change Committee has made clear that climate goals must be fully integrated into financial regulation for the UK to achieve its net zero target under the 2008 Climate Change Act.[15] Currently, the Bill amends a 'regulatory principle' to 'have regard' to the need to contribute towards achieving compliance with section 1 of the

[6] Guardian, 'No new oil, gas or coal development if world is to reach net zero by 2050, says world energy body', 18 May 2021
[7] IPCC, 'Climate Change 2022: Impacts, Adaptation and Vulnerability', April 2022
[8] International Energy Agency (IEA), 'Net Zero by 2050', May 2021
[9] ShareAction, ''Net zero' banks continue to finance oil & gas expansion, ignoring climate science', Feb 2022
[10] Rainforest Action Network, 'Banking on Climate Chaos', March 2022
[11] Half of the world's fossil fuel assets could become worthless by 2036, leaving stranded assets worth between £8.1 and £10.3 trillion. Nature Energy, 'Reframing incentives for climate policy action', Nov 2021; Guardian
[12] Bank of England, 'Results of the 2021 Climate Biennial Exploratory Scenario (CBES)', 24 May 2022
[13] NGFS, Central Banking and Supervision in the Biosphere, 2022
[14] Global Witness, Deforestation Dividends, October 2021
[15] https://www.theccc.org.uk/publication/the-road-to-net-zero-finance-sixth-carbon-budget-advisory-group/

Climate Change Act 2008. Legal analysis has shown this will be insufficient for shifting finance in line with a managed transition to net zero and to become a net-zero financial centre.[16]

12. There is precedent for more ambitious sustainability objectives for regulators in other countries. In Germany, the Federal Financial Supervisory Authority (BaFin) has 'sustainability' as one of ten medium term objectives that are all given equal weight, including 'stability and security' and 'market supervision'.[17] These are 'based on the current risks in the financial sector as well as risks that may arise in future'.[18]

13. The French regulator, under article L621-1 of the French Monetary and Financial Code (Code monétaire et financier)[19], is required to oversee asset managers' management of risks related to climate change, and set up a Climate and Sustainable Finance Commission under this objective in 2019.[20]

14. As a result, we are calling for a new statutory objective for regulators to support rapid decarbonisation and nature protection. Other NGOs[21] and private sector groups[22] have made similar proposals.

Recommendation 2: A new statutory objective requiring regulators to ensure the financial system is aligned with the government's environmental goals.

Capital requirements

15. The new Financial Services and Markets bill should also enable the government to work with the Bank of England to adjust capital requirements to increase the amount of shareholder equity that a bank has to hold against fossil fuel lending, to reflect the high risk of such investment. In a scenario in which the government bans new fossil fuel projects and restricts fossil fuel lending in line with credible pathways for net zero by 2050, capital requirements could be used as an additional tool to reflect the high risk of *existing* fossil fuel lending, which should be subject to a 150% risk weight at minimum.

---

[16] https://www.cms-lawnow.com/ealerts/2022/08/does-the-financial-services-and-markets-bill-2022-secure-the-uks-green-finance-agenda
[17] https://www.bafin.de/EN/DieBaFin/ZieleStrategie/zielestrategie_node_en.html
[18] https://www.bafin.de/EN/DieBaFin/ZieleStrategie/zielestrategie_node_en.html
[19] https://www.legifrance.gouv.fr/codes/section_lc/LEGITEXT000006072026/LEGISCTA000006170863/#LEGISCTA000006170863
[20] https://amf-france.org/en/amf/our-organisation/climate-and-sustainable-finance-commission
[21] https://financeinnovationlab.org/wp-content/uploads/2022/05/6-May-2022-Climate-Briefing_FINAL.pdf
[22] https://www.wwf.org.uk/sites/default/files/2022-05/Aligning-the-UK-Financial-System-to-Net-Zero.pdf

16. However, in the absence of these restrictions, new fossil fuel lending should be assigned a 1250% risk weight,[23] to ensure that investments incompatible with the IEA's pathway for net zero are funded wholly by banks' own capital, rather than putting the public's deposits at risk. This would mean that every unit of currency of financing provided to new fossil fuel projects be matched by one equivalent unit of currency of financial institutions' own funds. Central banks themselves within the Network for Greening the Financial System,[24] as well as the European Central Bank[25] and Bank of England[26] have proposed the use of climate-calibrated capital requirements.

17. We therefore recommend amending the bill to give the Secretary of State the power to create regulations requiring financial institutions to hold capital in reserve to reflect the climate risk profile of certain investments.

Recommendation 3: Amend the Bill to enable policymakers to use climate-calibrated capital requirements to require financial institutions to hold a pound in capital against each pound lent towards new fossil fuel infrastrure, to protect the financial system against the high risk of stranded assets (the 'one for one' rule).

Regulatory independence and accountability

18. The government has signalled it will amend the Bill to introduce new 'call in' powers.[27] 'Call in' powers were not included in the FSMB as introduced in July by the Chancellor at the time, Nadhim Zahawi, but it is reported that a new leadership will seek to insert them into the Bill, despite concerns from the Bank of England.[28]

19. We are concerned that such 'call in powers' could create new channels for industry to exercise undue influence over regulation. The financial services sector already has oversized lobbying power,[29] and may be able to use this to influence government into 'call in' regulators to reverse decisions made to protect consumers on the grounds that they are deemed 'uncompetitive'. Even if such powers are not used, the threat of them may deter regulators from taking actions in the public interest.

Recommendation 4: Reject any amendments that would introduce new 'call in' powers.

---

[23] https://www.finance-watch.org/wp-content/uploads/2021/11/One-for-One-Joint-letter-BCBS.pdf
[24] https://www.ngfs.net/sites/default/files/medias/documents/ngfs_guide_for_supervisors.pdf
[25] https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202110_1~5323a5baa8.en.html
[26] https://www.bankofengland.co.uk/prudential-regulation/publication/2021/october/climate-change-adaptation-report-2021
[27] *Financial Services and Markets Bill Volume 719: debated on Wednesday 7 September 2022. Col. 283*
[28] https://www.ft.com/content/633e164e-53e2-42a4-a11c-e7c202290db7
[29] https://positivemoney.org/publications/the-power-of-big-finance/

20. We support the proposals to strengthen the role of stakeholder panels, but there should be robust processes in place to ensure the diversity of all panels, with specific provisions to include civil society representatives and consumer groups.

Recommendation 5: Amend the Bill with an additional requirement for FCA and PRA stakeholder panels to consist of at least 50% public interest representatives.

Digital Settlement Assets

21. Cryptoassets such as stablecoins represent a new form of 'shadow money' - liabilities issued by institutions outside the purview of banking regulation which are able to function as money. If not properly regulated, stablecoins could pose systemic risks to monetary and financial stability, as has repeatedly been the case with earlier forms of shadow money throughout the past few centuries (most notably in recent years money market mutual funds in the run up to the 2008 crisis).

22. Regulation should strive for a level playing field of high standards between stablecoins and other forms of money (namely bank deposits and e-money), to reduce the risk of regulatory arbitrage undermining policy objectives and leading to a lowering of standards. If stablecoins are to function as a form of money, they should be regulated as such. Consumers must be able to have confidence that they can easily exchange their stablecoins for fiat money at par, on demand. Stablecoins trading at a discount to other forms of money could pose systemic risks to monetary and financial stability.

23. If cryptoassets are integrated into the payments system, and brought into the regulatory perimeter, this must not lead to 'tiering' between different monetary instruments subject to different levels of regulation. Adding another layer of private sector money on top of existing private sector money would ramp up complexity and systemic risks, posing significant challenges for regulators.

24. A key concern is that use cases for many existing stablecoins involve avoiding regulatory structures pertaining to matters such as AML, KYC, and tax enforcement, as well as monetary and financial stability. Stablecoin issuers may seek to benefit from providing banking services while avoiding the appropriate banking regulations, as we have seen with e-money issuers such as PayPal.[30]

25. We support the integration of digital settlement assets into existing regulation, and oppose the creation of new regulatory categories for stablecoins. There is currently no common and consistent regulatory classification of stablecoins across jurisdictions, and establishing a new category within the UK's regulatory perimeter would not provide a sound basis for efficient cross-border payments using stablecoins. Instead, stablecoin issuers should be directed towards achieving

[30] https://www.ft.com/content/455e3cd7-4eec-3c0e-ad77-ed602f6d9878

equivalence with existing systemic payment methods in adhering to well-established international standards.

26. However we are concerned that the e-money regulatory framework may not be the most suitable starting point for many stablecoin issuers. Operational risk for payments companies can easily escalate into systemic risk, and as a precaution all stablecoin issuers should be supervised appropriately by the PRA. Doing so would also safeguard the public interest in regards to issues such as consumer protection and financial crime.

27. E-money issuers do not benefit from the Financial Services Compensation Scheme. While customers' funds are backed by deposits or invested into high quality liquid assets held in a segregated account or by a custodian, customers are still unprotected against the insolvency of the e-money issuer or the custodian firm. Given the questionable practices of many firms involved in the cryptoasset industry, and the prevalence of cyberattacks targeting crypto exchanges and wallets, this raises further concern over the suitability of e-money regulation for stablecoins. For example, if stablecoin infrastructure is targeted by a cyberattack, in the absence of deposit protection stablecoin users are not guaranteed against losses, even if their holdings were fully backed by high-quality liquid assets. At the very least it must be made clear to customers that unlike bank deposits, balances with stablecoin issuers are not insured by deposit protection.

28. E-money provisions appear vulnerable to abuse for financial crimes such as money laundering. Nearly 40% of UK Electronic Money Institutions (EMI) have been flagged red for money laundering risk, according to 2021 research from Transparency International.[31] Transparency International has also documented UK e-money licences being offered for sale.[32] Given concerns that cryptoassets are being used extensively for money laundering,[33] e-money regulations may be an unsuitable basis for regulating stablecoins.

29. We are also concerned that regulating stablecoins as e-money may also give consumers less protection against fraud than with bank deposits. This is especially worrying given the high level of fraudulent activity associated with the crypto-asset industry.[34]

30. A more suitable approach would be to amend the banking regulatory regime to introduce new provisions for 'narrow bank' licences, which stablecoin issuers would be required to obtain. A 'narrow bank' is an institution that undertakes core banking activities such as accepting deposits and processing payments, but does not extend credit. This is more similar to the regulatory approach that emerged in the US, where

---

[31] https://www.occrp.org/en/daily/15667-ti-nearly-half-of-uk-s-e-money-firms-red-flagged-for-money-laundering-risk

[32] https://www.transparency.org.uk/together-in-electric-schemes-UK-e-payment-EMI-money-laundering-risk

[33] https://www.bbc.co.uk/news/technology-60072195

[34] https://www.ft.com/content/5987649e-9345-4eae-a4b8-9bfb0142a2ab

stablecoin issuers would adhere to bank-like regulation, as insured depository institutions.[35] In the UK case, this would mean all stablecoin issuers being authorised and supervised by the PRA, rather than just the FCA, as is the approach currently favoured in the Bill. E-money provisions often do not give regulators direct access to EMI's balance sheets, making it harder to ensure regular scrutiny

31. Narrow bank regulation could give stablecoin issuers access to the Bank of England's balance sheet and net settlement systems, as enjoyed by lending banks. While narrow banks would not be allowed to lend credit, they could be able to pay interest to depositors, taking advantage of their access to reserve accounts at the Bank of England remunerated at Bank rate rate to pass higher rates onto customers.

32. New narrow bank provisions could mean less barriers to entry than a conventional banking licence, with a less strenuous approval process including lower fees and capital requirements, but would ensure the safety and soundness of the monetary and payments system. Greater institutional separation between the provision of payments services and credit intermediation could also bring long-term benefits by reducing the concentration of systemically important infrastructure in the financial sector, and introducing genuine competitors to the large incumbent banks.

33. Stablecoin issuers would otherwise be 'piggybacking' off of commercial banks. In this case, banks should be required to take direct responsibility for the stablecoins issued on the backs of their balance sheets. If banks have no direct obligations to holders of stablecoins, and stablecoins regulated as EMIs become systemic payment methods, the value of stablecoins would still be structurally dependent on the banking institutions holding their backing assets, leaving stablecoin holders indirectly exposed to financial risk arising from the banks' credit intermediation activity while only being offered the weaker level of consumer protection currently offered by EMIs. In this scenario, the overall level of consumer protection in financial services could be significantly reduced.

Recommendation 6: The Bill should be amended so that stablecoin issuers are regulated more appropriately by the PRA, as 'narrow banks'.

Financial inclusion and cash

34. Free and universal access to cash is vital for an inclusive and resilient economy. The Bill seeks to ensure "reasonable provision" for access to cash, but it is unclear what this will mean in practice. It must be clarified to specify free access to cash.

[35] https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf

Recommendation 7: Amend the Bill to clarify that 'reasonable provision' for cash includes free access to cash.

35. We support the Treasury Select Committee's recommendation that the FCA should have regard to financial inclusion in its rule-making.[36]

Recommendation 8: Amend the bill to give the FCA a cross-cutting "must have regard" to financial inclusion.[37]

[36] https://committees.parliament.uk/committee/158/treasury-committee/news/172965/treasury-committee-publishes-government-and-regulator-responses-to-future-of-financial-services-regulation-report/

[37] Fair by Design (2022) https://fairbydesign.com/financial-inclusion-commission-campaign/