

Written evidence submitted by Innovate Finance (FSMB24)

Financial Services & Markets Bill:

About Innovate Finance

1. Innovate Finance is the independent industry body that represents and advances the global FinTech community in the UK. Innovate Finance's mission is to accelerate the UK's leading role in the financial services sector by directly supporting the next generation of technology-led innovators.

2. The UK FinTech sector encompasses businesses from seed-stage start-ups to global financial institutions, illustrating the change that is occurring across the financial services industry. Since its inception in the era following the Global Financial Crisis of 2008, FinTech has been synonymous with delivering transparency, innovation and inclusivity to financial services. As well as creating new businesses and new jobs, it has fundamentally changed the way in which consumers and businesses access finance.

3. **Summary:**

- i. Innovate Finance and our members are supportive of the Financial Services and Markets Bill, which is critical to supporting proportionate rules that promote innovation and ensure better outcomes for consumers.
- ii. We strongly support the provisions on regulation of stablecoin and on development of a Financial Markets Infrastructure sandbox.
- iii. We strongly support the proposal for the regulators to have a competitiveness objective. The Bill could, however, be bolder in putting in place a system that ensures that regulators do support international competitiveness. This includes strengthening the competitiveness objective, extending the framework to the Bank of England and the Payments Systems Regulator (both of which will have a critical role in the regulation of new technology-led innovation), and ensuring greater consistency between regulators and the Financial Ombudsman Service.

Why is the Financial Services & Markets Bill relevant to FinTechs?

4. The UK has consistently attracted the most global investment in FinTech after the US. Last year we [reported](#) a record-breaking \$11.6 billion USD invested into FinTech in the UK, more than the next 6 European countries combined. Our recent 2022 half year report showed that whilst this is levelling off, investment in the UK in H1 this year still exceeded H1 2021.

Global FinTech Investment, by half-year period:

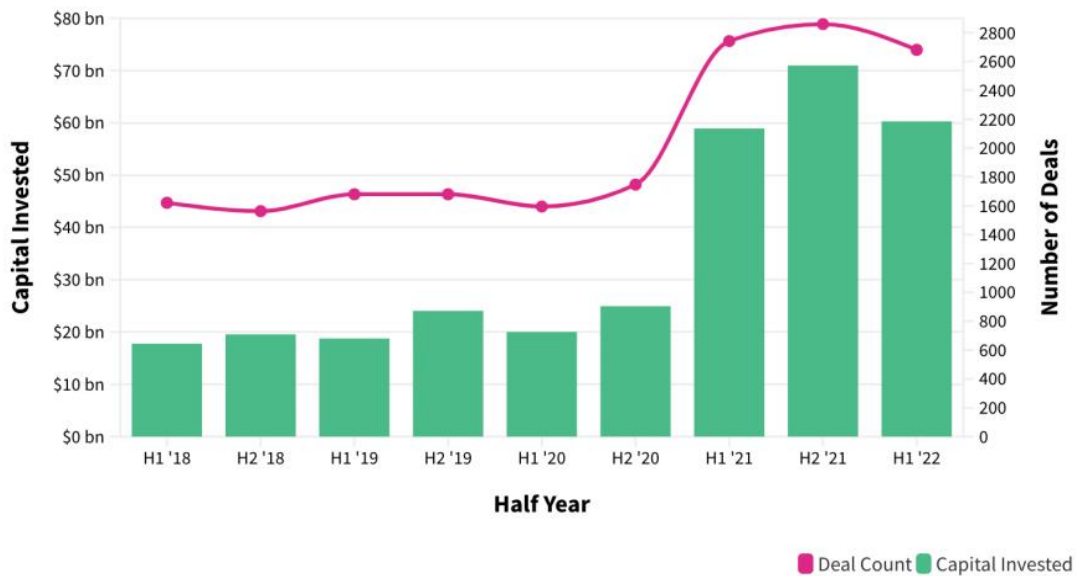


Figure 1: Global investment in UK FinTechs (capital and deals) between H1 2018 and H1 2022.

Source: Innovate Finance 2022 Summer Investment Report

5. This is a testament to the strength of our ecosystem, including our innovative entrepreneurs and founders, strong and diverse talent pool, and a supportive policy and regulatory framework. But we can not rest on our laurels, as the pace of change accelerates and we are seeing a new wave of digital transformation take place in financial services. Maintaining our global standing in FinTech innovation is critical to maintaining the UK's global standing in financial services as a whole. We need a regulatory framework which creates the right powers and principles to enable the UK's regulatory system to adapt and support innovation and international competitiveness. Below we have set out more detail on the critical areas of the Bill that are relevant to (current and future) UK FinTech:

- A. Stablecoin regulation
- B. Financial Markets Infrastructure sandbox
- C. Regulator objectives and relationships: including specific areas where the Bill could be strengthened to support competitiveness, competition and greater consistency between regulators and the ombudsman

A. Cryptocurrencies regulation - stablecoins

6. The Financial Services and Markets (FSM) Bill provides the enabling powers for a much needed regulatory framework for stablecoins. It will:

- **Enable the FCA to establish an authorisation and supervision regime** to mitigate conduct, prudential and market integrity risks for issuers of, and payment service providers using, stablecoins.
- **Enable HM Treasury to designate 'systemic' stablecoin providers and operators and for the Bank of England to regulate these to mitigate financial stability risk**, defined as services threatening the stability of, or confidence in, the UK financial system, or have serious consequences for business or other interests in the UK.
- **Enable the PSR to regulate payment systems using stablecoins** (digital settlement assets), to address issues relating to competition, innovation, user interests and access.
- **Enable HM Treasury to apply the Financial Markets Infrastructure Special Administration Regime**, a bespoke administration regime to mitigate the risks to financial stability associated with a systemic stablecoin firm's failure.
- Finally, it will **allow HM Treasury to amend or disapply existing FCA or PRA rules in areas relating to financial stability** to avoid relevant systemic stablecoin firms being subject to conflicting requirements.

7. Research by Checkout.com¹ has shown that retail customers increasingly want to pay using digital currencies and where trusted and regulated financial services players can support the crypto payment process, both consumers and corporates have an appetite to select the specific aspects of digital assets – in respect of payment and settlement – that they see as beneficial. These may include 'stablecoins', which are digital assets tied to a fiat currency value and typically underpinned by assets. Stablecoins are already deployed by large corporates to reduce their costs for cross border transactions (e.g., JPM Coin, JP Morgan's private stablecoin).

8. Payments systems based on digital assets such as stablecoins can reduce cost by removing the duplication of record keeping, enable instantaneous transactions without time delays,² and can bypass some intermediaries, thereby reducing transaction costs and fees for end-users and overcoming the challenge for merchants of trapped liquidity that can accompany complex bank-to-bank payment chains.

9. The volatility seen in crypto asset markets this year makes Government plans for regulation of stablecoins more important and more urgent. Arguably much of the volatility has arisen from a lack of clarity, consistency and transparency, which good regulation should provide.

10. If a consumer or business wants to hold value or make payments in stablecoin, they need to be sure that the token they are using is stable in practice, as well as in name. Well-calibrated guardrails for stablecoin issuers and holders should reinforce the vital role of

¹ Checkout.com, [Demystifying Crypto: Shedding light on the adoption of digital currencies for payments in 2022](#), 2022.

² Note instant payments are also possible using some existing systems.

stablecoins in digital markets. In developing a stablecoin regime, policymakers should ensure regulatory oversight of issuers, robust reserve requirements for issues, openness and transparency over the composition of those backing assets, and protections for stablecoin users.

11. HM Treasury's broad approach of applying the existing e-money regime to stablecoins (for which the Financial Services and Markets Bill provides enabling powers) is a sensible approach since it applies a familiar regime and will look to where this may need to be tweaked or tailored. Given the issues with stablecoins (particularly synthetic stablecoins) in the market this year, introducing this legislation is a priority.

12. The FSM Bill provisions on systemic stablecoins will enable the Bank of England to establish stability mechanisms for significant stablecoins, with regulatory supervision by the FCA and Bank of England providing a basis for market confidence. Plans for the regulation of systemic stablecoins (arguably like Tether) should provide verified, standardised approaches to capital assets underpinning stablecoins (and would probably, at least for now, rule out algorithmic stablecoins). This would provide the assurance that the market has realised (belatedly) it currently lacks.

13. The FSM Bill definition of digital settlement asset service providers, subject to these rules, includes coin issuers, exchanges, custody and wallet providers and system infrastructure providers. The inclusion of custody is welcome. Some of the wider volatility in crypto markets has been triggered by questions being asked about custodial activities and the guarantee of customer funds in the event of a service provider bankruptcy. Custodial activities relating to stablecoins are one of the issues that industry players have been working on and where industry standards by the Government are greatly anticipated. Custody is an important area for the security of assets and consumer confidence, not least in terms of rules which provide for segregation and records of customer assets, reporting to customers and a clear approach to situations where a custody provider goes into administration.

14. Globally, the regulation of stablecoins is now inevitable, and once in place it will enable the transformation of payment systems. The UK has been at the forefront of payment innovation and developing a UK regulatory approach creates the opportunity to maintain this new wave of transformation. This will enable the widespread adoption and usage of stablecoins as private digital money, transforming payment systems. In developing and implementing this regime it will be critical that the Bank of England builds in competition safeguards to ensure that the stablecoin market is not dominated by just a few global monopolies and that new entrants are able to enter the market.

15. The UK has been at the forefront of payment innovation and pressing on with the Government vision creates the opportunity to maintain this new wave of transformation. The success of the FSM Bill in regulating cryptocurrencies will be determined by the speed and detail of implementation as well as collaboration with industry. **We support the provisions in the Bill. It is important to give regulators the powers set out in the bill as quickly as possible and for these powers to then be exercised to develop a proportionate, competitive approach that protects consumers and supports innovation.**³

³ Further detail on how the UK can develop a competitive and proportionate approach to crypto-assets, and the opportunity for the UK to be the leading centre for digital finance, is set out in a paper we developed with Shearman & Sterling for the Treasury Select Committee inquiry on crypt assets: [Innovate Finance paper for Treasury Committee inquiry into Crypto-Assets](#)

B. Financial Services Infrastructure Sandbox: Regulator-as-a-Platform

16. The Bill **enables HM Treasury to set up one or more Financial Market Infrastructure (FMI) sandboxes**, which will enable participating firms to **test and adopt new technologies and practices**. An FMI sandbox will do this by enabling participating firms to be subject to temporary modifications to legislation, where that legislation does not currently accommodate such activities or is ambiguous as to whether or not it can be accommodated. **HM Treasury will also be able to make permanent changes to legislation via secondary legislation, on the basis of what is learned in each FMI sandbox**. HM Treasury will be able to temporarily display or modify relevant legislation relating to the regulation of FMIs and to allow FMI entities to innovate, within the scope of the activities they have been authorised to carry out, in an FMI sandbox.

17. **Why this matters: How technology can transform UK Financial market infrastructure.** The first wave of FinTech innovation over the last decade transformed the customer experience and the 'front end' of financial services (user interfaces and consumer friendly apps and platforms). The next wave of crypto-related innovation will transform the 'back end' of finance, including the infrastructure or 'plumbing' of capital markets.

18. Trading venues (such as stock exchanges and multilateral trading facilities) and post-trade infrastructures (clearing houses and settlement systems) provide for the transfer of legal ownership of assets and are therefore underpinned by the record or documentation of that ownership and trade. Moving to a system of digital record - or digital assets (in some cases using distributed ledger technology, but not necessarily) can enhance the functionality and efficiency of the financial system. Digital tokens hold the promise of representing existing financial assets, such as bonds or shareholdings, in a way that may be more efficient if proven at scale. Digitalisation can also enable the exchanges themselves to be programmed with prudential controls to spot signs of financial instability or unusual trading patterns. In addition, blockchain or DLT could potentially allow regulators to digitally monitor the market in real time. Therefore, these technologies open the potential for digital compliance and regulatory controls.

19. **FSM Bill provisions for sandbox for FMI:** Rigid, codified rules and approaches will not support innovation nor protect stability or consumers as new technology is combined and used in the financial system. Regulators will need to work collaboratively, including with industry, and flexibly. That includes working with start-up firms, both inside the sandbox and scalebox environments, and also increasingly working with established firms on innovation and, crucially, developing a more 'systemic' sandbox that tests widespread market applications at scale across numerous firms.

20. This means trying out regulatory approaches, testing them in real time (and in live markets) and adjusting the rules in the light of experience (and data driven monitoring). This is the concept of the 'regulator as a platform' – applying the tech model to regulatory activities. The new approach will require the regulators to learn alongside industry. It goes beyond current sandbox models – which are a form of 'hand holding' whilst new businesses develop and adopt existing regulatory rules.

21. The UK Government's proposals for a 'sandbox' for FMI, which would be enabled by the powers in the Financial Services and Markets Bill) are important and welcome. These would allow

HM Treasury to 'turn off' and/or modify certain onerous or inappropriate regulations as they apply to new forms of financial infrastructure, permitting the testing of new systems in a contained environment overseen by the appropriate regulator (Bank of England or FCA) and evolving the FMI regulatory framework to accommodate new technology and practices.

22. This is a radical reform to support innovation and allows for a very flexible 'beta testing' approach to regulation for participating entities. The regulatory approach FMI sandboxes represent will be important in enabling the UK to remain at the forefront of the next wave of digital innovation around payments and financial market infrastructure.

23. **The UK Government's proposals for a PRA/FCA 'sandbox' for Financial Markets Infrastructure are a welcome approach to supporting innovation in financial services.** This should provide a blueprint for all future financial services regulation – and it would be helpful to have a commitment from the Government to evolve this across the regulatory system.

C. Regulators: objectives and consistency

24. The Bill introduces a new 'secondary' objective for the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA) to have regard to the competitiveness of the UK and for economic growth. Regulators will have to report annually on how they are applying this. We are supportive of this competitiveness objective for regulators. This is critical to supporting proportionate rules that promote innovation and ensure better outcomes for consumers. The Bill could, however, be bolder in putting in place a system that ensures that regulators do support international competitiveness.

We would propose strengthening the Bill in the following areas:

i. Promoting competitiveness

26. The Bill introduces a secondary objective for the financial regulators which charges them with 'facilitating the international competitiveness of the economy of the UK'. This falls some way short of encouraging the type of action taken by our competitors such as Singapore, where the regulators actively promote their market alongside the government and industry. An amendment to replace (or append) 'facilitating' with 'promoting' competitiveness would make a big difference.

27. This is not about reducing consumer protection or financial stability measures. In a global financial system, where technology enables people to make transactions and investments anywhere around the world, protecting UK consumers in part depends upon increasing their access to products and services that fall within the UK regulators' rules, which in turn means creating a stable and proportionate regime that attracts providers to the UK.

ii. Competition

28. The existing competition objectives of the PRA and FCA should be extended to the Bank of England - especially as areas like Central Bank Digital Currency and the capital requirements rules for challenger banks very much need to take account of competition in the market and avoid favouring incumbents or a few large market players. The FSM Bill should add a competition

objective to the Bank of England. This would ensure, for example, that a CBDC is designed in a way that does not crowd out private sector innovation in the payments market.

iii. Payment Systems Regulator (PSR)

29. The proposed new regulatory framework in the Bill only applies to the PRA and FCA. The PSR should be aligned to the framework for FCA and PRA - including the competitiveness objective - as the PSR will be dealing with more and more critical areas including open banking in payments and stablecoin.

iv. Regulatory cooperation and Financial Ombudsman Service (FOS)

30. Inconsistent interpretation of rules by FOS and FCA is a major concern amongst our members. Firms reach an understanding with the FCA only to find that the FOS takes a different view in its case rulings. This creates uncertainty and unpredictability. We would welcome a provision to establish a principle whereby FOS should refer issues to the FCA and "take regard" of an FCA opinion.

31. The Bill contains sensible provisions on cooperation between FCA, FSCS and FOS - again, PSR should be included too (FOS will pick up complaints against handling of APP scam reimbursement cases, regulated by PSR).

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