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Financial Services and Markets Bill 2023

Overview of Bill and MP engagement to date

The Financial Services and Markets (FSM) Bill proposes a significant restructure of financial regulation following Brexit. The government has described it as a "once-in-a-generation opportunity" to reshape financial regulation. But the Bill makes no provision for sustainable finance, threatening both economic stability and the Prime Minister's commitment to make the City of London a 'net zero-aligned financial centre'. Instead, the FSM prioritises growth and competitiveness above all else.

The FSM Bill is an opportunity to shape regulation which drives the UK financial sector towards net-zero investment, enhancing our energy security and creating jobs in the process.

Cross-party support for sustainable finance in the Commons debates

Chris Grayling (Conservative) called for the Bill to mandate **supply chain due diligence** reporting, as many financial institutions inadvertently fund deforestation via their investments.

Sarah Olney (Lib Dem) put forward an amendment that would require **regulators to report** on how they have **promoted and encouraged green finance**.

Olivia Blake (Labour) called for more **robust stewardship standards** 'to put ethical engagement with companies on the climate crisis – and much more – at the heart of investment activity'.

Wera Hobhouse (Lib Dem) called for **fiduciary duty reform** to empower pension schemes to think holistically about their investments, noting 'pensions are there to provide adequate quality of life after retirement – how absurd if the climate crisis means there is little quality of life left?'

Tulip Siddiq (Shadow Labour Treasury Minister) urged the government to **update the Green Finance Strategy** with a clearly defined **Green Taxonomy**.

Caroline Lucas (Green) spoke to the importance of **One-for-One capital requirements** on fossil fuel assets, whereby for every pound invested in fossil fuels, a pound is held liable for potential future losses (e.g. due to stranded assets).

However, despite cross-party agreement that the Bill currently does not supercharge sustainable finance, none of these amendments passed.

Summary of suggested Second Reading speaking points

We recommend asking the Government:

- if it has considered the benefits of empowering the regulators via **statutory objectives to build a world-leading net-zero financial sector**
- what assessment it has made of the **risks posed to financial and economic stability** by **proposals to make growth and competitiveness the primary objective** of the FSM Bill
- **what sustainability provisions it plans to include in Solvency II** (insurance legislation) to help the UK fulfil its ambitions to be a world-leader on green finance
- how it plans to **amend laws on investment duties**, given this legislation is considered by many leading investors to be outdated
- how it plans to **raise standards** among investors who are lagging behind in stewardship practices, given their importance for greening finance
- what assessment it has made of the case for **increasing capital requirements on fossil fuels** to protect against economic instability and incentivise green investments
- how it plans to **create accountability** for the **financial institutions publishing net-zero transition plans**

Speaking points regarding existing clauses

Create a new objective focused on shifting the financial system to net-zero and reversing biodiversity loss

The government proposes a new **regulatory principle** on **contributing towards achieving net-zero emissions by 2050:** a positive change from the current principle on sustainable growth. However, the government is **making growth and competitiveness of the UK economy a greater priority for regulators than reaching net-zero**.

The green transition offers significant economic opportunities for the UK. One estimate suggests bold climate action could yield a direct economic gain of US$26 trillion through to 2030 compared with business-as-usual.

However, the government's ambition for the UK to become the world's first net-zero aligned financial sector **will require a monumental change of policies, processes and culture across the industry**. We need a clear legal duty for regulators to take action on the climate and biodiversity crises if we are to bring about a change of such scale. This would create policy certainty for investors, facilitate the disclosure of reliable market data and enhance the UK's international leadership.

We recommend asking the Government if it has considered the benefits of empowering the regulators via statutory objectives to build a world-leading net-zero financial sector.

Reconsider proposals to create new statutory objectives on competitiveness and growth

Adding a new secondary objective of competitiveness risks rules being weakened to attract business. That could undermine the very integrity of the UK market that makes it attractive. For example**, an over-focus on competitiveness has been widely acknowledged as a factor in bringing about the 2007/8 financial crisis,** including by 50 leading economists, Andrew Bailey (then head of the FCA and now Governor of the Bank of England), and the Treasury itself (in 2010).

Similarly on growth: **growth for growth's sake is not desirable when it comes to the financial sector.** Extensive research suggests that there is an optimum size for a financial sector relative to the rest of an economy.[1] The UK far exceeds this poin**t.**

We recommend asking the government what assessment it has made of the risks these proposals pose to financial and economic stability.

Include sustainability safeguards in Solvency II reforms

Solvency II is an EU directive that sets out how much capital insurance firms must hold to reduce the risk of them going insolvent. This Bill lays the groundwork for revoking Solvency II and transferring relevant powers to the PRA, with the plan of reducing capital requirement thresholds and giving insurers great investment freedom.

The Government claims these reforms will lead to increased green infrastructure investment, but this is not guaranteed. Reducing the amount of funds held back to protect the overall system should it fail is an extremely risky strategy, especially as the proposed legislation fails to account for material climate risks, which continue to increase. **Our research finds that even founding members of the Net Zero Insurance Alliance continue to funnel billions into fossil fuel expansion.** The Government could remove fossil fuels from the matching adjustment (the investments insurers are incentivised to make), and mandate that a certain threshold of money freed up from reductions in capital requirements be invested in green infrastructure.

We recommend asking the government what sustainability provisions it plans to include in Solvency II to help UK to fulfil its ambitions to be a world-leader on green finance.

[1] Cecchetti & Kharroubi, 2012; Baker, Epstein & Montecino, 2018

Further speaking points

Since this Bill addresses multiple miscellaneous areas, we see it as a good opportunity to table clauses addressing a range of sustainable finance issues. We recommend raising the following areas at second reading as points that the Bill should address.

Reform the investment duties of pension funds to include environmental or societal impact

The UK government needs to raise the ambition of what is expected of fiduciary investors, such as pension funds, as key actors in the economy and society. We believe fiduciary investors should retain the discretion to make the decisions they believe are in the "best interests" of beneficiaries. However, **a person's best interests are not only financial, but also depend upon the opportunity to live in a healthy, stable, secure society and environment.**

We propose a reform that broadens the "best interests" of beneficiaries to include the environmental and societal impacts of investment and stewardship decisions. This is not ideological thinking but instead **reflects closer attention to the purpose of a pension: to provide a standard of living to the beneficiary.** There is little point in gaining a few extra per cent return in the short term if the beneficiary retires into a world of wildfires and flooding.

We recommend asking the government what plans it has to amend laws on investment duties, given this legislation is considered by many leading investors to be outdated.

Mandate publication – and frequent regulatory scrutiny – of net-zero transition plans

Voluntary initiatives alone cannot guarantee that financial institutions are on the right path when it comes to combating climate change. In 2021, the 44 largest members of the Net-Zero Banking Alliance (NZBA) provided $143.6 billion in lending and underwriting for the 75 companies doing the most to expand oil and gas. It is high time that **policymakers make it mandatory for insurers to publish detailed net-zero transition plans**.

Financial institutions should be brought before UK Parliamentary Select Committees annually to explain why their transition plans are adequate and to evidence the progress they have made: this is clearly in the public interest.

We recommend asking the government how it plans to create accountability for the financial institutions publishing net-zero transition plans.

Increase capital requirements for assets that carry particularly high physical and transition risks

Following a basic risk management logic, the Basel Committee on Banking Supervision (the global standard setter for the regulation of banks) has recommended that the one-for-one capital requirements be applied to certain cryptocurrencies' exposures. Applied to climate change exposure, such a rule would mean that **for each euro or dollar that finances fossil fuels, banks and insurers should have one euro or dollar of their own funds held liable for potential losses**.

This targeted and proportionate measure will thus only affect financial institutions that choose to invest in highly risky assets, such as fossil fuel-related assets. It is **a financial stability measure that will allow institutions to have enough capital to absorb losses arising from the materialisation of climate change risks** and steer investments away from fossil fuels.

We recommend asking the government what assessment it has made of higher capital requirements on fossil fuels to protect against economic instability and incentivise green investments.

Raise the baseline of stewardship standards to help enable a whole-economy transition to net zero

As the Aldersgate Group identifies in its 2022 report, it is critical that financial institutions engage with systemic risk rather than managing portfolios by divesting from high-carbon assets. However, **stewardship practices among investors are still far from robust or effective enough to help the UK reach its goals for decarbonising the economy**.

The UK government should **raise the baseline standard of stewardship for asset owners beyond the minimum standards set by the UK's implementation of the Shareholder Rights Directive**. This baseline standard should draw on key elements of the FRC's Stewardship Code and should be a legal requirement for all large institutional investors.

We recommend asking the government how it plans to raise standards among investors who are lagging behind in stewardship practices, given their importance for greening finance.

ANNEX – KEY PROVISIONS IN THE BILL

- **EU law:** Revoking and restating certain parts of retained EU law to create a comprehensive FSMA model.
- **Growth and competitiveness:** Creating a new secondary objective of growth and competitiveness for the financial regulators.
- **Net-zero emissions target:** Creating a new regulatory principle for the FCA and the PRA to have regard to the UK net-zero emissions target.
- **Solvency II:** Allowing HM Treasury to implement Solvency II reforms by revoking Solvency II and transferring powers to the PRA.
- **Review of regulators' rules:** Requiring regulators to keep their rules under general review, with a power granted to HM Treasury to appoint a third party to review rules for them where the regulator's own review is not viewed as "appropriate".
- **Financial markets infrastructure (FMI) sandboxes:** Allowing HM Treasury to introduce FMI sandboxes to allow firms to test new financial propositions in the market with consumers.
- **Critical third parties:** Granting regulators a power to censure non-regulated financial intermediaries when they breach FCA, PRA or Bank of England rules.
- **Financial promotions rules:** Requiring authorised persons to obtain permission from the FCA to approve financial promotions prepared by third parties without a UK authorisation.
- **Position limits regime:** Revoking the requirement for the FCA to apply position limits to commodity derivative contracts and transferring the responsibility for setting position limits from the FCA to trading venues.
- **Settlement of crypto assets:** Creating a new power for HM Treasury to introduce rules on the payments relating to digital settlement assets.
- **Access to cash:** Requiring the Treasury to publish a statement of policy concerning cash deposit and withdrawal services.
- **Authorised push-payment (APP) scams:** Enabling regulators to ensure that victims of push payment scams are reimbursed.