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Submitted online

Dear Sir / Madam,

**Financial Services Consumer Panel response to the Treasury Select Committee's crypto-asset inquiry call for evidence**

The Financial Services Consumer Panel (the Panel) is an independent statutory body. We represent the interests of individual and small business consumers in the development of policy and regulation of financial services in the UK. Our focus is predominately on the work of the FCA and so we are responding to this call for evidence because it is part of the live debate about whether and to what extent the FCA should regulate crypto-assets.

Crypto-assets should be regulated to protect consumers. An agenda to attract crypto business to the UK to boost international competitiveness will not succeed unless consumer protection, including the overall soundness of the financial system, are built in to its foundations. At present, there are a number of unresolved issues, such as the legal status of crypto-assets and how to resolve any agency problems. Agency problems will arise if the interests of management and token holders, or token holders and other types of investor, are not aligned. In the Panel's view, there are clear consumer harms caused by crypto-assets and/or their issuers and distributors. Some of this harm is caused by fraud, some by the underlying volatility of the assets and a significant portion by the lack of legal framework and consumer protection regime around crypto-assets.

There are some aspects of the existing regulatory regime that could be usefully applied to cryptoassets. For example, we urge government to act on HM Treasury's intention to legislate to bring certain crypto-asset promotions into the scope of the financial promotions regime. The Panel supports the FCA's proposals in their consultation of financial promotions rules (CP22/2), to classify crypto-assets as 'Restricted Mass Market Investments' for the purposes of the financial promotions regime and was particularly pleased with the FCA's proposal not to apply the "self-certified sophisticated investor" exemption to the promotion of crypto-assets. The Panel also considers that HM Treasury and regulators should urgently review the crypto lending landscape and prioritise action in this area where we see significant potential for consumer harm.

In summary, we believe the Government should:

- Follow through on its intention to bring crypto-assets into the financial promotions regime (alongside the FCA raising standards in this area).
- Coordinate with regulators and their peers overseas, as well as with digital / internet providers more widely, in order to address some of the challenges presented by crypto and other digital assets.

- Empower the FCA to regulate crypto lending (perhaps as part of the review of the Consumer Credit Act) which carries new kinds of risk of over-leveraging and debt problems.

Our responses to the questions posed in the call for evidence are included at Annex A below.

Yours sincerely

Helen Charlton

Chair, Financial Services Consumer Panel

## **Annex A – Responses to consultation questions**

### **Q1. To what extent are crypto-assets when used as digital currencies (such as Stablecoin) likely to replace traditional currencies?**

The Panel considers that the ubiquitous circulation and acceptance of a single form of money as a medium of exchange within an economy is an important, if not an imperative, public good. The circulation of multiple currencies within the same economic system creates risks and costs which depress and limit economic activity, complicate price discovery and can lead to economic and social exclusion.

For digital currencies to be in any way *beneficial* to the UK economy, consumers and businesses, they would need to offer all the benefits of commercial bank money – be denominated in sterling, backed by sterling reserves, fully fungible at par with each other and freely and immediately interchangeable with all other forms of sterling. They should also be appropriately regulated and digital currency deposits protected under the Financial Services Compensation Scheme. In other words, digital currencies would need to offer consumers the equivalent utility and protections as commercial bank money.

For digital currencies to be in any way *additive* to UK consumers (and the UK more widely), they would need to lower transactional costs within the economy as a whole and /or offer novel means of value transfer and acceptance.

While the Panel does not have any particular insight into whether such digital currencies *could* or *would* displace current means of transaction, the Panel does have considerable reservations about the widespread adoption of any other form of digital money as a means of payment and/or unit of account than that we have outlined above. Should unbacked, unprotected, unfungible digital ‘currencies’ emerge, these would result in economic and social fragmentation, increased transactional costs, and consumers bearing very significant market and credit risk. This would represent a hugely retrograde step, that would undermine hundreds of years of policy development, investment and regulation to achieve the payment system that we have today.

### **Q2. What opportunities and risks would the introduction of a Bank of England Digital Currency bring?**

The opportunities and risks would very much depend on the form in which the Bank decided to introduce a Central Bank Digital Currency (CBDC). Given the private sector enthusiasm for introducing private digital currencies, the Panel believes it is imperative that a digital ‘money’ framework is put in place to ensure the fungibility and backing framework we refer to in our answer to Q1 above. The Panel also believes that as we exchange more and more value in digital form, it is important consumers have ready and easy access to move and store money ubiquitously across the UK in the most private, efficient and affordable way possible. Whether a CBDC would be necessary to achieve this is not something the Panel has a view on.

### **Q3. What impact could the use of crypto-assets have on social inclusion?**

To the extent that the legal, regulatory and governance structures outlined under Q1 above are in place, crypto technologies could play a useful role in lowering transactional costs and enabling fractional ownership. Crypto technologies could therefore help to enable and extend financial participation, which in turn may enhance social inclusion.

However, if such crypto frameworks and products emerge and take off, they will also exacerbate existing digital exclusion problems – thereby worsening social and digital exclusion and likely exacerbating the analogue premium.

**Q4. Are the Government and regulators suitably equipped to grasp the opportunities presented by crypto-assets, whilst at the same time mitigating against the risks?**

The UK government and regulators are, as others around the world, challenged by the fast-developing nature of the crypto world. There are considerable challenges around fraud, financial crime and other forms of criminality. There are also challenges associated with regulating the marketing and promotion of crypto-assets. The UK government and regulators will need to work in coordination with their peers overseas as well as with digital / internet providers more widely in order to address some of the challenges presented by crypto and other digital assets.

The Panel does not discount that crypto technologies could open new opportunities and enable beneficial new forms of economic activity. We also understand that government and regulators in the UK are keen to see these opportunities realised. That said, we would like to see that consumers interests are protected and prioritised and not considered as an afterthought.

**Q5. What opportunities and risks could the use of crypto-assets—including Non-Fungible Tokens—pose for individuals, the economy, and the workings of both the public and private sectors?**

The Panel considers that there are several risks associated with crypto-assets, including Non-Fungible Tokens, that will need to be addressed in order to ensure that the integration of crypto-assets into the UK financial services framework will be successful and benefit consumers. These include:

- Establishing a clear understanding of what it means to own a crypto-asset and the extent to which such assets can be considered as property.<sup>1</sup> Without a clearly understood legal foundation, it will not be possible to articulate properly any potential risks. Ideally any legal articulation of what it means to own a crypto-asset will be internationally recognised. However, from the point of view of the UK regulatory environment, it will be particularly important to ensure that English and Welsh and Scottish law, as well as law in Northern Ireland, are aligned.
- Ensuring that any non-fungible tokens have clear and non-fungible links to the underlying assets they are supposed to be linked to. Currently this is not always the case. For example, there are examples where non-fungible tokens have been issued linked to a digital image, but although the buyer's link to the token is secure, the link between the token and the image could be broken, allowing the image to be changed without the buyer's consent. Such risks would clearly disadvantage consumers.
- Ensuring that any agency problems are addressed so that consumers are protected. Agency problems will arise where the interests of management and token holders, or token holders and other types of investor are not aligned. An example of where agency problems may arise can be seen in relation to crypto-assets linked to infrastructure investment. Supposing a company owns and

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<sup>1</sup> The Law Commission, for example, has just launched a consultation into this question.

manages several large pieces of infrastructure, such as shopping centres, and it decides to issue non-fungible tokens linked to one specific property. If the company needs to make decisions about which properties to invest in or close down a tension arises because the interests of shareholders in the company as a whole and the holders of tokens for the single property may not be aligned. Shareholders are likely to receive higher returns on investment from investment in properties that do not have tokens associated with them, and similarly will be shielded from harm if the tokenised shopping centre were closed down, because of their interest in the underlying physical asset. The decision that is finally made will depend on whether the interests of managers (or agents to the owners) are aligned with token holders or with shareholders. Agency problems can be very hard to solve, meaning it is important to consider this issue in advance of any widespread adoption of tokenised investment options within the financial sector.

- Ensuring that issuance of crypto-assets is not simply a way to avoid providing the necessary disclosures associated with non-digital assets. The rules governing prospectuses and disclosure requirements for retail investors are in place to act as a safeguard and to address known issues. It would therefore be undesirable for the issuance of crypto-assets to be exempt from such rules where the underlying assets are comparable. If problems have been identified in applying to crypto the disclosure regimes for retail investors, or the prospectus regimes, then these should be addressed through reform of those requirements, not by allowing issuers to undertake regulatory arbitrage designed to circumvent such rules.
- Ensuring that there are ways that consumers can prove their identities and gain access to their digital wallets or crypto-assets, if they lose or forget the necessary access details (in much the same way that bank customer helplines can help reset access). This should include facilitating access to the digital assets of a deceased holder by the executors of their estate.
- Ensuring that those investing in, or borrowing in, cryptocurrencies properly understand the exchange rate risk they are taking on. As the recent shifts in the value of Bitcoin and other such products demonstrate, these risks can be considerable. Furthermore, exchange rate risks are also inherent in Stablecoins, as the history of fixed exchange rates would demonstrate.

The Panel does not pretend to understand all the opportunities or all the possible risks of crypto-assets, however we have observed that amongst the most widely and loudly proclaimed opportunities are the elimination of intermediaries and the reduction of costs. Clearly there would be benefits if cost savings were to be passed on to consumers, however we have some scepticism as to whether these cost savings will actually be realised and passed on to consumers. Even with such benefits, we believe the risks to consumers are significant and we strongly encourage regulators and government to move swiftly in addressing these.

**Q6. How can distributed ledger technology be applied in the financial services sector?**

No comment.

**Q7. What work has the Government (and its associated bodies) done to understand, prepare for and, where relevant, encourage changes that may be brought about by increased adoption of crypto-assets?**

No comment.

**Q8. How might the Government's processes – for instance the tax system - adapt should crypto-assets be adopted more widely?**

No comment.

**Q9. How effective have the regulatory measures introduced by the Government - for instance around advertising and money laundering - been in increasing consumer protection around crypto-assets?**

The Panel considers that the rules around financial promotions in general need to be strengthened to protect consumers more effectively, and this includes the rules governing the sale and promotion of crypto-assets. The Panel therefore supports the FCA's recent proposals in [CP22/2 to strengthen the financial promotions regime](#), including the FCA's proposal to apply the financial promotion regime to crypto-assets and classify them as 'Restricted Mass Market Investments'. The Panel considers that treating crypto-assets in this way (for example by including risk warnings and banning inducements) has the potential to help mitigate some of the risks in this sector. We therefore urge government to act on HM Treasury's intention to legislate to bring certain cryptoasset promotions into the scope of the financial promotions regime. However, as the FCA identified, this is an emerging sector and therefore it will be important to monitor how the regime is functioning, in order to assess whether more stringent measures are needed.

The Panel was particularly pleased to see the FCA's proposal not to apply the "self-certified sophisticated investor" exemption to the promotion of crypto-assets. The Panel considers that the use of self-certification should cease, and would like to see the FCA limiting its use in other areas as well. As set out in its [response to HM Treasury's consultation on "Financial Promotion exemptions for high net worth individuals and sophisticated investors"](#), the Panel also considers that the thresholds for high net worth investors are too low.

More generally, advertising rules are important and useful, but are by no means sufficient to ensure consumer protection in isolation. Whilst the rules may help to mitigate the risks of over-promising by some providers in some instances, public advertising is only one means by which consumers might learn about, understand and access crypto markets. Furthermore, there is widespread access to extremely risky crypto activity through providers' own websites where options such as crypto borrowing are prominently promoted. There is also prevalent advertising via social media and so-called 'finfluencers' where it may not always be clear to consumers whether content is an advert<sup>2</sup>.

The Panel has particular concerns about crypto borrowing which is highly risky for a number of reasons. Borrowers are not subject to credit checks and using their crypto investments they are able to secure high loan to value loans at low interest rates in minutes. The readily accessible nature of these loans is problematic on several fronts – most notably the fact that in depositing one currency (say a cryptocurrency) to borrow in another (say US Dollars) borrowers are assuming unlimited downside exchange rate risk – risks that could leave them (*in extremis*) indebted for life.

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<sup>2</sup> For further comment on this, see our response to DCMS' Online Advertising Harms consultation: [https://www.fs-cp.org.uk/sites/default/files/final\\_fscp\\_response\\_dcms\\_online\\_advertising\\_programme\\_20220531.pdf](https://www.fs-cp.org.uk/sites/default/files/final_fscp_response_dcms_online_advertising_programme_20220531.pdf)

Our understanding of this emerging market is that borrowers are required to collateralise their loans with crypto deposits, which the lenders then reinvest. This exposes the borrowers not only to the credit risk of the issuer, but also to its investment risk.

Given the marketing around these loans, their ready accessibility and the low interest charges they bear, they may seem an easy and attractive way to borrow. It is highly unlikely that consumers will understand the unlimited losses they are exposing themselves to when taking out crypto loans and we would encourage urgent attention be paid to this emerging but heavily promoted activity.

**Q10. Is the Government striking the right balance between regulating crypto-assets to provide adequate protection for consumers and businesses and not stifling innovation?**

Whilst there have been some welcome moves regarding advertising, we have concerns around an approach focussed on welcoming, nurturing and encouraging the crypto industry to develop in the UK in pursuit of competitive advantage. We are concerned that consumer protection is thereby deprioritised at precisely the time that it needs to be made a priority.

**Q11. Could regulation benefit crypto-asset start-ups by improving consumer trust and resilience?**

Regulation is imperative to ensure consumer safety and minimise the risk of consumer harm which should be the government's first order concern. The Panel therefore considers that this question is the wrong way round and that the correct question should be "Could consumer trust and resilience be improved through the regulation of crypto-asset start-ups?" The answer to this question is yes.

The Panel considers that regulation to benefit consumers should not simply be introduced where it would benefit the sector itself. Harm to consumers needs to be prevented (in line with the FCA's new Consumer Duty), and this is particularly the case where there is a disparity in either knowledge or power, which is likely to be the case in the crypto-asset sector, particularly with respect to retail investors.

The Panel also notes that a reputation for strong and effective regulation can act to attract financial services firms and inward investment. Firms benefit from their home regime's perceived strength and can use this as a way of virtue signalling to attract customers and investors. This suggests that effective regulation would not only help to protect consumers, but could also help to attract reputable firms and investment in the UK. If and when such safety and safeguards are in place, trust may grow, thereby benefiting start-ups.

**Q12. How are Governments and regulators in other countries approaching crypto-assets, and what lessons can the UK learn from overseas?**

No comment.

**Q13. The environmental and resource intensity of using crypto-asset technology**

The Panel has no specific views on the environmental and resource intensity of using crypto-asset technology. The Panel is not aware of how far crypto-asset activities contribute to UK emissions and their implications for government responsibilities towards achieving net zero. However, the Panel considers that it is important the environmental

impacts of any such technology should be disclosed to allow users and investors to understand the implications, so that they can make informed decisions that reflect their preferences. For such disclosure to be effective, it needs to be fully aligned to wider environmental disclosure requirements to allow comparisons between different options.