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Client Alert

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The Kalifa Review – Reshaping financial services regulation and policy

In brief

The UK's fintech sector is due to get a major boost in reforms suggested as part of the Kalifa Review of UK Fintech (the Review). These reforms are part of a suite of legislative reviews launched by the UK government to enhance the competitiveness of the UK market in the area of digital finance post-Brexit. The Review is intended to catalyse growth in the UK fintech sector and provides recommendations to ensure the UK maintains its position as a world leader in financial services as the sector undergoes a technological revolution and it remains the best place in the world to start and grow a fintech business. While recent HM Treasury consultations have sought to implement individual regulatory changes (for example, as part of its payments special administration regime, or the cryptoassets consultation), the Kalifa Review is a high level strategic document seeking to identify threats and opportunities for the UK fintech sector, and to create a facilitative and permissive environment for the industry to thrive.

This alert provides a high level overview of the Review's recommendations, and highlights some of the key ways in which the Review may fundamentally reshape financial services regulation and policy in the UK.

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Overview of key recommendations

The Review notes that there are three broad threats to the UK's fintech leadership position: fintech-friendly competitor jurisdictions like Singapore, Australia and Canada; regulatory uncertainty arising from Brexit; and the need for a quick and nimble government response to capitalise on the rapid acceleration of digital adoption arising from the COVID-19 pandemic. By creating a thriving fintech sector, the Review foresees that the UK is likely to benefit through the creation of high-income tech-based jobs and an upskilled and retrained workforce, the facilitation of the UK's position as a global leader in fintech regulation and trade, and an inclusive pandemic recovery with access to more sustainable financial services.

In order to allay these threats and achieve its strategic goals, the Review sets out a number of recommendations, grouped under a "five point plan", covering policy and regulation, skills, investment, international engagement, and national connectivity.

Kalifa Review 5 Point Plan

Policy and Regulation

- Digital finance regulatory framework
- Scalebox
- Digital Economy Taskforce
- Trade policy

Skills

- Short courses to retrain and upskill
- New visa stream
- Embedded work placements

Investment

- Expand tax-incentivised schemes
- Fintech Growth Fund
- Listing regime improvements
- Fintech indices

International engagement

- International action plan
- International Fintech Taskforce
- Fintech Credential Portfolio

National connectivity

- Fintech clusters
- National coordination strategy
- Further investment

The Review proposes that a new Centre for Finance, Innovation and Technology (CFIT) will be the organisational link to deliver the five point plan, taking responsibility for driving the national coordination and international collaboration strategies, leading the Fintech Credential Portfolio, and supporting the growth of the fintech clusters. CFIT will establish a set of specific deliverables aimed at improving the UK fintech upscaling path, with indicative targets including (among others) to increase the percentage of SMEs making use of external finance, to double the number of UK domiciled fintech unicorns, and to increase the number of fintech listings on the London Stock Exchange (LSE).

The evolution of the fintech industry is likely to have a knock on impact on many other parts of the financial services sector. We set out below how the recommendations set out in the Kalifa Review might shape financial services regulation and policy in years to come.

Strategy and collaboration

Unsurprisingly for a review focused on economy wide reforms required to foster fintech growth, the Review identifies a number of areas of collaboration between industry participants and regulators, as well as with international bodies. In particular the Review notes the need for certain industry "coalitions" (including coalitions on SME Finance, Open Banking and Digital IDs) with a centralising, organising institution at its core. To this end the Review proposes the creation of a new CFIT which will be at the heart of the digital finance revolution, to develop digital finance strategy, co-ordinate industry responses and collaborate with international efforts to promote the UK as a digital finance hub.

CFIT will also assist with research into and promotion of national connectivity regimes such as maintaining a national fintech database and researching into and liaising with expert bodies to promote fintech cluster excellence and to assist UK fintechs compete on a global stage. To this end CFIT would also be mandated to set an international agenda to increase the global scale and impact of UK fintech alongside a new International Fintech Taskforce established by the Department for International Trade. Together these bodies would promote the UK's fintech credentials and to support UK fintech business to export their services and to compete in a global environment.

While a number of industry bodies are currently engaged in high quality work in various segments of the fintech sector, CFIT will be the first central body coordinating and leading fintech efforts in the UK. As a new forum for participants it is hoped that CFIT will provide a much needed central voice for the fintech industry.

Investment and direct support

One of the Review's most significant recommendations is to support changes to tax incentives and the development of a fintech growth fund. A key part of gaining access to capital also involves freeing up capital for investors in fintech businesses and for incumbent institutions investing in fintech proposals. The Review suggests that research and development tax credits should be expanded to accommodate the cost of financial data sets to help growth fintechs to develop and to scale. It also suggests that tax relief should be expanded to assist founders and investors to access existing tax schemes (such as the enterprise investment scheme, seed enterprise investment scheme and tax relief for venture capital trusts). In addition, the Review supports the development of a £1bn domestic fund to invest in fintech businesses (along the lines of the Business Growth Fund). This fund would be supported by the government (using its influence and convening power) and industry groups, and funded by private capital.

These tax incentives and additional capital pools, together with the proposed changes to the listing rules, should make growth capital easier for fintechs to access at a key point in their development. Importantly, as many challenger banks scale up to full authorisation and supervision by the Prudential Regulation Authority (PRA), the demand for additional capital produced by the confluence of increased regulatory capital requirements (including in particular recent announcements by the PRA that it will be removing exemptions for software assets from the intangible asset deduction from regulatory capital) alongside the need to invest in greater systems and controls infrastructure means that competition for investment will be keen, and new avenues to capital targeted to fintechs should provide a welcome boost to the industry.

Immigration reform

In a globally mobile and online industry, the free movement of high quality human capital is seen as key to maintaining the UK's edge in fostering innovative business. The Review recognises the threats posed by Brexit to this flow of human capital and, in particular, the difficulties emerging in accessing EU-based talent and navigating complex immigration and visa regimes. To combat these challenges the Review suggests introducing a new visa stream for employees in fintech businesses. This visa stream would be actively marketed by government to attract fintech talent and "job creators" to the UK, with the hope that the multiplier effect created by this will stimulate further growth. Fintech businesses seeking to draw on the overseas talent pool will be able to engage with support from immigration staff with the intention of expediting and easing the employment of new talent.

Listing Regime

The Review notes that the UK is falling behind in offering fintechs access to public capital, with NASDAQ and NYSE together accounting for 53% of total fintech IPO listings between January 2015 and December 2020.

The Review notes that current FCA Listing Rules only allow for a single share class, whereas other exchanges permit dual class structures thereby allowing founders to entrench their control. Furthermore, premium listing requires a company to maintain at least 25% of its shares as a free float, which offers little flexibility for fintechs that may wish to offer a smaller percentage of their shareholding through the IPO so as to maintain their current capital structure. In contrast, the NYSE and NASDAQ impose value thresholds rather than a percentage depending on the market, meaning that the percentage being offered can be considerably lower than 25%.

The UK Listing Review, published on 3 March 2021 by HM Treasury, also makes similar proposals to bolster the LSE, involving dual class share structures and reducing free float requirements. The Listing Review also proposes to relax rules around special purpose acquisition companies (SPACs) which allow special listing vehicles to be created with the intention of that vehicle then acquiring an operating business - in effect, providing a simple route to listing status for businesses. Traditionally, governance and investor protection concerns have limited the availability of SPAC regimes, but with the large volumes of SPAC activity occurring in the US and with competitor jurisdictions such as Hong Kong and Singapore investigating or launching their own SPAC regimes, the UK government is now consulting on whether to amend the existing UK listing rules to remove barriers to SPAC activity. For further details on the UK Listing Review, see our alert here.

This is likely to be a key area of change in the UK's regulatory regime as the UK seeks to cement its position as a global capital centre and to recover some of the ground lost to US capital markets in respect of fintech activity. UK founders and shareholders looking to IPO in the medium term future should keep a keen eye on these developments.

Regulatory "scalebox" and related reforms

A key component of the UK's fintech regime to date has been the development and expansion of the FCA's regulatory sandbox. The sandbox is a 'safe space' in which businesses can test innovative products, services, business models and delivery mechanisms without immediately incurring the regulatory consequences of engaging in the activity in question. The Review notes that this has helped support new fintech firms and ensure a more nurturing regulatory environment, but that as businesses, technologies and solutions scale the UK's policy and regulatory approach must continue to create an environment which encourages growth and competition. To this end, the Review proposes a "scalebox" to support firms' growth, building on the success of the regulatory sandbox by:

- enhancing the regulatory sandbox by making it available on a rolling (rather than time limited) basis, offering support to proposed businesses delivering innovative propositions that may not be "first of a kind", and creating a dedicated space for priority fintech areas
- creating an FCA-led "permanent digital sandbox", focused primarily (but not exclusively) on fintech priority areas, providing access to a broader range of tools than the regulatory sandbox and allowing testing by both fintechs and established institutional participants with innovating products;
- supporting the partnering of fintech firms and incumbent financial institutions through a digital scalebox and through government action to encourage established firms to partner with fintech / regtech companies (e.g. through regulatory encouragement, tax incentives etc); and
- increasing support for firms in the growth phase of their business, a key stage for fintechs when many face the challenge of ensuring appropriate allocation of resources between front end and back end functions. To help firms manage this uncertainty, the Review suggests that regulators should also provide proactive support to firms in the growth phase to help them navigate the increasing regulatory burden that they face.

The Review flags that the FCA's objectives may need to be reconsidered to allow the regulator to operate in this manner. In addition, the Review notes that the Competition and Markets Authority (CMA) must adapt its approach to the fintech sector to better balance competition and growth. The Review suggests that there is a case for more flexibility in the assessment of mergers and investments for nascent and fast-growing markets such as fintech. Some consolidation will therefore be critical in facilitating the growth that UK fintechs need in order to become global champions. The Review recommends that the CMA’s mandate should reflect these market dynamics.

The Review's conclusions in this regard are clear that regulators will need to evolve with the fintech sector in order to deliver innovative products and, in doing so, accept some element of regulatory and market risk which accompanies innovation. It is anticipated that new regulatory initiatives relating to the regulatory sandbox and to support growth stage start-ups will be announced over the coming period. Given how international regulators responded to the FCA sandbox, it is likely that similar regulatory initiatives in major global financial centres will also be watching these developments with interest.

Payments regulation

In considering areas where further regulatory intervention may be required, the Review notes that the existing regulatory framework for payments is problematic as it creates barriers to new market entrants and hinders innovation. In order to keep pace with the fast-evolving payments world, the UK needs to ensure its payments regime is fit for purpose, does not hinder innovation and adapts with the adoption of fintech and the growing prominence of cryptoassets.

The UK is currently considering reform of the payments regime and is in a strong position to reshape the landscape to create an environment to foster growth for fintechs. The Government is actively evaluating the regime through the Treasury's payment landscape review, including how the regime needs to adapt in order to maintain the UK's position as a world-leader in payment networks. In addition, the FCA is currently consulting on changes to its approach to payment services and strong customer authentication, and the Payment Systems Regulator is undertaking a programme of development on its future strategy, including engagement on innovation and future payment methods, which will shape regulatory outcome targets going forward. In particular, the new payments architecture will provide businesses with a fast, safe and accessible payments framework as the infrastructure to build a future payments economy. These regulatory reforms are intended to make the payments landscape safer for customers and the broader economy, but will need to be carefully weighted to avoid over complication and the creation of new barriers to entry for new participants, and to balance safety with innovation and competition.

Crypto regulation

The Review notes that the UK has the potential to be a leading global centre for the issuance, clearing, settlement, trading and exchange of crypto and digital assets. It cites that other jurisdictions are developing their own propositions for crypto, such as the EU’s Markets in Crypto-Assets (MiCA) proposal and therefore suggests that the UK acts quickly to preserve its strong position in the crypto market, for example by developing a bespoke regime that is more innovation driven and adopts a functional and technology-neutral approach. This regime can then be tailored to the specific risks arising from the crypto-asset related activities.

The Treasury has issued a consultation on the regulatory approach to cryptoassets and stablecoins. It seeks views on how the UK can ensure its regulatory framework is equipped to harness the benefits of new technologies, supporting innovation and competition, while mitigating risks to consumers and stability. The consultation proposes to begin by focusing on establishing a sound regulatory environment for stablecoins and then future regulation of a potentially wider set of tokens and services will follow. The Review welcomed the government's proposal to investigate a wider ranging crypto regulation (similar in breadth to the MiCA, but being more innovation driven). For further details on the Treasury's consultation, and how it compares to MiCA, see our alert here.

Interestingly, the review also supports the introduction of a UK Central Bank Digital Currency (CBDC) - a concept which is currently being consulted on by the Bank of England. The introduction of a UK CBDC would be a major driver for the uptake of crypto currencies and could be a catalyst for cryptoassets to be adopted by mainstream businesses.

Given the Review's recommendations, the Treasury's consultation and the fledgling status of the UK's crypto regulatory regime, there will be impetus for HM Treasury to bring forward its consultation on regulating other cryptoassets to capitalize on the UK's strong position in the fintech world and forge the global path towards regulating crypto with a bespoke regime. Similarly, the Review's recommendations may boost enthusiasm for the introduction of a UK CBDC, which, if adopted, would position the UK as among the global leaders in establishing virtual fiat currencies. However, these actions will require extensive reform to bring crypto on within the regulatory perimeter on a much broader scale, and with challenges arising from the need to ensure a balance between innovation, competition and market safety, it remains to be seen how ambitious the UK is willing – or able – to be.

Going forward

It is clear that the Kalifa Review has the potential to reshape the financial services landscape in the UK through its ambitious programme of reform and reorientation, and other major financial centres will be watching the UK progress with interest, as jurisdictions compete with one another for fintech-friendly bragging rights. New funding commitments, listing regime improvements and tax incentives, together with targeted immigration reforms, will help draw late stage fintechs seeking growth capital and developed talent pools to the UK. Regulatory reforms (including reforms to the payments and crypto regulatory landscapes) should help to create a dynamic environment to foster new and innovative fintech businesses - encouraging founders with novel ideas to head to the welcoming regulatory environment envisaged for the UK. However, as with all ambitious plans for significant reform, the proof is in the implementation, and it remains to be seen how committed the UK will be to such a programme of wholesale change - in particular, how a welcoming attitude to innovation and reform will survive the inevitable challenges which accompany rapid technological change.

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