INNOVATE FINANCE

Bank of England Discussion Paper
Regulatory regime for systemic payment systems using stablecoins and related service providers
Innovate Finance response

Innovate Finance welcomes the opportunity to respond to the Bank of England's Discussion Paper (DP) on a regulatory regime for systemic payment systems using stablecoins and related service providers. 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.

In HM Treasury's update on plans for regulating fiat-backed stablecoins, it highlighted the importance of creating a regulatory framework that established the required standards to manage risks, such as consumer protection and financial stability, and also provided the ability for firms to harness the potential benefits of cryptoassets to support economic growth and innovation in the sector. Innovate Finance supports this overarching principle as the UK continues to develop its regulatory framework towards cryptoassets and cements its place as a leading centre for digital assets. We also see stablecoins as part of a future payment ecosystem with a diverse range of payment options available to consumers and businesses.

The Bank's DP, as part of a wider package of publications, is a welcome next step in this regulatory process. We appreciate the Bank's openness to engagement as part of the consultation process and the intentions behind the proposed regime in general, which could see the UK reap the benefits of stablecoin payments in the future. That said, while the proposals have been designed with the best of intentions, our members have several concerns that if enacted as conceived could lead to a stifling of innovation due to the narrow commercial parameters in which systemic payment systems using stablecoins could operate. We outline the main areas of concern from our members below, along with some other observations.

One major issue we see across both the Bank and Financial Conduct Authority's (FCA) DPs is how some of the main underlying principles in designing the regulatory framework do not seem to be consistent with the actual risks or business models in question. This leads to a second overarching challenge we see in both DPs from the Bank and FCA, that in proposing a comprehensive regime for stablecoins used as a means of payment before any market has developed, risks undermining its development. Setting out such a prescriptive framework based on today's use cases will potentially inhibit new innovation in the future, unless both the Bank and FCA actively consider how these regimes will adapt over time to cater to a wider set of use cases. We strongly urge consideration of how to ensure any regime is future proof in this respect.

We believe that with further refinement and engagement with industry a regime could emerge that would ultimately position the UK to benefit from the introduction of stablecoins while ensuring financial stability and consumer protection.

Same risk, same regulatory outcome

The DP outlines a regulatory framework based on the concept of 'same risk, same regulatory outcome', in that systemic payment stablecoins must provide an equivalent level of protection against loss of value and loss of confidence compared with commercial bank money. This approach is based on ensuring the 'singleness' of money to maintain confidence in money and payments.

Our members recognise and support the intention behind the singleness of money, however, we are concerned that the same risk, same regulatory outcome framework used in relation to systemic payment stablecoins compared with commercial bank money is disproportionate given the respective business models in question.

The business models underlying commercial bank money and systemic payment stablecoins are fundamentally different. The former is based on lending, while the latter is based on payments. Given the risks associated with lending and the possibility of a bank run as a result, it's not clear to us that the threat of a run on a systemic payment stablecoin is the same, especially in cases where the assets are fully backed. The risk profile of commercial bank money and stablecoins are different for this reason, which means that a modified approach to the principle of same risk, same regulatory outcome is warranted.

As a result, we believe the Bank should reassess the possibility of stablecoin backing assets being held in a range of high quality liquid assets, similar to the Financial Conduct Authority's (FCA) regime. We also believe that the Bank could enact such an approach and still be consistent with the Financial Stability Board's (FSB) recommendation that reserve assets should consist of only conservative, high quality and highly liquid assets. The FSB does not state these reserve assets have to be central bank deposits.

Commercial viability and scope for innovation

For a competitive market to grow and provide consumers with choice and a range of products, firms in any industry must have the ability to innovate and offer different types of product services. Our members have concerns that the framework as conceived in the DP would create a very narrow regulatory regime in which potential systemic payment systems using stablecoins could operate on a commercial basis. The DP sets out a framework for issuers where they can derive income solely in exchange for payment services, arguing that business models that are focused on generating returns on backing assets would be more suited to other regulatory regimes, such as the banking regime. The idea proposed that issuers should not receive interest on their central bank deposits would put any potential issuer at a competitive disadvantage compared to other institutions with interest generating reserves under other regulatory regimes. It is not clear how a stablecoin issuer could scale given these commercial constraints and our members fear this would lead to a narrow market where only existing large banks or large global tech companies could sustain the commercial viability of a systemic payment system using stablecoins (e.g. as part of a wider economic model where payments only form part of the business). We encourage the Bank to consider how the regime can be made proportionate to allow new entrants and innovators to scale over time in a safe and commercially viable way.

While the DP argues the framework would be "flexible and could accommodate different business models" our members feel that in practice the regime would constrain the types of business models available. Moreover, payments are an extremely competitive market and the ability to generate sufficient revenue solely on payment fees would potentially make it difficult for any firm to build a commercially viable systemic stablecoin payment system, with the exception of an issuer who had a broader pre-existing business and launched a stablecoin that is deemed systemic at launch.

Our members also highlighted a broader risk regarding the potential direction the regime could take as a result. Given the wider 'Dear CEO letter' from the Prudential Regulation Authority (PRA) which set out expectations for banks with regards to stablecoins and tokenised deposits, if conditions are such that discourage banks to be able to innovate in stablecoins, and if non-banks are limited to generating revenue from just payments in this space, it could lead to a scenario where the only type of firm that could operate a systemic stablecoin payment system would be a firm with a large established business looking to leverage stablecoins as a payment system, similar to the then Facebook's Libra project.

Transition between regulatory regimes

In contrast to the Bank's proposed approach, the FCA regime would allow issuers to generate returns from the underlying stablecoin assets. Our members welcome this aspect of the FCA's approach but are concerned that the gap between the FCA and Bank's regime would create problems for firms pre and post systemic designation. Any stablecoin issuer that built a business under the FCA regime and began to scale to a point which prompted supervisory conversations about potentially being designated systemic would need to consider a potential pivot in their business model.

While it is important that systemic stablecoins are subject to stronger regulatory oversight, differences between the Bank and FCA regimes may create unintended consequences. For example, too much of a cliff edge would create timely and costly changes operationally in scaling up. Furthermore, the increased compliance burdens may cause a disincentive to FCA regulated stablecoin issuers to reach, or purposely avoid, the systemic threshold. This would also run counter to the desire to attract firms to come to the UK and scale.

The Bank's proposal for issuers of systemic payment stablecoins to be set up in the UK as subsidiaries in order to carry out business and issuance activities into the UK and with UK-based consumers, and for backing assets and the issuer's capital to also be held in the UK, may also require dramatic changes to a firm's business.

We believe that important steps are needed to prevent this cliff edge risk otherwise it would undermine potential investment in the sector in the future. Two steps we recommend would be for the Bank and FCA to work together to see how greater alignment could be made between regimes (e.g. generating returns on backing assets) and a clearer process for firms on what a transition between the regimes would mean in practice assuming the systemic stablecoin payment system was not designated at launch.

Designation process

The transition between regulatory regimes raises broader questions on the designation process under Part 5 of the Banking Act 2009. Part 5 sets out certain criteria that will be considered in a possible designation order, but the Act itself does not provide any clear metrics (e.g. number or value of transactions), while other criteria are also hard for firms to judge (e.g. threaten the stability of, or confidence in, the UK financial system). This is in contrast to the EU's Markets in Crypto Assets (MiCA) regulation which outlines quantifiable tests that would be applied to establish whether an issuer is deemed 'significant' as defined under MiCA.

Since stablecoins represent a new innovation in payments, it is also unclear how the criteria set out in Part 5 would be interpreted by HM Treasury and the Bank of England, and whether new or different factors would be taken into account as part of a designation process. Further guidance on this topic would be helpful for industry to understand how the growth of any potential business model would be viewed.

The uncertainty around the designation process, combined with the challenges of transitioning between regulatory frameworks, would create considerable uncertainty for firms or potential market entrants in having the necessary clarity on the commercial and regulatory standing of systemic payment systems using stablecoins. Our members did, however, find it helpful that the DP clarified that no existing stablecoin or wallet would be considered systemic.

Without clear guidelines as to when this is and the timings around it, it could pose great difficulties as when a firm moves from being non-systemic to systemic there are quite substantial changes including that the firm moves from being regulated by the FCA to the BoE. Whilst the change in regulator is not the biggest issue, the requirements that are in place from each regulator are more concerning. When non-systemic, an issuer is able to hold high quality liquid assets and cash reserves and generate income from the assets but if or when it becomes systemic it will have more stringent requirements on what assets are held and no longer be able to generate income from assets but instead only be able to do so from transactions. This completely changes the type of business models that these firms use and the cost for transition will be incredibly high. This in and of itself could create stability issues.

Related service providers

Members also highlighted a concern that a service provider, such as a wallet provider could be classified as systemic and it is unclear as to how this designation process would be assessed (similar to the point above). For example, will it be based on how integral that wallet is to a stablecoin or a series of stablecoins, and how will this be assessed?

Separately, there is increasing debate around the use of self-hosted wallets. In line with our discussions with the FCA and also in line with positions we have taken with HMT in the past, it is important that we remain open to firms engaging with self-hosted wallets. Restricting interaction puts the Bank, in this case, of picking winners. Instead, we suggest that measures are put in place with requirements and disclosures that self-hosted wallets will need to make to be able to give the comfort that AML/KYC rules are being followed.