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

Positive Money response - February 2024

Positive Money welcomes the opportunity to respond to the Bank of England's discussion paper on the regulatory regime for systemic payment systems using stablecoins and related service providers.

We are a not-for-profit research and campaigning organisation, working towards reform of the money and banking system to support a fair, democratic, and sustainable economy. We are funded by charitable trusts, foundations, and small donations, and therefore do not have a pecuniary interest in the design of the regulatory regime for stablecoins.

Contact: Simon Youel, Head of Policy & Advocacy: simon.youel@positivemoney.org.uk.

General comments and key points

While the future of stablecoins may seem uncertain, or even irrelevant to financial stability, much is at stake with their regulation. The stability of not just the financial system, but the entire economy, relies on households and businesses being able to trust that a pound is always worth a pound. Though this may sound like a truism, stablecoins may disrupt this trust and risk undermining the wider monetary and financial system, unless regulated appropriately.

We therefore support the Bank of England's approach to preserve the singleness of money by ensuring stablecoins are fully backed by risk-free reserves (i.e central bank deposits). However to meet the Bank's objectives, these requirements should apply to all stablecoins being integrated into the UK monetary system, whether deemed 'systemic' or not.

We strongly support the need to increase competition in payments by reducing barriers to entry, and to this end we have long-argued for the Bank of England to open up access to settlement accounts to non-bank firms that only provide payments.[1] However, we are concerned by risks that stablecoin issuers may not only confine themselves to payments, and may seek exposure to credit, liquidity and market risk. Stablecoin issuers are already acting as 'shadow banks', providing liquidity at the off-ramp/on ramp margins of the cryptoasset industry, such as exchanges.[2] Stablecoin issuers currently derive most of their revenue from the interest and returns from backing assets.

Stablecoin issuers will likely complain about the restrictiveness of backing assets. They will likely argue that even with a wider range of backing assets they will still be able to fully repay depositors, just as money market mutual funds argued the same, before a run on

[1] https://positivemoney.org/publications/increasing-competition-payment-services/

[2] https://www.coindesk.com/policy/2021/10/19/gensler-for-a-day-how-rohan-grey-would-regulate-stablecoins/

their short-term liabilities ultimately sparked the global financial crisis in 2008. The industry will likely also argue against being subject to stricter requirements than e-money institutions (EMIs), but unlike stablecoins, e-money does not have the potential to seriously compete with bank deposits as a means of payment.

We urge regulators to stand firm against such lobbying. The supposed use cases for stablecoins are payments - if this is truly their purpose then non-interest bearing reserves should be a sufficient backing asset. If stablecoins issuers fear they would be 'uncompetitive' with banks or EMIs, attention should be focused on improving existing standards for incumbents, rather than watering down standards to make new business models viable. Otherwise the entire system will be inevitably undermined by regulatory arbitrage.

If stablecoin issuers want to introduce maturity transformation into their business model, they should apply for a banking licence. Otherwise there is a significant risk of stablecoin issuers exacerbating problems with shadow banking, undermining the uniformity and integrity of the monetary system we all rely on.

1. Do you agree that, to preserve the singleness of money, systemic payment stablecoins must be fully interchangeable with other forms of money at par?

We agree it is vital that stablecoins must be fully interchangeable with other forms of money at par in order to preserve the singleness of money. It is crucial for monetary and financial stability that there is uniformity between all forms of money, whether cash, deposits, e-money or stablecoins. Economic and financial history illustrates the grave issues with monetary instruments not being accepted at par, with the ‘wildcat banking’ period in the US offering an instructive parallel for the risks presented by stablecoins.[3]

The stability of the economy rests on households and businesses being able to trust that a pound is always worth a pound. Though this may sound like a truism, unless regulated appropriately stablecoins may disrupt this trust and risk undermining the wider monetary and financial system.

However, we are concerned that having different standards for stablecoins depending on whether they are considered ‘systemic’ could threaten the degree to which they would be exchangeable at par and undermine the aim of preserving the singleness of money. If stablecoins are going to function as sterling denominated money they should be regulated as such, regardless of whether or not they are considered systemic. This is necessary to

[3] https://lawreview.uchicago.edu/sites/default/files/2023-04/03_Zhang%20%26%20Gorton_ART_Final.pdf

protect against stablecoins acting as ‘shadow money’ - monetary instruments that are able to act like bank deposits but without being subject to the same regulation.

To avoid risks of regulatory arbitrage watering down standards and undermining monetary and financial stability, it would therefore be prudent for all sterling-dominated stablecoins, whether deemed ‘systemic’ or not, to be regulated by the PRA to the same standards in order to ensure that they trade at par. This would mean that any such PRA-authorised stablecoin issuer would have access to Bank of England infrastructure, including deposit accounts, where they would be obligated to hold reserves fully backing their stablecoins.

2. Do you have views on further requirements that may be needed to ensure the singleness of money when stablecoins are traded in secondary markets?

If a stablecoin is traded on a secondary market this appears to bring into question the extent to which it is actually money, in the same way it would not make intuitive sense to speak of bank deposits being traded on secondary markets.

3. Do you agree that the most likely, and suitable, payment systems using new forms of digital money to become systemic in the UK are sterling-denominated stablecoins which are backed by assets denominated in fiat currency?

We agree that the key motivation for stablecoins currently is to benefit from the ‘branding’ of the national unit of account (i.e the pound sterling in the UK), given that there has been little demand for cryptoassets denominated in non-national currencies, particularly as a means of payment. However, there remain tail risks of non-sterling denominated stablecoins scaling to become threats to UK monetary sovereignty, including those denominated in other national currencies, as well as those denominated in new unit of accounts, as has been put forward by Big Tech firms like Meta with the Libra/Diem project, as well as stablecoins denominated in other national currencies. Regulators should therefore remain on guard against such risks.

4. Do you agree with the Bank’s proposed approach to assessing the systemic importance of stablecoins used for payments?

As argued elsewhere in this response, we do not see value in assessing the ‘systemic importance’ of stablecoins, just as we would not expect bank deposits to be treated with various degrees of systemic importance. Rather, it would be more prudent for all stablecoins to be regulated by the PRA to the same standards. This would best preserve the singleness of money that monetary and financial stability fundamentally relies upon.

5. Do you agree with the Bank's proposed approach to the regulatory framework for systemic payment stablecoins, as set out in Section 2?

We broadly agree with the Bank's proposed approach to the regulatory framework, though as argued throughout this response, we contend that this framework should not only be applied to 'systemic payment stablecoins', but to all sterling denominated stablecoins integrated into the UK payments system, to preserve singleness of money and prevent risks of regulatory arbitrage.

6. Do you agree with the Bank's assessment of the risks posed by vertical integration of stablecoin functions? Are there other risks that the Bank should consider based on existing business models? What mitigants could be put in place to ensure that risks posed by multi-function entities are addressed?

We agree with the Bank's assessment of the risks posed by vertical integration of stablecoin functions. As argued elsewhere in this proposal, we are particularly concerned by risks of stablecoin issuers seeking business models resembling shadow banking. Ensuring all stablecoins are fully backed by reserves would mitigate these risks.

11. Do you agree with the Bank's assessment of the important role of backing assets in ensuring the stability of value of the stablecoin?

We strongly agree with the Bank's assessment of the importance of backing assets, and therefore support all stablecoins being fully backed by reserves (i.e central bank deposits) to minimise credit, liquidity and market risk.

If stablecoins become widely accepted, and issuers are able to back their stablecoins with assets other than reserves, this raises the question of whether stablecoin issuers would be able to engage in money creation. For instance, if stablecoins can be issued to purchase government bonds, both the stablecoin issuer's liabilities and assets will have increased, and thus new money will have been created while the issuer is still meeting the requirement that stablecoins must be fully backed by high quality liquid assets.

Stablecoin issuers will likely complain about the restrictiveness of backing assets. They will likely argue that even with a wider range of backing assets they will still be able to fully repay depositors, just as money market mutual funds were confident of the same, before a run on their short-term liabilities ultimately sparked the global financial crisis in 2008.

We urge regulators to stand firm against such lobbying. The supposed use cases for stablecoins are payments - if this is truly their purpose, risk-free reserves should be a sufficient backing asset. If stablecoin issuers want to introduce maturity transformation into their business model, they should apply for a banking licence. Otherwise there is a significant risk of stablecoin issuers exacerbating problems with shadow banking, undermining the uniformity and integrity of the monetary system we all rely on.

12. Do you agree that the proposed remuneration policy is consistent with systemic stablecoins being used primarily for payments?

We broadly agree with the proposed remuneration policy. If stablecoin issuers want to benefit from reserve remuneration they should apply for a banking licence. However we believe there could be a case for allowing stablecoin issuers to apply for a less onerous ‘narrow banking’ licence which could give them access to remunerated reserve accounts at the central bank, which they use to pass changes in Bank Rate onto their depositors, thus enhancing competition and the transmission of monetary policy.

13. Do you agree with the Bank’s proposed requirements on the redemption process, including the role of all firms in the payment chain?

We tend to agree with the Bank’s proposed requirements for the redemption process.

14. Do you have views on requirements on redemption fees, or prohibiting these, to minimise any frictions across the redemption process?

We support the prohibition of redemption fees. Among other risks, fees could act as de facto ‘haircuts’ for stablecoins, undermining the intention for stablecoins to trade at par in order to preserve singleness of money.

19. Do you agree with the requirements for stablecoins owned by the issuers held in treasury wallets?

We agree with these requirements.

22. Do you have views on the requirement to hold reserve assets in a statutory trust, to ensure that stablecoins are fully backed and the backing assets are duly protected and available to satisfy coinholders' redemption requests at all times?

We support the requirement for reserve assets to be held in a statutory trust to ensure stablecoins are fully backed and depositors are protected.

23. Do you have views on the range and quality of the assets issuers would be required to hold to mitigate shortfall risks?

We agree that shortfall reserves should take the form of high quality and highly liquid assets, particularly central bank reserves and UK government debt.

24. Do you agree that, at least during a transition, limits would likely be needed for stablecoins used in systemic payment systems, to mitigate financial stability risks stemming from large and rapid outflows of deposits from the banking sector, and risks posed by newly recognised systemic payment systems as they are scaling up?

We are concerned that limits on holdings risk undermining the Bank's aim to preserve the singleness of money, just as how caps on a central bank digital currency (CBDC) could cause different forms of money not to trade at par.[4] Enforcing limits on stablecoin holdings will also be more operationally challenging, given that there will likely be multiple stablecoin issuers.

A more optimal solution to address such potential financial stability risks emerging from new forms of digital money would be requiring banks to pre-position adequate collateral with the central bank to withstand sudden deposit outflows, as has been proposed by a Group of 30 report,[5] as well as US regulators,[6] in light of recent banking crises. Banks could also low-cost wholesale funding via the central bank's discount window to replace lost deposit funding and thus mitigate adverse impacts on credit conditions, as financial regulation scholar Rohan Grey has suggested in response to concerns about a migration of deposits to CBDC.[7]

[4] https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2018/central-bank-digital-currencies-design-principles-and-balance-sheet-implications

[5] https://group30.org/images/uploads/publications/G30_Lessons-23-Crisis_RPT_Final.pdf

[6] https://www.occ.gov/news-issuances/speeches/2024/pub-speech-2024-4.pdf

[7] https://academic.oup.com/book/36505/chapter-abstract/321223902?redirectedFrom=fulltext

25. Do you have views on the use, calibration and practicalities of limits?

As expressed in our answer to question 24, we fear the use of limits could undermine efforts to ensure the singleness of money, and believe that other policy options could better fulfil the same goal.

27. Considering the requirements for issuers in Sections 4 and 5, how might business models need to change in order to retain commercial viability from those in the market today?

The requirements outlined in this paper will hopefully mean that stablecoin issuers' business models will be based on offering better payment services, rather than engaging in unlicensed banking activities, which appear to be the business models for many stablecoin firms currently.

28. Do you agree with our proposed expectations for custodial wallet providers for systemic stablecoins (including when provided via exchanges) and how we propose applying them in a systemic stablecoin payment chain?

We tend to agree with the proposed expectations for custodial wallet providers.