PositiveMoney

# UK REGULATORY APPROACH TO CRYPTOASSETS AND STABLECOINS

## *POSITIVE MONEY SUBMISSION, MARCH 2021*

Positive Money welcomes the opportunity to HM Treasury's consultation on the UK regulatory approach to cryptoassets and stablecoins.

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 trusts, foundations and small donations.

### KEY POINTS:

- Stablecoins are forms of 'shadow money' that present significant challenges to financial stability, and if not properly regulated would present more direct risks to consumers.
- Policymakers should strive for regulatory convergence between stable tokens, e-money and deposits, in order to ensure a 'level playing field' of high standards that mitigates risks to financial stability and users. Any categorisation of stable tokens should avoid reinforcing or exacerbating the existing fragmentation of payments infrastructure and monetary instruments, which would serve to water down financial regulation across the board.
- Stable token issuers should be treated as either e-money issuers or 'narrow banks' for regulatory purposes
- Regulatory enforcement of stablecoins issued on decentralised networks should focus, where possible, on systemically important institutional intermediaries, including large commercial issuers, exchanges, mining pools, and community governance organisations, rather than private individual node operators.

<u>1 Do you have views on continuing to use a classification that is broadly consistent with existing guidance issued by UK authorities, supplemented with new categories where needed?</u>

We support the use of a classification that is broadly consistent with existing guidance issued by UK authorities, and would caution against the creation of new regulatory categories that are functionally redundant or contribute to the further balkanisation of the UK payments infrastructure.

Stable tokens are a form of 'shadow money' — money-like claims that can function like bank deposits, but escape the purview of conventional banking regulation. Creating new categories for forms of shadow money like stablecoins would serve to water down banking regulation.

We are not convinced of the need for a new regulated category for 'stable tokens', and would instead recommend that stablecoins are governed under existing FCA regulation for deposits or e-money tokens, depending on the issuer and nature of the network, and incorporated into the regulatory framework which governs commercial banks, e-money operators and payment processors.

Policymakers should avoid further fragmentation of regulation, and should ultimately aim for a single layer for payments which merges stable tokens, e-money and deposits, all of which function synonymously as 'money' for end users.

2 Do you have views on the proposed new regulated category of 'stable tokens'?

As set out above, we are sceptical about proposals to introduce new regulated categories for 'stable tokens', and believe policymakers should strive to bring cryptoassets under the existing regulatory regimes covering e-money balances and commercial bank deposits.

We would particularly oppose the inclusion of tokenised forms of central bank money, such as CBDCs, under a new regulated stable tokens category, as—unlike other digital currencies—CBDCs are direct government liabilities, and are not issued by third-party private actors.

3 Do you have views on the government's proposed objectives and principles for cryptoassets regulation? Do you have views on which should be prioritised, or where there may be tension between them?

The emergence of cryptoassets, including stablecoins, presents significant challenges to financial stability, in the forms of market, liquidity and credit risk, and if not properly regulated could also present more direct risks to consumers. Stablecoins are just one of the latest in a long line of shadow money, which has repeatedly undermined monetary and financial stability throughout modern economic history, such as Eurodollars in the twentieth century, and money market mutual fund shares in the run up to the 2008 crisis.[1]

We therefore welcome the government's inclusion of 'protecting financial stability and market integrity' as well as 'delivering robust consumer protections' as objectives for regulation. We are concerned that a third objective focused on competitiveness may risk undermining these objectives. As FCA chief executive Nikil Rathi has argued, specific competitiveness objectives are not "fundamentally necessary in order to have a strong, successful and dynamic financial sector", and that "the risk that some regulators have with a competitiveness objective is that every single time you make a decision, it gets challenged on those grounds", which "can lead to complications in the decision-making process."[2]

We would however submit that the government should consider the risks to competitiveness posed by stablecoin issuers who may be in a position to monopolise markets by integrating stable tokens into existing networks, such as the Facebook-led

[1]

[2] https://committees.parliament.uk/oralevidence/746/html/

Diem project. In this context, policymakers must not only consider competitiveness between fintech firms, but also competitiveness between stablecoin issuers and UK deposit takers. This means that regulators should aim for a ‘level playing field’ between stable tokens and deposits, which ensures that the same high standards are applied to both banks and stablecoin issuers.

A further consideration is that publicly-issued money plays a crucial role as the foundation of trust in privately issued currencies, as well as the primary channel for monetary policy.[3] Public money must therefore remain a viable and competitive means of payment as preferences shift towards digital payment methods, and all systemically important flows of funds should ultimately take place on central bank infrastructure. The regulatory framework for cryptoassets and stablecoins should not unduly complicate or inhibit the creation of a robust digital public payments infrastructure.

We also agree that regulation should be guided by the principle of ‘same risks, same regulatory outcome’, and policymakers’ approach should therefore be to integrate stable token issuers under the existing regulatory regime for e-money issuers and deposit takers, rather than creating new bespoke regulation.

<u>4 Do you agree with the approach outlined, in which the regulatory perimeter, objectives and principles are set by government and HMT, with detailed rules to follow set by the UK’s independent regulators?</u>

We support the approach outlined by the government, but emphasise the need for the resulting detailed rules to be subject to ongoing scrutiny by both Parliament and civil society. The government should ensure it maintains the level of scrutiny to accurately assess whether the expanded perimeter and powers of regulators are being used effectively in service of the stated objectives, and (if necessary) clarify or amend the objectives and principles guiding the independent regulators.

<u>5 What are your views on the extent to which the UK’s approach should align to those in other jurisdictions?</u>

The UK’s approach should seek to align with the Stablecoin Tethering and Bank Licensing Enforcement (STABLE) Act being introduced to the US Congress.[4] The STABLE Act aims to ensure that stablecoin issuers are also subject to the same rules as regulated banks. Stablecoin issuers would be required to gain approval from regulators, obtain a banking charter and follow banking regulations. Furthermore stablecoin issuers would also need to obtain deposit insurance or maintain reserves at the central bank.

<u>6 Do you agree with the government’s assessment of risks and opportunities?</u>

We agree with the government’s characterisation of the risks stablecoins can pose to financial stability, consumers and consumers. We would contend that stablecoins by their very nature constitute money-like instruments or ‘shadow money’, and regulation must reflect the risks associated with this from the outset. Therefore we recommend that stablecoin issuers are treated as either e-money issuers or ‘narrow banks’ for the

[3] https://positivemoney.org/money-we-trust/
[4] https://tlaib.house.gov/sites/tlaib.house.gov/files/STABLEAct.pdf

purposes of regulation - i.e. a bank which holds deposits fully backed by safe assets, and isn't able to lend new deposits. The latter would mean issuers being required to obtain a banking licence and being subject to regulation for deposit-takers. As we have seen from e-money operators like PayPal, it is unlikely that stablecoin issuers will not also seek to become lenders.

We welcome that the government is also aware of the risks to competition posed by stablecoins, such as Facebook's Diem project, which if able to plug into existing online networks would be able to scale and monopolise the UK's money and payments system. Regulators must be proactively in guarding against such outcomes, and the severe implications it could pose to financial stability and even monetary sovereignty, including the ability for central banks to conduct monetary policy.

We are less convinced of the opportunities, and contend that many of the functions offered by stablecoins could be better served by innovations such as CBDCs without the corresponding risks.

9 Do you agree that the activities and functions outlined above are sufficient to capture the activities that should fall within the scope of regulation?

Though stable tokens may appear to function similarly to bank deposits to consumers, they are not covered by deposit insurance and other regulatory protections afforded to bank deposits. Differences in the relative safety of the available forms of money should be made as transparent as possible for consumers by compelling institutions issuing stable tokens to provide a clear explanation of the risks users are exposed to, such as mandatory disclosures of the composition of underlying assets.

10 Do you agree that the government should primarily use existing payments regulations as the basis of the requirements for a new stable token regime, applying enhanced requirements where appropriate on the basis of mitigating relevant risks? What other existing legislation and specific requirements should also be considered?

We agree that the government should use existing payments regulations, with the aim of establishing a payments network where all liabilities which function as money, be they bank deposits, e-money or stable tokens, operate on a single layer.

12 Do you have views on whether single-fiat tokens should be required to meet the requirements of e-money under the EMRs, with possible adaptation and additional requirements where needed?

As explained above, we believe policymakers should strive for a convergence between stable tokens, e-money and deposits. Single-fiat tokens should therefore be required to meet the requirements of the EMRs, with the goal of keeping regulatory divergence at a minimum. All stablecoins should either be incorporated under either existing e-money or banking regulation.

13 Do you have views on whether exclusions to the authorisation regime are needed in relation to the stable tokens regime, in light of the government's objectives? If so, which activities do you think should be excluded?

Exclusions should be in place to protect individuals operating as 'nodes' on a stable token network. We would also be open to a lighter touch regime for small firms below a certain turnover.

15 Do you agree Part 5 of the Banking Act should apply to systems that facilitate the transfer of new types of stable tokens?

Yes. This would be particularly sensible for stable tokens that can be plugged into existing online networks and could therefore scale up to systemic importance.

16 Do you have views on potentially extending Bank of England regulation of wider service providers in the stable token chain, where systemic?

To the extent that issuers and operators of stable tokens are authorised to become systemic, they should be subject to the same rules and standards as existing financial institutions providing similar services and functions. Stable tokens with significant potential to be systemic at launch should be captured from launch by Bank of England systemic regulation, and be subject to enhanced standards. We judge this would be in accordance with the government's stated principle of 'same risk, same regulatory outcome'.

17 Do you agree that Part 5 of FSBRA 2013 should apply to payment systems facilitating the transfer of new types of stable tokens?

We support Part 5 of FSBRA 2013 applying to such payment systems, but have concerns that the PSR lacks the necessary powers of intervention to ensure full compliance - as highlighted by the PSR's failures on protecting cash as a means of payment. As such we would welcome the FCA and Bank of England also taking a more 'hands on' role in the regulation of stable token payment systems, as well as the wider payment system.

18 Do you have views on location and legal entity requirements?

We would support a requirement for firms to be authorised in the UK in order to actively market stable tokens to UK consumers. If the UK's payment system became overly dependent on financial firms based in other jurisdictions, effective interventions would likely require cross-border coordination with regulators in other jurisdictions, and be more difficult to enact as a result (especially in the short time frames demanded by financial crises).

A lack of location and legal entity requirements for providers of stable token services would unduly increase the overall threat stable tokens could pose to financial stability, both in the UK and internationally.

27 Do you see value in the government capturing tokens typically used by retail consumers as a form of speculative investment under the regulatory perimeter in the future?

We would see value in regulators designing protections for consumers from the risks associated with speculative cryptoassets such as Bitcoin, and holding cryptoasset promotions to higher standards. With an expanded regulatory perimeter, regulators would be better able to identify and respond to the wider risks posed by cryptoassets (including financial instability, facilitation of criminal activity and the considerable negative environmental impact).

29 What are the risks and opportunities you see in relation to DeFi?

DeFi poses additional risks, in that there are greater challenges to regulating cryptoassets which lack centralised counterparties who manage reserve assets and collateral, and which may appear to lack centralised authorities who can be held liable. A reliance on algorithm or protocol-based collateral management systems can also make DeFi susceptible to major disruption from governance or coding errors.

While DeFi regulation should avoid targeting individual operators, it could still hold systemically important parts of the infrastructure, such as a project's core developers, those operating exchanges and large mining pools, liable.[5] Policymakers should ensure that regulation features exclusions to protect individuals operating on a small scale.

We are also concerned that issuers and operators of tokens may attempt to transfer downside risks and costs of regulatory compliance away from themselves and towards consumers by formally adopting a 'decentralised' infrastructure while functionally retaining a high degree of centralised control over the wider network (and benefiting from its operation).

In the case of 'decentralised' token networks—with a distributed infrastructure operated by multiple distinct parties—responsibility for compliance and legal liability for violations should rest primarily with the network's key decision makers and the operators of core infrastructure, as opposed to falling on larger numbers of individuals engaged in small-scale participation.

We also note that the provider of the interface through which payment services are accessed is located should be a factor considered by regulators. Interface providers may be distinct to the issuer or operator of the payment system, but could nevertheless impact the system's operation and outcomes to an extent relevant for regulators. For example, the interface provider could advertise other financial products (including other crypto or token products) within the interface, or use coercive design techniques that shape consumer purchase behaviour (such as randomised rewards).

[5] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3326244