FNALITY

Response to CPMI-IOSCO Consultation Report on the Application of the PFMI to Stablecoin Arrangements

Fnality International Limited

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Introduction

We very much welcome this timely guidance by CPMI and IOSCO and the opportunity to comment on the consultative report. Stablecoin Arrangements (SAs) have grown significantly; some may become systemically important soon. More broadly, the adoption of distributed ledger technology (DLT) in financial markets including in the post-trade space is advancing quickly. Private sector initiatives like Fnality as well as some central banks are planning the deployment of DLT based wholesale payment systems. Earlier this month the Swiss Digital Exchange started trading and settling the first bond with cash and securities being recorded on a distributed ledger. Despite radical technological innovation the well-established regulatory paradigm of "same activity, same risk, same rules/regualtion" should prevail.

Fnality is a private sector led solution established by 15 global financial institutions. Each FnPS (Fnality Payment System) enables the making of large value payments in the local currency among its eligible wholesale participant institutions to meet a wide range of business needs. The FnPSs settle in central bank money or equivalent depending on the legal provisions of the jurisdiction. Each FnPS is also designed to be interoperable with each other FnPSs to enable PvP settlement of FX transactions and with third party business platforms (e.g. securities settlement systems, CSDs) to enable DvP settlement for many potential use cases.

For reasons explained in more detail below, the FnPSs are payment systems and not SAs. Nonetheless, Fnality submits a response to the consultative report because we think that some of the guidance in the report may be applicable more broadly to all DLT based FMIs.

This submission first elaborates on the key differences between SAs and payment systems that use DLT. Then, it responds to the questions set out in the consultation report.

1 SAs and DLT based payment systems

The FSB (2020) defines a stablecoin as "a *crypto-asset* designed to maintain a stable value relative to another asset (typically a unit of currency)". It is reasonable to assume that any SA that has to comply with the PFMI will need to ensure convertibility at par at all times to the underlying asset.

SAs that peg their value to a sovereign currency are a new form of private money that is very similar to bank deposits or e-money. Public money is issued by the central bank in the form of bank notes (for the public) and reserves (for the banking sector). Private money is traditionally issued by the banking sector in the form of deposits (for the public or other banks). Both forms of money are based on the same unit of account ("the currency"). Bank deposits are kept "stable" vis-à-vis public money thanks to a provision that private money can always be converted at any time into public money at par. The credibility of this "promise to convert at par" depends on the quality of the assets of the bank and is supported by supervisory requirements for capital and liquidity as well as deposit insurance. Against this background it is not surprising that the President's Working Group (PWG (2021)) proposes that SAs to be regulated as "insured depository institutions".

In turn, a payment system is "a set of instruments, procedures, and rules for the transfer of funds between or among participants; the system includes the participants and the entity operating the arrangement." (CPMI Glossary). This definition of a payment system is technology neutral. Today, many private sector payment systems exist, e.g. CHIPS, RT1 or EURO1. None of them issue private money as settlement asset, but all of them settle in central bank money (or equivalent). Importantly, the settlement assets in these payment systems are not liabilities of the operator.

The functionality and risk profiles of the Fnality Payment Systems are very similar to these existing private sector payment systems with the only difference being the method of record keeping. Since the settlement assets held by the participants in an FnPS are not a liability of Fnality (the operator), it does not make sense to subsume DLT based payment systems under the heading of stablecoins. Or put differently, conventional payment systems could also be viewed as DLT based. They would just have one validator (the operator) and two or three nodes (the backup centres). To our knowledge no one has so far proposed that these conventional payments should be considered SAs.

Hence, we would welcome more clarity in the final report about the scope of the application of the guidance. In particular, the report should state whether payment systems and other FMIs that use DLT for record keeping are carved out and if not, which sections would apply to them.

2. Answers to CPMI-IOSCO Questions

2.1 Is it clear when SAs are considered FMIs for the purposes of applying the PFMI?

We welcome the approach that the transfer function of stablecoin arrangements (SAs) should be compliant with the PFMI, if they are deemed systemically important. Moreover, we are of the view that there is no need to develop additional regulatory standards on the transfer/payment function of SAs or DLT based payment systems. The principle of same activity, same risk, same regulation should be applied to all FMIs independent of the technology they use.

2.2 Are the suggested considerations for determining the systemic importance of SAs clear, comprehensive and useful? Are there any risks or considerations missing?

We welcome the additional guidance on the determination of systemic importance. The criteria listed in the consultative report seem adequate. We would add that the same criteria should be applied to conventional payment systems, DLT based payment systems like the Fnality Payment Systems and SAs.

CPMI-IOSCO should provide more guidance for FMIs that are currently not systemically important, but are expected to become systemically important in the near future. This is particularly relevant today where new entrants are emerging.
Delegating discretion to authorities ("At their discretion, authorities may consider the potential growth and future state of an SA in determining the systemic importance of an SA that is under development.") is likely to lead to unequal treatment across jurisdictions.

2.3 Is the guidance provided on governance clear and actionable to inform how SAs will need to ensure clear and direct lines of accountability and set up governance arrangements to observe the PFMI?

We fully support the guidance provided on governance. We would like to propose, however, to add an explicit reference that governance arrangements should be proportional to the relative systemic importance of an SA or a distributed payment system.

In particular, new entrants - when they are processing only low volumes and values - don't require the same full-fledged governance arrangements as established FMIs. Obviously, the bar should be raised quickly as new entrants grow in importance, requiring engagement between the operator of the arrangement and the local jurisdiction regulator to ensure fully fledged governance arrangements are established when the volume and value requires it.

2.4 What are the challenges that SAs may face due to the use of distributed and/or automated technology protocols and decentralisation, when seeking to observe Principle 2 on governance, in particular when ensuring the clear allocation of responsibility and accountability?

As a distributed payment system, we don't see material challenges for Fnality. We do not believe governance arrangements should or can be decentralised due to a need to ensure the operator of the system is held accountable for its activities. In the same way, we believe that SAs should have a Board (shared accountability/responsibility model), and an executive team etc. (CRO, CEO etc) who retain, for instance, the legal accountability for operating arrangement.

However, unlike governance which needs to be centralised, we find it preferable to distribute technology operations (e.g. hosting nodes) because we see huge operational resilience benefits from such a model as it removes single points of failure.

2.5 Is the guidance on Principle 3 clear and actionable to inform how SAs will need to comprehensively manage risks from other SA functions and entities and their interdependencies?

We agree with the proposed guidance the comprehensive risk management also includes functions that are not related to the transfer function of the infrastructure. The system operator should have binding contracts with the providers of these services and define rights/obligations.

2.6 Is the guidance on Principle 8 on settlement finality clear and actionable to inform how SAs will need to manage risks arising from a misalignment between technical and legal finality?

In our view probabilistic finality should not be acceptable in systemically important FMIs, including SAs. Thus, i) the SA should be able to define a specific moment of finality and ii) the underlying ledger must not allow for a concurrent occurrence of different version of the ledger at any moment (an occurrence commonly referred to as "forking") unless such events are clearly recognised in the relevant rulebook and that finality is defined in such an event.

Technological irrevocability and legal finality of settlement need to be clearly defined and aligned with each other.

2.7 Is the guidance on Principle 9 on money settlements clear and actionable to inform how SAs will need to manage risks associated with the use of a stablecoin as a settlement asset? In particular, is the guidance clear on the considerations which an SA should take into account when choosing a stablecoin as a settlement asset with little or no credit or liquidity risk as an appropriate alternative to central bank money?

Under the "same activity, same risk, same rule" paradigm SAs will need to comply with Principle 9. But unlike most systemically important payment systems (see Section 1 above) the settlement asset in SAs is subject to *run risk* as the consultative report points out correctly. This additional risk needs to be taken into account when compliance with Principle 9 is assessed.

Furthermore, we agree that the distinction between "central bank money" and "commercial bank money" is somewhat outdated. However, this is not really a consequence of the advent of SAs. While the SA may not be charted as a "commercial bank", existing and new private sector payment systems (again see Section 1 above) use settlement assets in the form of funds held in an omnibus account at a central bank or a joint account of domestic banks held at the central bank. The quality of such settlement assets is essentially equivalent to central bank money, while in the strict sense they are not. An explicit recognition of these forms of settlement assets as being compliant with Principle 9 would be welcome.

2.8 Are there other issues or principles of the PFMI where additional guidance for SAs would be useful? If so, what is the issue identified and how is it notable for SAs?

Fnality would welcome additional guidance on operational risks (Principle 17).
Distributed payment infrastructures rely on decentralised node operators, some of which or all are also validating transactions. Thus, there are entities operating the system instead of just one in a traditional FMI.

For the availability of the system, the failure of a single, individual node (or small subset of nodes) is not a problem. Thus, it would seem unreasonable that the operational requirement or standards for each individual node should be the same as for a traditional centralised FMI. The operational standard should be applied at the whole system level, rather than at each individual node level.

2.9 Are there any terms used in this report for which further clarification would be useful for SAs when seeking to observe the PFMI?

See our comments in Section 1 above.