UK Finance response to CR 03/2021: Application of the Principles for Financial Market Infrastructures to stablecoin arrangements

Date: 1 December 2021

Sent to: cpmi@bis.org
consultation-03-2021@iosco.org

UK Finance is the collective voice for the banking and finance industry.

Representing more than 300 firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation.

- UK Finance and its members are supportive of international efforts to further understand the complexities the emergence of stablecoins has brought, and the potential risks they may pose to the financial system. We support the ongoing work of the G7 Working Group on stablecoins, the Financial Stability Board (FSB) research on the impact of global stablecoin arrangements (SAs), the joint work undertaken by the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO), as represented in this paper, and the consequent recommendations for regulation, supervision, and oversight of SAs.
- We encourage that regulatory communities engage internationally with SA. Any restrictions on their use by established financial providers should avoid being prescriptive; else the regulatory community has little leverage over potentially systemically important SAs.
- SAs could play an important role in improving cross-border payments through embracing the increasing digitalisation of the economy. We agree that opportunities will be enabled, and risks controlled by clarifying existing international standards and principles in a flexible and pragmatic way.
- The financial market continues to evolve as new products and technology continue to impact the way consumers transact and save. Undertaking a holistic approach to regulation that is principles based (including respecting the principle of same activity, same risk, same regulation) and technology neutral will help promote financial stability and, at the same time, foster competition and innovation in financial services, better serve customers and ensure the flexibility to adapt to an evolving market. There are a number of potential vulnerabilities and risks that may arise from SAs as explained further in this response. Innovations can only contribute to economic development and welfare if risks and vulnerabilities are kept in check.
- Establishing a 'level playing field' that applies to all stages of the stablecoin ecosystem will promote innovation and safely open up new services for businesses and consumers. The approach should be internationally harmonised, recognising that retail customers are likely to want to use stablecoins for international cross-border payments. The application of PFMI principles to all types of SAs, both retail and wholesale, is supported by our members.
- We believe that collaboration between public and private bodies is an essential success factor and will deliver enhanced innovation and competition within the financial ecosystem. All the while maintaining trust, supporting resilience and ensuring inclusion. It is not the responsibility of financial stability authorities to preserve any particular business models, including in

banking. However, these authorities have a legitimate interest in ensuring any transition does not generate instability.

If you have any questions relating to this response, please contact:
Megan.Otway@ukfinance.org.uk

Applicability of the PFMI to SAs

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

- Based on the statements that the use of a SA to make transfer of value between participants through its operation, it appears clear to UK Finance members that SAs should be considered as payment systems, subject to the PFMI when they provide this function to the market and when considered systemic, as determined by the relevant regulatory body or community.
- Indeed, stablecoin "transfer function" enables the transfer of coins between users and typically entails the operation of a system, a set of rules for the transfer of coins between or among participants, and a mechanism for validating transactions.
- We commend the technology-agnostic approach being taken in the application of the PFMI to SAs and recognise that this creates a level playing field for the diverse set of participants in the financial ecosystem. Entities or activities that create the same kind of risk, should be subject to the same kind of regulation.
- Given the variability in SA business models and functions, we note that regulators should always consider the similarity of a purported SA to other FMIs considered within the PFMI, such as trade repositories or securities settlement systems. It is always important to ensure the same activities with the same systemic risk are covered by the same regulatory principles.
- However, we consider that there are other cases of crypto-assets not mentioned in the reports and whose systemic risk should be taken into account. They are:
    - Basket-backed multi-currency stablecoins (the report mentions that they will be processed in a subsequent report)
    - Algorithmic stablecoins
    - Crypto-assets without collateral (bitcoin and others, and those arguably most problematic from a systemic point of view).
- UK Finance note that UK regulators, including the Bank of England and HM Treasury, are already applying these principles within a UK environment.

Considerations for determining the systemic importance of an SA

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

- We agree with the FSB that SAs have the potential to enhance the efficiency of the provision of financial services (including cross-border payments), and to promote financial inclusion. In the absence of responsible regulation, they may also generate risks to financial stability. The comprehensiveness of the factors suggested within the document of the size, nature and risk profile of the SA, the type of stablecoin users and the type of transactions are fairly set out and provide clear mechanisms by which regulators can assess the systemic importance of SAs in question.

- As the CPMI has observed in the past year, even smaller firms can be critical to the software supply chain of the broader digital ecosystem. When firms are compromised by cyber-attacks, there can be amplifying systemic cyber risks. Firms that support the SA ecosystem are not immune from these cyber risks, and systemic cyber risk is an area that the CPMI should devote greater attention, generally. The provision of clear guidance within the consultation on mechanisms to identify systemic players are useful. We consider that this should be expanded to include a measurement of cyber systemic risk.
- It is important that innovation is able to flourish. Applying the PFMI to SAs which are not critical to and interconnected with the broader economy at a significant scale would be detrimental. Some smaller SAs could become systemically important in the future so systemic risk may need to be managed at all levels of the ecosystem and it may not be possible to adopt a one-size-fits-all approach.
- The development of stablecoins for general purpose use at scale should not come at the cost of lower standards or higher risks to financial stability. The statement of CPMI-IOSCO that a "systemically important SA primarily used for making payments would be expected to observe all of the relevant principles including those principles for which no further guidance is provided in this report" is helpful to provide clarity that regulatory authorities should ensure that the standards that apply to current systemic payment systems apply equally effectively to any systemic or likely to be systemic SA.
- The CPMI-IOSCO provision of the factors indicative of introducing systemic risk are useful. However, more needs to be done to co-ordinate different definitions of systemic risk by jurisdictions. In the absence of clear definitions, and normal risk modelling, government discretion and international courses of action are often necessary to drive consistent outcomes. Formal analysis should provide coherency and transparency to economic policy.
- It will be important that regulators and subsequent supervisory engagement recognise the international nature of SAs and work cooperatively to identify and mitigate the risks that a SA, or group of SAs, may pose to wider objectives of financial and operational resilience of the financial system. UK Finance has long been a strong supporter of the supervisory college system and recommends that analogous mechanisms are developed to ensure regulatory requirements are complied with.
- The rise in use of cryptoassets more broadly does give rise to systemic stability considerations, particularly for international products. We appreciate the work that the Financial Stability Board has done to address global stablecoins and the potential systemic risk they pose to the economy.
- Members remained confident that the risks associated with increasing use of cryptoassets can be managed proactively.

Governance

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?

- UK Finance is supportive of the PFMI being used here and agree with the CPMI/IOSCO judgement that there are complications to decentralised governance considerations.
- We would also encourage, per other international guidance, that regulatory communities engage internationally with SA. Any restrictions on their use by established financial providers should avoid being prescriptive; else the regulatory community has little leverage over potentially systemically important SAs.
- We believe that the guidance makes clear that a SA needs to be governed by one or more discrete legal entities with accountability for the operation of the arrangement and for the management of risk. This includes ensuring that any wider interdependent functions within the arrangement are governed in such a way that the arrangement can meet this governance standard as a whole.
- However, the current guidance should not preclude the appropriate management of SAs by national and international regulatory mechanisms that become systemically important but fail to demonstrate compliance with the PFMI. We consider this further in our response to the following question.
- It is possible to create governance arrangements where more than one legal entity has authority to govern a SA. Similarly, multiple regulatory supervisory responsibilities could be created for these legal entities under some regulatory regimes. It can be confusing to regulators and the private sector if a legal entity or regulator themselves are unsure about where their authority begins and ends. Confusion over agency authority could both stymy growth in the stablecoin marketplace, but also lead to regulatory gaps which contributes to greater risk.
- There is also an important concern to raise around the risk of operational disruption in the stablecoin environment. This is of particular concern in a large decentralised global environment that may include both regulated and nonregulated participants and linkages to the existing financial system. Banks have robust and well-established risk management functions in place, and this should also be the case with SAs, in that they should also have a comprehensive governance framework in place with a clear allocation of accountability.
- We would also support moves to ensure that SAs have effective risk management frameworks and governance to manage cyber security risks. Additionally, the Financial Action Task Force (FATF) report to the G20 raised similar concerns on potential money laundering and terrorist financing risks from stablecoins and SAs under the PFMI should be able to provide clear governance around their management of these risks.
- This will need to be supported by regulatory co-ordination. The FATF, in its recent October 2021 report Virtual Asset and Virtual Asset Service Providers, recommends, “the FIU, and law enforcement authorities to ***co-operate*** (emphasis added) with one another and any other relevant competent authorities in order to develop and implement effective policies, regulations, and other measures to address the ML/TF/PF risks associated with covered VA activities and VASPs.”

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?

- We recognise that the typically centralised nature of FMI functions compared to the varying levels of decentralisation found in SAs may create some difficulties in seeking to observe Principle 2 on governance. There are initiatives, such as the FCA's DLT sandbox and comparable initiatives in Europe that will need to consider these difficulties in greater detail.
- Financial institutions, and many crypto exchanges, are already licensed and subject to comprehensive and robust risk management, supervision and examination processes, maintain strong capital buffers, carry deposit insurance, undertake well-developed AML/CTT practices and KYC programs, and have a general familiarity with incorporating new technologies into the financial system in a way that manages the novel risks derivative from new technology in a way that complies with regulation. We believe that the benefit of regulated institutions, including crypto exchanges already regulated, in protecting their customers will be important to replicate in any new system for digital money.
- For SAs with cross-border applications, a cooperative international regulatory approach will be key. It should be considered that the home state regulator, in the jurisdiction in which the stablecoin issuer is registered and licenced, to be able and willing to share information with host state regulators. We support the principle of 'embedded supervision' to be delivered by SAs; any technology on which SAs are based should ensure the ability to collect and monitor data on these instruments.
- Notwithstanding the assertion that 'the organisation of an FMI composed of one or more legal entities, ultimately controlled by natural persons, is essential for an FMI's observance of Principle 2'; it is possible that a SA may become systemic to national and international financial ecosystems outside of existing regulatory controls. This could arise through a systemically significant proportion of transactions being handled by the SA, either from unregulated entities participating in SAs or through a significant number of individuals and smaller entities utilising a SA. As the paper notes, it is also possible that SAs may deliberately adopt 'governance [that is] partially or fully decentralised'.
- We agree with the paper that there may be circumstances, such as in times of crisis 'where expert judgment and discretionary decision-making may be required to deal with unforeseen situations, or in instances where there is an identified problem or error with the software implementation.' It is therefore important that, in order to support the overall objective of maintaining strong and stable financial markets, such processes are instituted under regulatory processes.
- Given, then, the scenarios outlined above which may give rise to the introduction and use of systemic SAs, we believe it is important that the use of the PFMI by regulators does not preclude their ability to appropriately manage SAs within international or national ecosystems and, to the point noted above, those SAs whose organisation may not explicitly meet requirements of being ultimately controlled by natural persons or that have adopted fully decentralised governance.
- Alternative approaches to the management of SAs arising without clear governance arrangements should be considered in order to establish appropriate mechanisms to ensure long term national and international financial stability. This could include for cases where participants of a SA are few in number, guidance on the governance of these participants; for cases where governance of SA participants is impractical, possibly due to the anonymity or large numbers of participants, guidance on the governance of systemically significant participants in such SAs; for cases where there are systemically significant infrastructure providers involved in the provision of a SA, guidance on the governance of these entities. For cases where it is not possible to provide sufficient regulatory oversight of systemically

significant participants, the encouragement of known legal entities to operate in these markets could be considered to ensure that a systemically significant portion of these SAs is managed by entities under sufficient regulatory supervision.

Interdependencies

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 that for those SA which have clear governance arrangements in place to consider the risks of the SA's own function and vis-à-vis a wider market; the guidance in place appears clear to SAs on how they should manage these risks.
- Per the discussion within the previous question on governance, the current guidance risks precluding the regulatory approaches to the management of SAs which do not have conventional governance arrangements in place.
- Similarly, alternative approaches to the management of SAs which arise and do not have such governance arrangements could be considered. CPMI-IOSCO should consider the appropriateness of managing financial stability risks of such SAs through the systemically significant entities transacting over a SA, providing SA infrastructure and approaches encouraging appropriate entities to begin utilising, or providing infrastructure, for such SAs.

Settlement finality

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?**

- We agree with the paper that approaches based on 'probabilistic settlement' raise concerns for users of SAs.
- As a general principle, we consider that the legal agreement of transfer should always take precedence over whatever errors may arise through the operation of a SA utilising 'probabilistic settlement' and that firms should always have recourse to legal action in the event of a technical error in the recording of transactions in a ledger.
- Nonetheless, the principle of settlement finality is important to consider. It may be possible for firms to utilise SAs which lack responsible or governing legal entities by mutually monitoring, or utilising third parties responsible for the monitoring, of the ledger to ensure that a transaction has reached a point of statistical improbability of being revoked.
- It may be that certain technical designs of SAs may meet market requirements, and stability requirements, better than others. Those that adopt technical designs that meet market requirements, and the requirements of regulators, may become more systemic than others.

Money settlements

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?

- We agree with the paper in the consideration that it gives to the potential credit and liquidity risks that could exist through the use of 'stablecoins' as a settlement mechanism between participants of a SA.
- Similarly, the discussion the paper gives on the extent to which holding a 'stablecoin' as potentially issued by a SA grants the holder a claim on the underlying asset is helpful. The guidance is helpful for SAs which may rely upon mechanisms other than central bank money to settle transactions.
- The potential use of stablecoins represents a significant point of innovation for the way that settlements are handled by financial markets. The provision of central bank money as a mechanism to remove settlement and credit risk from transactions remains a significant benefit to industry.
- The guidance appears to presume that the mechanism for stability utilised by a stablecoin will be the backing of said stablecoin through the holding of backing assets. While it is considered improbable that unbacked digital assets will become systemically important, the approach taken may appear to preclude the possibility of regulators applying the PFMI to unbacked stablecoins. Further, it may be useful for CPMI-IOSCO to consider in future work how systemically important FMIs utilising unbacked digital assets might be brought within the PFMI.

General

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?

- There are many potential forms of SA that could be developed, for different use cases and through different mechanisms. We would therefore advocate for flexibility in application.
- Stablecoins are part of a set of instruments aiming at a full and efficient digitalisation of the economy. However, they also have the potential – as with any financial product – to increase fragilities in conventional domestic currency and facilitate the cross-border transmission of financial shocks. While as stated by the FSB, no SA should begin operation until it is licensed within its particular jurisdiction and that regulation should be proportionate to the risks. With this understanding, we are confident that SAs may grow with their risks managed. The regulatory community should continue to proactively and pragmatically reduce gaps and standardise their processes towards mitigating risk.
- We agree that a holistic risk-based approach to regulation is necessary so that stablecoin arrangements are looked at as a whole, in addition to their individual components.
- Impacts on financial stability, monetary policy and competition should be looked at carefully. As explained in the FSB report[i], the current size of the stablecoin market is limited. If, however, a SA were to become a substitute form of money and significant value shift from accounts at regulated financial institutions to unregulated holding of stablecoin in virtual 'wallets' provided by unregulated firms, there are concerns that these arrangements could frustrate existing regulatory approaches. There already exist large and/or cross-border customer bases, and a SA could achieve scale rapidly and have uncertain impacts on the efficacy of monetary policy.

A sizeable shift in demand toward these arrangements could reduce the demand for cash thereby affecting a central bank's balance sheet.

- These factors would reduce the influence that currently regulatory bodies have on the financial stability of modern economies. This is a scenario that the regulatory community should face into. Approaches that adopt no flexibility to existing guidance and presume that static categories and entity types will continue to be valid in a changing digital world are unlikely to continue to be able to support the core objective of financial stability and resilience.
- It is not the responsibility of financial stability authorities to preserve any particular business models, including in banking. However, these authorities have a legitimate interest in ensuring any transition does not generate instability.

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

- UK Finance has no comments to make.

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[i] https://www.fsb.org/wp-content/uploads/P131020-3.pdf