

Stablecoins and digital assets: prospects and challenges for the EU economy and financial sector

Essential crypto asset characteristics

The ECB has chosen to define crypto assets¹ as “a new type of asset recorded in digital form and enabled by the use of cryptography that is not and does not represent a financial claim on, or a liability of, any identifiable entity.” This definition stresses two essential aspects of crypto assets: (i) the focus is not on the use of technologies that are currently needed for crypto assets’ existence but are not specific to it; and (ii) the value of a crypto asset is only supported by the expectation that other users will be willing to pay for it in the future, rather than by a future cash flow.

In particular, this means also that assets in digital form can be recorded by means of DLT without necessarily differing from their non-DLT equivalents in terms of economic impact and legal nature. Cryptographic techniques, in these cases, are used in order to replace any trusted bookkeeper in the recording of crypto assets with a view to: (i) ruling out any unexpected increase in crypto assets issued on a distributed ledger; and (ii) getting the network of users to agree on who owns what. In addition, DLT approaches feature a specificity which is to scatter the validation processes of the recording of the issuance of assets and asset transfers among a set of providers who do not necessarily have to trust one another and may even have conflicting incentives.

Addressing even more demanding consumer needs stimulates the creation of new payment means

Consumers need “instantaneous, continuous, and standardized payments” in the context of always increasing interlinking through the internet and GSM. Such a demand is to a large extent already met by an increasing number of diversified payment services providers.

The BIS considers² that, although an increasing number of countries have payment systems that provide inexpensive and near instant domestic payments, challenges in current payment services remain for addressing these emerging needs. It stresses that, in particular, cross border payments remain slow, expensive and opaque, especially for retail payments. Indeed, additional compliance costs – multiple regulatory regimes, more complex and numerous AMLTF processes – and more burdensome processing arrangements (lack of standardisation) reduce processing efficiency, while reduced payments volumes (compared to domestic transactions) jeopardise necessary investments. As a result, cross border retail payment costs are estimated to be up to 10 times domestic ones, taking into account forex costs, and completing such payments may take up to seven days. In addition, there are 1.7 billion people globally who are unbanked or underserved with respect to financial services.

In this context, web-based technologies, notably blockchain, enable provision of new payment services, be they business-to-consumer or peer-to-peer; in order to mitigate volatility risks, “stablecoins” may prove more attractive. Indeed, stablecoins which share many features with crypto assets seek to stabilise the price of the “coin” by linking its value to that of a pool of assets.

Stablecoin risk specificities

These approaches have to address their specific weaknesses. Many regulators³ consider that stablecoins are, at this stage, far more fragile than settlement assets with legal tender status. Indeed they consider that: (i) they are not entirely stable since their price stability depends on the value of a basket of assets; (ii) they may offer no complete guarantee of a refund in the event of fraud; (iii) they often have an only partially regulated nature; and (iv) they often lack a formal governance structure.

According to the 2019 G7 report on stablecoins⁴, such schemes are significantly exposed to legal, financial, and operational risk in addition to compliance risk concerning money laundering and terrorist financing, competition law, and consumer and investor protection. These features expose related holders to uncertainty and possible losses. Consequently, the financial system may also be exposed to these risks, and related spill-over effects may eventually transmit them to the real economy. Actually, the impact of a possible price crash may be passed on to the creditors of the holders and other entities.

The ECB considers that, more generally, holders of crypto assets, investment vehicles and retail payments represent the main potential linkages between the crypto asset market and the financial systems, and more broadly the economy. In particular, new as well as existing intermediaries provide the channels that facilitate the interconnections between crypto assets, financial markets and the economy.

Stablecoin regulatory and supervisory challenges

Although it is the responsibility of the private sector to design stablecoin schemes that do not bring undue risks to payment systems, regulatory and oversight authorities have to define the appropriate comprehensive risk management requirements while preserving the potential for technological innovation offered by crypto assets and stablecoins.

Provided that a number of identified issues are familiar, existing regulatory and oversight frameworks only require adapting to address them. However, adaptation of local national regimes should fit into a larger regulatory framework to be adopted at the global level. There is indeed a need for overall consistency to prevent regulatory arbitrage. The “same activities, same risks, same rules” principle is, in this respect, a bedrock.

¹ ECB 2019 - Understanding the crypto-asset phenomenon, its risks and measurement issues - https://www.ecb.europa.eu/pub/economic-bulletin/articles/2019/html/ecb.ebart201905_03~c83aeaa44c.en.html#toc3

² Investigating the impact of global stablecoins - <https://www.bis.org/cpmi/publ/dr87.pdf>

³ Stablecoins - a good or a bad solution to improve our payment systems? Denis Beau Deputy Governor Banque de France - <https://www.bis.org/review/r200115c.htm>

Investigating the impact of global stablecoins - <https://www.bis.org/cpmi/publ/dr87.pdf>

⁴ Investigating the impact of global stablecoins - <https://www.bis.org/cpmi/publ/d187.pdf>

Finally, public authorities must coordinate across agencies, sectors and jurisdictions to make innovation in payments affordable by ensuring a globally consistent response to mitigating all identified risks.

It is also necessary to address risks that fall outside existing frameworks. To that end, three specific areas should notably be regulated and supervised:

- the legal qualification of a stablecoin, which should provide legal clarity on the nature of the claim to all participants in the stablecoin ecosystem, among which are issuers and holders;
- the conditions under which a crypto asset can be exchanged for another one, in commercial bank money or in central bank money;
- the venues and arrangements used to exchange them, since these schemes rely on novel and untested technologies and new entrants to financial services.

Central Banks Digital Currencies (CBDC) may represent an alternative solution... at domestic or regional levels

For addressing these fast-raising, notably cross border, instant and cheap payment needs, it is envisaged that central banks will issue digital currencies available to the general public. In this scenario, business-to-consumer or peer-to-peer payments would likely be cash-like, convenient, resilient and widely accessible by-design, although many technical and architectural design options remain to be settled⁵.

However, since there is no global legal and technical infrastructure, central banks will have to address in way or another currency conversion and provide cross border liquidity services at the international level. They also have to achieve the necessary adjustment and harmonisation of operating hours, access criteria, clearing and settlement procedures, messaging across national central banks or national payment schemes, and get countries' payments systems interoperable.

Finally, they also will have to shoulder compliance tasks and costs related to preventing money laundering and the financing of terrorism, while addressing legal issues. This is not to mention the business case of such CBDC, which still have to be described.

Closed loop arrangements, notably those that reach global scale, favour the development of supranational stablecoins

Fulfilling all of these constraints probably provides a technical and competitive advantage to closed loop digital currencies given that, in addition, GAFA's business models behind certain of these initiatives (ability to leverage the data collected) may facilitate making their business case sustainable.

Indeed, closed loop digital currencies are provided by a single payment service/arrangement which may not necessarily be "domestic" but rather supranational. Web-based digital currencies are not necessarily physically located in a specific jurisdiction but are actually essentially "distributed". Related "terms and conditions of use" are applied by providers similarly worldwide. This architecture is characterised by a de facto extraterritoriality. It also raises the question of the capacity of a judicial authority to enforce the law.

Finally, since proposed transactions involve a digital currency rather than various currencies, the need to develop contact points with existing currencies, and more generally financial systems, is reduced, which lowers processing and forex costs.

Stablecoins may trigger a fundamental shift toward new value-storage forms

The BIS report also stresses that stablecoins, notably those that reach global scale, could challenge and pose risks also to monetary policy and the international monetary system, and raise a fair competition concern. The report considers that these risks are of a systemic nature.

Indeed, closed loop stablecoins supported by BigTechs benefit from unprecedented global customer bases and represent, to a large extent, a mandatory crossing point which provides them with huge network effects. The high probability of accessing your counterpart through related stablecoin arrangement encourages its use, which in turn increases the attractiveness of the payment scheme and its efficiency. These schemes possibly becoming de facto essential facilities represent an important issue for regulators, since effective and fair competition is a precondition for developing innovation, choice and optimal cost.

Furthermore, since these new transaction arrangements reduce the necessity for consumers to have a bank current account and possibly propose them new value storage opportunities, the roles of banks and related business models are expected to be dramatically transformed. This should be compounded by the expected reduction of the cost of transactions.

Eventually, current lending mechanisms – and subsequently monetary policy transmission channels – may change due to the withdrawal of banks whose deposits will progressively melt away. This would also be the case should Central Banks Digital Currencies develop, the Bank of England stresses.

Both aspects deserve attention and preventative monitoring by regulators and central banks, since the continuity of lending availability and maintaining lively competition requires prompt reactions to prevent any irreversible negative change in the financial system.

In parallel to stablecoin challenges, regulators should also factor into EU regulations the most recent evolutions of the competition landscape as well as the emerging sovereignty concern

While cryptocurrency and, more recently, stablecoin challenges are gaining pace, existing payment schemes are also swiftly evolving and raising parallel regulatory and supervisory challenges.

PSD2 has been focusing on competition enhancement. The discussions are now widening the scope from open banking to open finance in order to include the full scope of all financial products, ranging from insurance to savings and pensions. There is also the question of whether enhanced portability of all customer data should also fuel innovation.

Favouring the evolution of business models specific to payment transactions is also essential. In this respect, the Interchange Fee Regulation (IFR), initially principally focused on eventually capping interchanges, has reinforced existing providers rather than favour the emergence of additional ones and has not enabled the emergence of EU payment systems. It is probably necessary to update this regulatory approach factoring in the new stakes facing the EU, e.g. the definition of an adequate level of sovereignty in the EU regarding the processing of transactions, or the recalibration of interchange fees taking into account the recent emergence of effective new contenders based on different business models challenging existing payment schemes. These

⁵ BIS - Raphael Auer & Rainer Böhme - The technology of retail central bank digital currency – 2020 https://www.bis.org/publ/qtrpdf/r_qt2003j.pdf

⁶ It's time to talk about money- Bank of England - Jon Cunliffe - <https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/its-time-to-talk-about-money-speech-by-jon-cunliffe.pdf?la=en&hash=A39E014DBBA2C5E88D1B8339E61598CBD62BCA3E>

elements may be prerequisites to a wide and swift adoption of the recently launched TARGET Instant Payment Settlement (TIPS). Achieving a balanced business case is certainly also essential to the take off of the European Payment Initiative.

Indeed, a recent but essential topic in the EU is to preserve European sovereignty. This has been highlighted by the current health crisis context, which illustrated the need to avoid any possible knock on effects resulting from excessive dependency on non-European providers (e.g. IT, Cloud providers, payment schemes and processors, etc).

Digital assets – Tokens

Benefits and specific risks

Distributed ledger technology (DLT) is thought to have useful applications in particular for securities and their settlement. Transforming securities into digital tokens – representations of value not recorded in accounts – could make ownership records more transparent and settlement much faster.

However, in addition to the risks tokens pose to investor protection and market integrity, among which the most significant risks are fraud, cyber attacks, money laundering and market manipulation, and in addition to the technological challenges posed by tokenising securities, their management raises challenges.

Indeed, the validation and update of transactions would not be centralised anymore in a CSD and some large intermediaries, but rather addressed by all the parties. Furthermore, although DLT techniques reduce the size of securities inventories to be held by market makers, the key smoothing and financing roles of these intermediaries are also questioned, despite their contribution to the efficiency of the overall settlement processes. Finally, increased speed also increases the possibility of settlement failures.

Regulatory challenges posed by tokens

A key question is whether the existing regulatory framework applies to such instruments. In addition, there may be areas where crypto assets require interpretation in order to allow for an effective application of regulations. In particular, an important aspect is the legal status of crypto assets, which determines whether financial services rules are likely to apply. Where regulation does not apply, regulators need to consider whether it should and, if so, how.

One should add that uncoordinated regulatory initiatives at the national level could trigger regulatory arbitrage and, ultimately, hamper the resilience of the financial system to crypto asset market based shocks. Finally, it is very unlikely that a large scale coordinated move will take place any time soon and will thus need to cooperate with existing account based cash and securities systems.

In the current regulatory framework, crypto assets can hardly enter EU financial market infrastructures (FMIs). Crypto assets cannot be used to conduct money settlements in systemically important FMIs. To the extent that they do not qualify as securities, central securities depositories (CSDs) cannot undertake settlement of crypto assets. Even if crypto assets based products were to be cleared by central counterparties (CCPs), these would need to be authorised and satisfy existing regulatory requirements, albeit at additional costs and with no clear benefits to EU CCPs.

Reduced financial stability issues so far

According to the ECB Internal Crypto-Assets Task Force, the ECB (ICA-TF), crypto assets do not currently (January 2019) pose an immediate threat to the financial stability of the euro area. Their combined value is small relative to the financial system and their linkages with the financial sector are still limited. At present, crypto assets' implications for and/or risks to the financial stability of the euro area, monetary policy, and payments and market infrastructures are limited or manageable.

The sector nevertheless requires continuous careful monitoring since crypto assets are dynamic and linkages with the wider financial sector may increase to more significant levels in the future. ●