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EBF response to CR 03/2021: Application of the Principles for Financial Market Infrastructures to Stablecoin Arrangements

The European Banking Federation (EBF) welcomes the joint report from the Committee on Payments and Markets Infrastructure (CPMI) and the International Organisation of Securities Commissions (IOSCO) on the Application of the Principles for Financial Markets Infrastructures to stablecoin arrangements.

We agree with the general aim of this report, notably that of applying the current principles for financial markets infrastructures (PFMI) to systemically important stablecoin arrangements (SAs) without creating additional standards for SAs.

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 and technology neutral will help promote financial stability and, at the same time, foster innovation in financial services, better serve customers and ensure the flexibility to adapt to an evolving market. However, the potential vulnerabilities and risk arising from SAs should not be neglected and be properly addressed, as better explained in this response.

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 also be internationally harmonised recognising that retail customers are likely to want to use stablecoins for international cross-border payments and that the line between retail and wholesale uses of stablecoin is likely to be blurred.

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 stablecoin arrangement to make transfer of value between participants through its operation, it is clear that SAs should be considered as payment systems, under the PFMI when they provide this function to the market.

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.

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.

We assume that other crypto-assets including algorithmic stablecoins and crypto-assets without collateral (bitcoin and others) will be addressed in future reports. We note that this is already the intention for basket-backed multi-currency stablecoins.

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 acknowledge the FSB's view that SAs have the potential to enhance the efficiency of the provision of financial services (including cross-border payments), and to promote financial inclusion. SAs may also generate risks to financial stability, particularly if they are adopted at a significant scale. While such financial stability risks are currently limited by the relatively small scale of these arrangements, SAs could become systemically important in the future, challenging the comprehensiveness and effectiveness of existing regulatory, supervisory and oversight approaches.

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.

International bodies should then look to identify protocols by which growing, and potentially systemic players are identified, depending on their nature, scale and interconnectedness with other components of the stablecoin ecosystem. **We strongly**

believe that the same activity should be subject to the same regulatory approach, regardless of the type of entity or infrastructure through which it is carried out.

It will be important that regulators and subsequent supervisory engagement recognise the international nature and blurred characteristics of SAs and work cooperatively to identify and mitigate the risks that a SA, or group of SAs, may pose to their wider objectives of financial and operational resilience of the financial system.

The rise in use of cryptoassets more broadly does give rise to systemic stability considerations, although it would be improper to assume that systemic risk cannot arise also from smaller, but strategically important, initiatives. Systemic risk will need to be managed at all levels of the ecosystem and it may not be possible to adopt a one-size-fits-all approach. Members remained confident that the risks associated with increasing use of cryptoassets could be managed proactively.

Moreover, other unstable crypto-assets can have a systemic scope and therefore create dependencies with the systemic actors covered by the report. In this regard, while the report clearly focuses on the interdependence between SA functions, it does not consider interdependencies with actors not directly linked to the functions of the SAs. Therefore, we invite to reintegrate in Paragraph 2.1.3 the notion of interdependence with unstable crypto-assets and with algorithmic cryptos. It is necessary to regulate all assets with a systemic impact, even those without an issuer that fits into any of the existing legal definitions.

Finally, we consider that it will be important to continue with the analysis and monitoring of these initiatives in order to assess the practical applicability of these principles.

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?**

We are generally 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 the international arena engages in SA and any restrictions should avoid being prescriptive; else the regulatory community has little leverage over systemically important SAs.

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 cyber security safeguards in place to manage cyber security risks. The Financial Action Task Force (FATF) report to the G20 raised similar concerns on potential money laundering and terrorist financing risks from stablecoins, particularly if they are adopted on a widespread scale. FATF indicated that both global stablecoins and their service providers would be subject to FATF standards.

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?**

Considering the difficulty in applying Principle 2 arising from the decentralised nature of some stablecoin arrangements, the transfer function of some stablecoins can only be performed by software according to rules predefined by the participating parties (who have encoded them in a set of smart contracts) and there can be no identifiable entities or legal persons intervening as responsible in the transfer function. For instance, it is important to emphasise that no one could intervene interrupting a transfer or refusing an incoming payment where certain regulatory requirements are not met. Thus, it is essential for both decentralised and centralised solutions to clearly define the roles and responsibilities of the various participants that may intervene in the decision-making process of a stablecoin arrangement and in its transfer function. Often, in the most decentralised infrastructure the actors involved in the decision-making process are the users or holders of specific tokens.

Initiatives using a distributed ledger rely on consensus mechanisms to ensure the technical irrevocability of a transfer. However, specific protocols implemented by the networks may involve different processes that must be agreed upon by its operators or participants in order to achieve legal irrevocability and make the transfer enforceable against third parties. Due to the heterogeneity of the techniques used to achieve a transfer, it will be responsibility of the stablecoin arrangement to decide which moment is to be deemed legally irrevocable and to establish a hierarchy between records in case of mismatch.

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 the guidance proposed in the report is clear for those SAs which have clear governance arrangements in place to consider the risks of the SA's own function and vis-à-vis a wider market.

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 report 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 an SA using 'probabilistic settlement'.

It may be that certain technical designs of SAs may meet market requirements, and stability requirements, better 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 consideration that the report 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 report is useful concerning the considerations that it gives on the extent to which holding a 'stablecoin' as potentially issued by a SA grants the holder a claim on the underlying asset. The guidance is therefore 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.

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 to increase fragilities in conventional domestic currency and facilitate the cross-border transmission of financial shocks. The regulatory community should continue to proactively and pragmatically agree approaches to handle developing market 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.

Impact on financial stability, monetary policy and competition should be looked at carefully. 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 invalidate existing regulatory approaches. There already exist large and/or cross-border customer bases, and a SA could achieve scale rapidly and negatively impact the efficacy of monetary policy. A sizeable shift in demand toward these arrangements could reduce the demand for cash thereby affecting both central and commercial banks' balance sheets.

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 presume that existing guidance, existing categories and existing entities 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?

No further clarification needed.