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RETAIL CENTRAL BANK DIGITAL CURRENCIES AND GLOBAL STABLE COINS
ROLE OF CENTRAL BANKS, COMMERCIAL BANKS AND OTHER PRIVATE ACTORS

The banking sector has undergone significant changes over the past decade with many consumers seeking more convenient, efficient ways to carry out their day-to-day transactions. The COVID-19 pandemic has only accelerated this movement to electronic payment solutions. Long before COVID-19, banks responded by introducing new platforms for their services while remaining dedicated to protecting their customers' data. Banks continue to adopt new forms of technology to meet the needs of consumers while at the same time providing trust and stability as regulated financial institutions. Consumers benefit from a range of delivery options for their banking services from branches and ATM machines to online and mobile banking. Behind the scenes, banks are also involved in maintaining a stable and efficient payments infrastructure that is overseen by national supervisory authorities and operated on the basis of a stable and secure fiat currency.

Central bank digital currencies and global stable coins[1] are seen by some as an important instrument towards attaining a full and efficient digitalization of the economy, including the promise of a smart, fast and more efficient cross border payment system,. At the same time, the implementation of a CBDC would have sweeping implications on a country's economic and financial systems that can create serious risks if not carefully managed.

Central banks already provide wholesale digital money to banks. Commercial bank account-based money has been digital for decades, and digital means of payment are already used on a daily basis. There are now considerations to digitise all money, including cash. Central banks are working on the development of Central Bank Digital Currencies. Several banks are planning to issue stable coins.

In this memo we assess how the creation of digital currencies could potentially support the digitalization of the economy. We also discuss the role of central banks, commercial banks and other private actors in this journey, the advantages and disadvantages of different scenarios. We will focus on Retail Central Bank Digital Currencies, leaving out the initiatives taking for wholesale purposes. Last but not least, we address the potential effects to the banking business model and to consumer and commercial customers.

[1] The Financial Stability Board defines a Stablecoin as a crypto-asset that aims to maintain a stable value relative to a specified asset, or a pool or basket of assets. A global stable coin has a potential reach and adoption across multiple jurisdictions and the potential to achieve substantial volume. https://www.fsb.org/wp-content/uploads/P131020-3.pdf

1. RETAIL CENTRAL BANK DIGITAL CURRENCIES (CBDCs)

In a recent report published by the Bank for International Settlements (BIS) and seven central banks, the business case for a CBDC is introduced as follows:[2] Central banks have a mandate for monetary and financial stability in their jurisdictions and, explicitly or implicitly, to promote broad access to safe and efficient payments. Providing cash to the public, as well as to banks and businesses, is a core responsibility of central banks and a public good. Yet, the use of cash is falling in many jurisdictions. The Covid-19 pandemic may be accelerating this trend. Taking the place of cash is private digital money and alternative payment methods.

To evolve and pursue their public policy objectives of providing trusted money to the public in a digital world, central banks and tech/infrastructure firms are actively researching the pros and cons of offering a digital currency to the public, a "general purpose" CBDC[3]. A CBDC could provide a complementary central bank money to the public, supporting a more resilient and diverse domestic payment system. It might also offer opportunities not possible with cash, while supporting innovation. As fiat currency a CBDC must be convenient and accessible at no or low cost. The underlying system should be resilient, available 24/7, flexible, interoperable, private, programmable and secure for the general public.

CBDC issuance and design are sovereign decisions to be made by each jurisdiction, and has to be in agreement with the mandate given to each central bank. Central banks will make that decision for their jurisdictions, in consultation with governments and stakeholders. However, domestic CBDCs would still have international implications, requiring cooperation and coordination across jurisdictions.

Challenges and Foundational Principles

The BIS report describes the risk of disintermediating banks or enabling destabilising runs into central bank money, thereby undermining financial stability. One of the risks is that a widely available CBDC could trigger "digital runs" towards the central bank, especially during a period of financial instability, with unprecedented speed and scale. If banks begin to lose deposits to CBDCs over time, they may come to rely more on wholesale funding, and possibly restrict credit supply in the economy with potential impacts on economic growth.

The BIS report puts three foundational principles forward for a central bank's consideration of CBDC issuance:

"*Do no harm*" - New forms of money supplied by the central bank should continue supporting the fulfilment of public policy objectives and should not interfere with or impede a central bank's ability to carry out its mandate for monetary and financial stability. For example, a CBDC should maintain and reinforce the "singleness" or uniformity of a currency, allowing the public to use different forms of money interchangeably (i.e. permit exchange at par with cash).

[2] "Central bank digital currencies: foundational principles and core features", published in 2020, https://www.bis.org/publ/othp33.pdf

[3] A CBDC is a digital payment instrument, denominated in the national unit of account, that is a direct liability of the central bank.

"*Coexistence*" - Central banks have a mandate to promote stability and proceed cautiously in new territory. Different types of central bank money – new (CBDC) and existing (cash, reserve or settlement accounts) – should complement one another and coexist with robust private money (eg commercial bank accounts) to support public policy objectives. Central banks should continue providing and supporting cash for as long as there is sufficient public demand for it.

"*Innovation and efficiency*" - Without continued innovation and competition to drive efficiency in a jurisdiction's payment system, users may adopt other, less safe instruments or currencies. Ultimately, this could lead to economic and consumer harm, potentially damaging monetary and financial stability. The payments ecosystem is comprised of public authorities (in particular the central bank) and private agents (e.g. commercial banks and payment service providers). There is a role for the public and private sectors in the supply of payment services to create a safe, efficient and accessible system. Private economic agents should generally be free to decide which means of payment they use to conduct their transactions.

IBFed's viewpoint

1. The business case should be clear

We agree with the report's statement that a central bank's decision to embark on issuing a CBDC will require assessing the value of opportunities to further pursue its objectives, balanced against any risks. The business case for issuing the CBDC should be clear. It should bring benefits to private individuals and corporates and the economy, and present a viable and optimal solution to unserved needs in the market for which no other more efficient solution exists or can be developed by the private sector. Above all, central banks must show why it is necessary for a digital currency to represent a claim on their balance sheet and why a claim on a commercial bank's balance sheet – as is the case of book money in todays two-tiered banking system – is considered insufficient.

2. Financial stability should be preserved

The risk of disintermediating banks as described in the report is real. "Do no harm" is a good principle to start but mitigating measures should be put in place such as:

- The use of an indirect model (or two-tier model) whereby banks have access to the CBDC infrastructure, and then provide access to retail users via accounts and wallets (bank account centric model). All participants need to be governed by the same regulatory framework, with clearly defined roles and responsibilities.
- The provision of a cap on CBDC wallets to ensure they are used as a means of payment and not for savings or investment. This won't totally offset the risk though. The European Central Bank estimates that a €3,000 cap could still result in €1 trillion deposits leaving the banking system. As said above, the long term implications for the deposit base and the consequences for credit availability should be carefully investigated before launching a CBDC.
- Consideration should be given to potential customer impacts, depending on the model of CBDC distribution chosen by a government. Central banks do not deal directly with customer and doing so could give rise to new risks. A retail CBDC would change the role of a central bank. Banks have worked for decades to address risks associated with dealing directly with end-users and are therefore better positioned to manage those risks going forward.

3. CBDC should complement and stimulate innovation and efficiency in payments

The role of the public and the private sector need to be identified and any synergies exploited so that CBDCs would not crowd out private solutions or discourage new initiatives in the payment market. The setup, integration and running costs of operation need to be estimated and compared with the expected benefits, considering alternative private solutions and effects on existing ones. Central banks should not be allowed to use their position to unfairly compete with the private sector Instead it is preferable to complement and stimulate innovation and efficiency in payments, provided by a competitive private banking sector.

4. The infrastructure should be secure, resilient and accessible

Cybersecurity and resilience are the indispensable foundation for any successful and sustainable digital innovation. Therefore, a state of the art, secure and resilient infrastructure is needed. CBDCs would need to meet the highest security requirements and fully respect the regulatory framework, with particular attention to the protection of personal data of citizens, risk of counterfeiting, cyber risk and anti-money laundering/counter terrorist financing requirements.

Offline capabilities need to be developed to allow for the distribution and use of funds in case of poor internet coverage (geographically remote location or instable broadband coverage) or during natural disasters.

Last but not least, increasing digitalization can both increase financial inclusion, as more people can access financial products, but it could also leave sections of society behind due to lack of trust, digital literacy, access to technology and data privacy concerns. Banks have longstanding experience in this domain and can contribute to finding solutions.

2. STABLECOINS

The G20 called on the Financial Stability Board (FSB) in June 2019 to examine regulatory issues raised by "so-called global stablecoin" (GSC) arrangements and to advise on multilateral responses as appropriate, taking into account the perspective of emerging market and developing economies (EMDEs). The FSB issued a report with proposed recommendations for consultation in April 2020[4] and a final report in October 2020[5].

Stablecoins are defined as crypto-assets that aim to maintain a stable value relative to a specified asset, or a pool or basket of assets. Global stablecoins have a potential reach and adoption across multiple jurisdictions and the potential to achieve substantial volume. The potential widespread use of private digital currencies, and resulting impacts on central banks' ability to influence monetary policy, has been cited as a key factor motivating governments to introduce CBDCs.

Challenges and Foundational principles

According to the FSB, stable coins have the potential to enhance the efficiency of the provision of financial services (including cross-border payments), and to promote financial inclusion.

But, they 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, global stablecoins could become systemically important in the future, challenging the comprehensiveness and effectiveness of existing regulatory, supervisory and oversight approaches.

[4] https://www.fsb.org/2020/04/addressing-the-regulatory-supervisory-and-oversight-challenges-raised-by-global-stablecoin-arrangements-consultative-document/ In this document the FSB definition was used. Other definitions have been used by other standard setters. One of the basis question is whether the stable coin is convertible (or not) to a fiat currency. Commercial banks for example could issue digital currencies, (e€, e$...)

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

The activities associated with GSCs and the risks they may pose can span across banking, payments, and securities/investment regulatory regimes both within jurisdictions and across borders. GSCs also can give rise to specific vulnerabilities. For example, depending on the facts and circumstances, specific money laundering/terrorist financing risks may emerge; the decentralised nature of GSC arrangements could pose governance challenges; stabilisation mechanisms and redemption arrangements could pose market, liquidity, and credit risks; and, the infrastructure and technology used for recording transactions, and accessing, transferring and exchanging coins could pose operational and cyber security risks.

The FSB issued 10 high-level recommendations to ensure appropriate regulation, supervision and oversight within jurisdictions, and international alignment to prevent any potential gaps and avoid regulatory arbitrage. The recommendations can be summarised in two categories:

1. <u>Provide a legal mandate for supervisory authorities to oversee GSC arrangements</u>

Authorities should have and utilise the necessary powers and tools, and adequate resources, to comprehensively regulate, supervise, and oversee a GSC arrangement and its associated functions and activities, and enforce relevant laws and regulations effectively. This includes the undertaking of inspections or examinations, require corrective actions, take enforcement measures and/or prohibit the activities all together.

Authorities should apply comprehensive regulatory, supervisory and oversight requirements and relevant international standards to GSC arrangements on a functional basis and proportionate to their risks.

Authorities should cooperate and coordinate with each other, both domestically and internationally, to foster efficient and effective communication and consultation in order to support each other in fulfilling their respective mandates and to ensure comprehensive regulation, supervision, and oversight of a GSC arrangement across borders and sectors.

2. <u>Provide a regulatory framework for Global Stablecoins</u>

The focus should be on the functions performed by the GSC arrangement and risks posed and apply the appropriate regulatory framework in the same manner as they would apply it to entities performing the same functions or activities, and posing the same risks ("same business, same risk, same rules" principle). Authorities should apply rules and policies, including applicable international standards, as appropriate and to the extent that the GSC arrangement provides the same functions and poses the same risks as other financial service providers.

Examples given are:

- standards and rules for e-money issuers, remittance companies, financial market infrastructures including payment systems, collective investment schemes, and deposit-taking and securities trading activities to maintain market integrity, consumer and investor protection, rules on conflicts of interest, disclosure requirements, rules that allocate responsibility in the event of unauthorised transactions and fraud, and rules governing the irrevocability of a transfer orders ("settlement finality").
- a comprehensive governance framework with a clear allocation of accountability for the functions and activities within the GSC arrangement. In case of working with a third-party, the GSC governance body should provide a comprehensive assessment of how its reliance on the third-party does not impede its ability to meet regulatory requirements and expectations for performance, resilience, security, development and maintenance, and regulatory compliance.

- effective risk management frameworks especially with regard to reserve management, operational resilience, cyber security safeguards and anti money laundering/counter terrorist financing measures, as well as “fit and proper” requirements
- robust systems for collecting, storing and safeguarding data
- appropriate recovery and resolution plans
- legal clarity to users on the nature and enforceability of any redemption rights and the process for redemption, where applicable

Authorities should ensure that GSC arrangements meet all applicable regulatory, supervisory and oversight requirements of a particular jurisdiction before commencing any operations in that jurisdiction, and adapt to new regulatory requirements as necessary.

IBFed’s viewpoint

Stable coins are part of a set of instruments aiming at a full and efficient digitalization 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. As stated by the FSB no GSC project should begin operation until the legal, regulatory and oversight challenges and risks are adequately addressed through appropriate designs and by adhering to regulation that is clear and proportionate to the risks. We support the FSB’s contributions to better regulating and supervising GSCs, considering the potential risks to financial stability from GSCs through certain key channels. Risks may also be elevated by the participation of non-regulated market participants. That’s why we believe that bank issued global stable coins are the preferred route. 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. In general, we agree with the FSB’s recommendations for authorities on regulating GSCs, and we provide comments on certain items below.

1. The FSB rightly focuses on privately issued Global Stablecoins

We agree with the FSB’s focus on privately issued GSCs primarily used for retail purposes as we believe the risks and vulnerabilities are heightened in these circumstances, especially with respect to the financial system and real economy. By contrast, regulated financial institutions have begun exploring the use of stable coins on a more limited basis for specific purposes such as internal cross-border money transfers and the transfer of payments between institutional clients. These initiatives are being undertaken in a more controlled environment with regulatory oversight and no direct impact to consumers. We therefore believe such activities should not be subject to any additional regulatory treatment.

2. The FSB rightly identifies the valuation risk and data privacy concern to consumers

Even stablecoins backed by fiat currencies can represent a valuation risk, translating into significant fluctuations in users’ wealth. The European Central Bank found that algorithmic stablecoins have not yet proven capable of withstanding market shocks and maintaining a stable value in the currency of reference. And tokenized funds (i.e. backed by fiat currency) are dependent on the trust users have in the entity backing the stablecoin initiative, while other collateralized stablecoins can have a stable price only to the extent that the volatility of collateral is properly managed. There is also the risk that a GSC arrangement may fail and that consumers will be under the false impression that their holdings will benefit from the same protection offered by deposit insurance coverage for bank deposits.

A high degree of data privacy and protection will be paramount, particularly in the case of GSC arrangements, where data privacy and protection concerns can be elevated if a GSC were to become the custodian of a large quantity of users' personal information.

3. The FSB rightly points out the risk of operational disruption in the GSC environment

This is of particular concern in a large decentralized 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. GSC arrangements should have a comprehensive governance framework in place with a clear allocation of accountability.

Cyber security risks introduced by GSC arrangements are evident from both a technology, infrastructure and consumer perspective. We support the FSB recommendation that authorities should ensure GSC arrangements 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 so-called 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. Impact on financial stability, monetary policy and competition should be looked at carefully

As explained in the FSB report, the current size of the stablecoin market is limited. If however, a GSC arrangement would become a substitute form of money where money shifts from accounts at banks to holding stablecoin virtual 'wallets' provided by non-banks, there are concerns that these arrangements, built on the backbone of existing large and/or cross-border customer bases, 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 a central bank's balance sheet.

We agree with the FSB that changes in competition dynamics could endanger the resilience of the financial sector and adversely impact financial stability. It could also lead to a concentration of financial services instead of bringing diversification, with emerging providers becoming new sources of systemic risk. This would especially be the case for BigTech firms launching GSC arrangements. Given the potential for these arrangements to span across jurisdictions, we would encourage a coordinated, harmonized response across regulators.

CONCLUSION

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.

There are a number of potential vulnerabilities and risks that may arise from CBDCs and GSC arrangements as explained in this memo. Innovations can only contribute to economic development and welfare if risks and vulnerabilities are kept in check.

With this memo we want to contribute in the debate. We are willing to further exchange with the different stakeholders, to create the right guidance and principles framework at international level.