



HMT Consultation - Managing the Failure of Systemic Digital Settlement Asset (including Stablecoin) Firms

Crypto UK Response 2 August 2022

CryptoUK is an independent industry body that exists as a cohesive, credible voice for the evolving UK crypto industry. It represents the UK's cryptoasset sector, working directly with policymakers and market players to advocate for better education, mutual understanding, and fair and balanced policy. Its 140+ members include crypto natives, services, custodians, and institutional investors.

CryptoUK works with policymakers and agencies to improve protections where they are needed and remove barriers where they are not. It works with industry market participants to identify and promote use cases for digital and cryptoassets which create value for UK PLC as well as promoting the UK crypto industry on the world stage. To find out more, please go to cryptouk.io.

Having run a series of member workshops to obtain views from a wide range of firms, CryptoUK is pleased to respond to this consultation.

Introduction

A recent report by the World Economic Forum states that “ Although still a relatively small part of the global financial system, the crypto-asset market capitalisation grew by 350% in 2021.¹ In the UK HMRC commissioned research² dated June 2022 shows that,

- 10% of UK adults said they hold or have held a cryptoasset. The majority of which currently held cryptoassets (82%, equivalent to 8% of the adult population), with 55% never having sold any (equivalent to 5% of the adult population). 53% of current owners had holdings of up to £1,000, with 7% holding more than £5,000 in value and at present
- Cryptocurrencies were reported to be the most commonly held type of cryptoasset (79%), followed by utility tokens (20%). The most mentioned reason for having cryptoassets was that they are a ‘fun investment’ (52%), while 19% said cryptoassets were a ‘core part of my investment portfolio’.

¹ The Macroeconomic Impact of Cryptocurrency and Stablecoins

https://www3.weforum.org/docs/WEF_The_Macroeconomic_Impact_of_Cryptocurrency_and_Stablecoins_2022.pdf

²Individuals holding cryptoassets: uptake and understanding

<https://www.gov.uk/government/publications/individuals-holding-cryptoassets-uptake-and-understanding>

Although still small, the market for cryptoassets continues to increasingly attract individuals and businesses.

Our consultation response contains two parts:

1. General observations that may assist HM Treasury's (HMT) overall approach and thinking on the proposals and ;
2. Specific responses to the consultation questions.

General Observations

HMT issued an additional, separate request for information: "Open consultation: Payments Regulation and the Systemic Perimeter: Consultation and Call for Evidence³ (the Perimeter Consultation) " on 20 July 2022 (ten working days before the deadline to submit comments to this consultation), seeking input on the Government's approach to reforms to the payments regulatory landscape, including the systemic payments perimeter of the Bank of England. CryptoUK notes that two distinctly different consultations, seeking to address similar and related evidence on payments regulation and systemic designation, are open for comment in asynchronous timing. CryptoUK strongly recommends that HMT assimilate and consider the findings from both consultations in tandem.

We understand HMT expediting this consultation, especially in light of recent market events, but the scope of the Perimeter Consultation, the inclusion of definitions in the Financial Services and Markets Bill and the outstanding FCA and BoE consultations on the authorisation and supervision regime for stablecoin firms and stablecoin payment systems highlights that this consultation considers only one aspect of stablecoin operations in isolation. It attempts to evaluate risks related to DSA firm failure prior to considering and articulating a holistic regulatory framework for such firms. We encourage HM Treasury to consider a comprehensive and cohesive regulatory framework for cryptoassets, which DSA firms could be included within, that considers the interoperability of stablecoins within both the cryptoasset and traditional finance markets.

Without the holistic overview of the role and remit of the UK regulators for this ecosystem, and the regulatory requirements applicable to firms, dealing with only one piece of the puzzle in this way creates an awkward sequencing for the market and makes it challenging to provide a robust and informed view on a framework for firm failure .

A holistic approach is an opportunity for HMT to provide clarity and send a clear message to the market that will ensure that the UK is able to continue to lead and embrace innovative technology and practices that have the potential to deliver many benefits to UK consumers and businesses.

³ Payments Regulation and the Systemic Perimeter: Consultation and Call for Evidence
<https://www.gov.uk/government/consultations/payments-regulation-and-the-systemic-perimeter-consultation-and-call-for-evidence>

CryptoUK welcomes HMT's commitment to progress a regulatory framework as outlined in the "UK regulatory approach to cryptoassets, stablecoins and distributed ledger technology in financial markets: Response to the consultation and call for evidence (April feedback statement)".⁴ However, CryptoUK strongly encourages HMT to evaluate the FMI SAR framework through the lens of open public blockchains that securely execute transactions, and assess any infrastructure gaps or anomalies between these networks and the proprietary inter-bank payment systems the current FMI SAR framework was implemented to oversee.

The absence of clarity on a number of topics being considered within the consultation, and a methodology for establishing systemacy, has left us challenged in formulating our response to HMT, and, in determining if:

(i) the Financial Market Infrastructure Special Administration regime is the correct regulatory framework for the special administration regime for all the providers outlined in the consultation and

(ii) whether the Bank of England should in all cases be the lead regulator.

Financial Market Infrastructure Special Administration regime

The consultation seeks a view on the appropriate special administration regime for digital settlement asset firms and payment systems and details a preference for the Financial Market Infrastructure Special Administration regime ("FMI SAR") over the Payment and E-money Special Administration Regime ("PESAR").

The consultation highlights that the two special administration regimes address very different priorities,

- the FMI SAR oversees the functioning of an interbank payment system, the failure of which would have a catastrophic impact on the UK economy and
- the PESAR oversees returning funds to consumers and was enacted in 2021⁵ to address the fundamental concern about protection for consumers and funds not covered by the FSCS⁶.

It is proposed that the correct regime, with critical amendments, is the FMI SAR.

⁴ UK regulatory approach to cryptoassets, stablecoins, and distributed ledger technology in financial markets: Response to the Consultation and Call for Evidence.
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1088774/O-S_Stablecoins_consultation_response.pdf

⁵ The Payment and Electronic Money Institution Insolvency Regulations 2021
<https://www.legislation.gov.uk/ukdsi/2021/9780348222814>

⁶ Using payment service providers
<https://www.fca.org.uk/consumers/using-payment-service-providers#:~:text=Some%20are%20made%20through%20a,process%20known%20as%20'safeguarding'>

Role of Regulators

The mandates of the four UK regulatory authorities with banking and payments oversight and supervision sometimes have an overlapping remit. This overlap is addressed in the Memorandum of Understanding between the Bank of England (BoE), the Financial Conduct Authority (FCA), the Payment Systems Regulator (PSR) and the Prudential Regulation Authority (PRA)⁷.

This memorandum details the objective of the various regulators and states that the BoE is responsible for financial stability and payment systems and that the FCA has the operational objective of 'securing an appropriate degree of protection for consumers'.

Within the consultation, there is a proposal to extend the FMI SAR to the return of funds to end users with a new power for the BoE to direct administrators on this matter. This suggestion, in effect, gives the BoE a consumer protection mandate that we believe could be at odds with its *raison d'être*, financial stability.

CryptoUK contends that the proposal to extend the FMI SAR to the return of funds to end users is a fundamental change to the 'intent' of the FMI SAR and the BoE's mandate, and we are unclear from this consultation on the rationale for such a foundational change, which would impact the very fabric of the the BoE's regulatory mandate and the FMI SAR. We do, however, note the wider changes proposed in the Perimeter Consultation.

High level Concerns

We also highlight the following high-level concerns.

(a) The definitions for Digital Settlement Asset and Digital Settlement Asset service provider have only recently been articulated, are potentially broader than originally envisaged by previous consultations and due to their breadth, may bring unintended and inappropriate market participants within the proposed FMI perimeter.

Digital Settlement Asset – within this consultation HMT has continued with the concept of a digital settlement asset ("DSA") and stated that "we use the broad term "digital settlement asset" to refer to stablecoins of the type consulted on previously, together with wider forms of digital assets used for payments/settlement."

The recent draft Financial Services and Markets Bill⁸ contains the following definitions for the term.

⁷ Financial Services (Banking Reform) Act 2013: Memorandum of Understanding between the Bank of England, the Financial Conduct Authority, the Payment Systems Regulator and the Prudential Regulation Authority
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/727664/BoE_FCA_PRA_Payments_MoU.pdf

⁸Financial Services and Markets Bill
<https://publications.parliament.uk/pa/bills/cbill/58-03/0146/220146.pdf>

A “digital settlement asset” means a digital representation of value or rights, whether or not cryptographically secured, that

- a. can be used for the settlement of payment obligations,
- b. can be transferred, stored or traded electronically, and
- c. uses technology supporting the recording or storage of data (which may include distributed ledger technology).

DSA service provider -similarly, in this consultation “DSA firm” refers to “systemic DSA payment systems and/or an operator of such a system or a DSA service provider of systemic importance. In the case of stablecoins, this might include – but is not limited to – the issuer of a stablecoin, a wallet, or a third-party service provider”

The recent draft Financial Services and Markets Bill adds context with the following definition for the term.

A “DSA service provider” is a person who provides one or more services in relation to a payment system that includes arrangements using digital settlement assets where

- a. the person creates or issues the digital settlement assets involved in the payment system,
- b. the person provides services to safeguard, or to safeguard and administer, digital settlement assets including their private cryptographic keys (or means of access),
- c. the person is directly involved in any of the activities mentioned in paragraphs (a) or (b),
- d. the person is a digital settlement asset exchange provider,
- e. the person sets rules, standards, or conditions of access or participation in relation to the payment system, or
- f. the person provides any service that facilitates, or supports, a transfer of money or digital settlement assets to be made using the payment system, including any infrastructure provider in relation to the system.

The scope of these definitions means that a DSA firm would include issuers and custodians, firms that operate the payment system; associated service providers to payment systems; governance bodies; and associated service providers to the above. Where firms meet a certain threshold they will be classified as ‘systemic’ and will fall within the provision proposed in this consultation.

The breadth and scope of solely consumer-facing firms captured by these definitions has the potential over time to move a variety of firms out of FCA oversight and supervision to BoE oversight and supervision. Given the different regulatory remits of these organisations we

question if this is the correct approach for solely consumer facing firms, and whether the firm and the ecosystem is better served by dual oversight and supervision by the FCA and PRA, aligned with the current remit of these regulators and their existing dual regulation model.

The Perimeter Consultation deals with this issue of the different roles of the various regulators and we suggest that the responses to that consultation are considered before any final decision is made on the lead regulator for DSA firms that are not systemic payment systems or associated service providers to systemic payment systems.

(b) Threshold for “systemic” - The meaning of systemic is well understood in the context of failure of a financial institution or that of a payment system such as FPS and BACS. However, it is unclear what “systemic” means in the context of a DSA or DSA firm.

At present the size of the stablecoin market in the UK is very small relative to other means of payment, and there is no stablecoin market participant that is “systemic” from a financial stability perspective. The BoE Financial Stability in Focus report published 24 March 2022⁹ indicates that “direct involvement in cryptoassets and associated markets by UK banks has been limited to date...” and explains that “stablecoins currently account for under 0.1% of the total financial system”

The Perimeter Consultation explores in greater depth the remit of the BoE for systemic risk in payment chains. We believe it is important for there to be transparency on the threshold for ‘systemic’ firms in this ecosystem. Careful consideration must also be given to;

(i) the impact for firms that have similar business models and products - the obvious example being the similarity between single currency backed stablecoins and e-money. The Perimeter Consultation is considering a wide range of issues on the scope of systemic perimeter and we recommend that HMT is mindful of the links between all the current consultations in ensuring a holistic and proportionate outcome to scope and the remit of the BoE, FCA, PRA and PSR.

(ii) ensuring that any threshold does not impede competition and stifle innovation by introducing caps such as those proposed in the pending EU MICA legislation.

Post Brexit, the UK is uniquely positioned to tailor a bespoke regulatory approach that differentiates the UK from Europe and attracts the leading market participants who are creating jobs and economic growth associated with an emerging industry; whilst delivering continual evolution in payments and new retail-focused forms of exchange and value creation.

⁹Financial Stability in Focus: Cryptoassets and decentralised finance
<https://www.bankofengland.co.uk/financial-stability-in-focus/2022/march-2022>

(c) Wider Framework

(i) Sequencing - We are concerned that the Perimeter Consultation duplicates a question from this consultation. It is likely that firms responding to the Perimeter Consultation may not have considered this more specific consultation and thus respond out of context and we are concerned HMT will need to give weight to such responses in its final determination.

We acknowledge the BoE's remit for oversight of payment system operators and suggest that HMT awaits the outcome of the Perimeter Consultation before making a final decision on the mandate of the BoE with regard to solely consumer-facing firms.

(ii) Non Bank firms - The proposed regime under the FMI SAR only applies to non-bank firms. We can only assume that for the purposes of consumer protection this regime is not intended to apply to bank issuers as funds received by a bank in exchange for a stablecoin or DSA will be 'deemed' a deposit and protected by FSCS and returned according to FSCS rules. We also assume, given the intention to take current payment services regulation as the basis for future stablecoin regulation, that funds received by non-bank firms in exchange for stablecoins or DSA will need to be 'safeguarded'.

If this assumption is correct, then this framework results in anomalies that exist today between the deposit guarantee scheme and safeguarding and should be addressed.

If our assumptions are correct we believe that the position is as detailed below,

- (i) In the event of the insolvency of a bank, the funds backing the DSA and held by a bank as a deposit will be protected in line with FSCS limits. In contrast, safeguarded funds are not subject to such a limit as 100% of the funds are safeguarded.
- (ii) In the event of bank failure FSCS will protect depositors however customers of the non-bank firm whose safeguarding account is held with the bank do not benefit from FSCS protection and are unlikely to receive their funds in a timely manner as they will not benefit from FSCS rules or the PESAR in this situation.

(iii) Other matters -In order to determine if the proposals in the consultation fully addresses the risks that HMT seeks to mitigate including consumer protection risks further clarity is needed on

(i) the treatment of a bank that could also fall into the scope of a DSA firm or DSA service provider.

(ii) the wider consumer protection issues that can arise from the wide ranging definition of DSA.

(iii) the treatment of reserve assets in an insolvency situation.

(iv) the roles of the PRA and PSR in this ecosystem given their own respective role for firms and payment systems.

In conclusion we are of the view that,

- The April feedback statement proposed a robust regulatory regime for stablecoins and we are fully supportive of the direction of travel proposed by HMT. This consultation, when taken together with the definitions in the Financial Services and Markets Bill, creates a regulatory framework for a wider range of digital assets and captures a broad range for firms. Whilst we understand the need to futureproof, the current lack of clarity on which business models and firms will be subject to these proposals leaves us concerned about the end outcome for our industry.
- A well-thought-out regulatory framework for stablecoins used for payments is essential if they are to be safely and widely adopted in the mainstream markets. We support a regulatory regime for stablecoins similar to that of electronic money, considering design features and use and clarity on the distinction between a single currency backed stablecoin and e-money.
- We believe that stablecoin payment system operators should be treated in the same manner as other FMI and that any enhanced requirements for operators or firms should be subject to the principles of proportionality and 'same risk-same regulatory outcome'.
- HMT should await the outcome of the Perimeter Consultation before determining if firms that are solely consumer-facing should fall within the BoE's remit.

Specific responses to the consultation questions

1. Do you have any comments on the intention to appoint the FMI SAR as the primary regime for systemic DSA firms (as defined at para 1.8*) which aren't banks?

Whilst there are elements of the existing FMI SAR that can serve as a guide toward future comprehensive regulation for DSA firms, the entirety of the existing FMI SAR is not an appropriate pathway to regulate every systemic DSA firm in the UK.

CryptoUK supports establishing a bespoke regulatory and oversight regime for systemic DSA firms, and for fully-reserved digital currency issuers to be subject to sound prudential regulation. Given the ecosystem complexity presented by digital assets and their unique use of open-source blockchain software networks, we encourage HMT to consider evaluating the FMI SAR framework through the lens of open public blockchains in order to assess material infrastructure differences or anomalies between these networks and the proprietary inter-bank payment systems the current FMI SAR framework was implemented to oversee.

Emerging, open-source business models may negate the need for some of the mitigating factors included within the FMI SAR framework. In most cases, digital asset issuers do not own or operate the payment rails on which digital assets run. Blockchain market participants are innovating, developing continually upgradable infrastructure which offers consumers and merchants new options to engage with the digital asset economy.

For example, Circle's fiat-backed payment stablecoin, USD Coin (USDC), circulates over payments rails enabled by open and transparent public blockchains, securely executing millions of transactions. External to Circle's proprietary systems, there are a variety of public blockchains, exchanges, Virtual Asset Service Providers (VASPs), and digital wallets that support USDC, enabling its use for payments, trading, lending, transactions, and remittances. Circle on its own does not function as an inter-bank payment system, CSD, or third party service provider. Numerous market participants make up a dynamic and complex ecosystem of DSA firms, servicing various functions of a complete FMI architecture.

2. Do you have any comments on the intention to establish an additional objective for the FMI SAR focused on the return or transfer of customer funds, similar to that found in the PESAR, to apply solely to systemic DSA firms?

We understand the need for certainty and a framework that allows the UK regulators to act in an expedient and timely manner but we are cautious on this extension of the FMI SAR at this time taking into account the sequencing mentioned above, the lack of clarity on the impact of this change on the wider market and that this proposal changes the BoE's regulatory mandate.

We are of the view that expanding the regulatory remit of BOE to protect consumers is a matter that requires further consideration of long term and unintended consequences. This proposal also takes the UK down a path that diverges from proposals in other regulatory frameworks such as MICA.

At this time, we are of the view that the FCA would be better equipped to deal with the oversight of any situation dealing with customer funds and the return of consumer funds. Given the wide scope of the DSA definition, further work is needed to distinguish between different business models and types of risk to better understand if firms that are not payment systems or service providers to payment systems are better covered by the PESAR regime.

3. Do you have any comments on the intention to provide the Bank of England with the power to direct administrators, and to introduce further regulations in support of the FMI SAR to ensure the additional objective can be effectively managed, or what further regulation may be required?

We would reiterate our response to question 2.

4. Do you have any comments on the intention to require the Bank of England to consult with the Financial Conduct Authority prior to seeking an administration order or directing administrators where regulatory overlaps may occur?

We are of the view that the FCA is better placed to deal with certain firms given its existing supervisory remit and expertise with non-bank firms. We believe that the existing Memorandum of Understanding between the Bank of England, the Financial Conduct Authority, the Payment Systems Regulator and the Prudential Regulation Authority with suitable amendments, would be a better place to accommodate the engagement between regulators.

We would be happy to discuss any of our responses with you and ask that that you contact

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