IRSG

INTERNATIONAL REGULATORY STRATEGY GROUP

International Regulatory Strategy Group (IRSG)

RESPONSE TO THE BANK OF ENGLAND DISCUSSION PAPER

THE BANK OF ENGLAND'S APPROACH TO INNOVATION IN MONEY AND PAYMENTS

Introduction

The International Regulatory Strategy Group (IRSG) is a joint venture between TheCityUK and the City of London Corporation. Its remit is to provide a cross-sectoral voice to shape the development of a globally coherent regulatory framework that will facilitate open and competitive cross-border financial services. The IRSG welcomes the opportunity to respond to the Bank of England's (the Bank) discussion paper 'The Bank of England's approach to innovation in money and payments' dated 30 July 2024 (the Paper).

This response sets out some key considerations in response to the Paper. Overall, we are strongly supportive of the Bank's leading efforts to support and deliver innovation in payments and money. The modernisation of UK financial services through innovation in payments is key to their continued international competitiveness. We look forward to continuing to work with the Bank to support this.

Regarding the Bank's approach to innovation in money and payments, it is the IRSG's view that:

- The Bank is taking steps to advance wholesale central bank digital currencies (wCBDCs) and Real-Time Gross Settlement (RTGS) systems, with initiatives like the Digital Securities Sandbox (DSS) to enhance the UK's competitiveness. However, the UK is behind global leaders like France/the Eurozone and Singapore in wCBDC implementation.
- The private sector's role is vital for accelerating innovation, particularly in digital currency and payment systems. Private-led digital identity (ID) solutions and tokenised financial products have shown promise in reducing fraud and enhancing efficiency.
- Clear and consistent legal frameworks for digital money and assets are essential for safe innovation, including protections for users of new payment technologies. A collaborative regulatory approach between the Bank and the Financial Conduct Authority (FCA) is needed to address systemically important stablecoins and develop supportive environments for tokenised assets and stablecoins.
- Diverse distributed ledger technology (DLT) platforms need consistent regulatory standards to achieve interoperability. While mandating a single solution is not feasible, establishing industry-wide standards through private-public collaboration can reduce complexity, lower costs, and encourage adoption of DLT-based financial solutions.
- To remain competitive in cross-border payments, the UK's engagement in international projects like Project mBridge is critical. Cross-border wCBDCs could streamline FX and correspondent banking, reinforcing the need for consistent regulatory standards across jurisdictions to support multilateral payment infrastructures.

We wish to thank Clifford Chance LLP for their support in drafting this response.

Key considerations

International Competitiveness

We welcome steps taken by the Bank to proactively explore innovation in money and payments. The Bank's efforts to modernise UK financial services through initiatives such as the exploration of wCBDCs and innovations for the RTGS system, and the development of the DSS alongside the FCA, are essential to keeping pace with global advancements and ensuring the continued competitiveness of the UK financial and related professional services.

The pace of development in the UK is lagging behind other jurisdictions. The private sector plays a crucial role in accelerating progress by driving innovation and delivering solutions. Many countries, such as France/ the Eurozone and Singapore, are already ahead with advanced wCBDC projects. The Banque de France has experimented with wCBDCs for tokenised asset settlement using DLT, while the Monetary Authority of Singapore (MAS) has piloted wCBDCs on DLT for real-time settlement. WCBDCs can help preserve the singleness of money, and the Bank should actively support private sector developments in this space.

We believe that a wCBDC offers greater potential benefits for the international competitiveness of the UK compared to a retail central bank digital currency (rCBDC), for example given the role that a wCBDC could play in capital markets and trade.

Moreover, innovation in money and payments goes beyond currency and assets. For example, digital ID solutions should be considered to enhance payment authentication and reduce fraud—a field in which the industry is already taking the lead with individual digital ID offerings and collaborations with the Centre for Finance, Innovation, and Technology (CFIT). To ensure the UK remains at the technological frontier, further advancements in these broader areas are essential. This should be considered as central to the Bank's secondary objective to support the international competitiveness and growth of the UK economy in the medium to long term.

Benefits

We agree that there are areas in which programmable platforms enabled by DLT could bring significant benefits to payments and settlement. In this context, there are already certain innovative use cases. Examples of opportunities arising from the use of DLT include:

- The digital representation of interests in securities by a custodian to achieve movements of collateral in repurchase agreements and similar transactions.
- The use of tokenised deposits to improve efficiencies and capabilities in settlement internalisation by a financial institution.
- The digitisation and automation of primary market issuances to drive operational efficiencies and mitigate risk.
- The use of DLT-based platforms and tokenisation with features such as fractionalisation to increase liquidity in secondary markets, support greater retail involvement in the equity market and support financial inclusion.
- Automated processes and risk mitigation in DLT-based clearing and settlement.

- The mitigation of operational risk in custody by establishing "golden-source" records and workflow automation in post-trade processes.
- The automation of asset servicing and lifecycle management to improve reporting efficiencies and mitigate operational and compliance risks.
- The streamlining of home buying processes and enabling programmable payments in peer-to-peer marketplaces, enhancing customer experience and efficiency.
- Further automatisation and efficiency gains in liquidity management.
- Improvement of efficiencies in cross-border payments.

However, to realise these benefits and achieve greater efficiencies in this space from technological developments, the Bank should consider its role in facilitating private sector-led innovation by ensuring the necessary combination of three elements:

1. A robust legal and regulatory framework.
2. The ability to put assets on the ledger.
3. The ability for payments of any resulting transactions to be achieved through analogous means, on the platform or through another platform, which achieves an analogous result.

<u>Robust legal and regulatory frameworks</u>

We welcome the Bank's collaboration with the FCA in fostering the development of innovative payment solutions with a clear regulatory framework. Key initiatives such as the DSS, digital ID frameworks, guidance on CBDCs, and steps towards crypto asset regulation are important steps forward. Establishing a robust legal and regulatory structure for digital money is essential to ensure that the use of new technologies does not introduce additional legal risks compared to traditional systems. This framework will help build confidence among market participants while maintaining customer trust by providing clear, consistent guidelines, with proper recourse and liability models for consumers when issues arise.

It is crucial that consumer protections and appropriate commercial models are in place before the rollout of initiatives such as account-to-account (A2A) payments. These initiatives must prioritise safe customer outcomes, ensuring protections that are transparent and easy for customers to understand. Regulatory standards should be applied consistently across all participants in the payments ecosystem, ensuring that customers have recourse where harm occurs, and placing liability on the party responsible for the harm. This approach will better incentivise all players in the ecosystem to maintain high standards of security and accountability.

A robust legal and regulatory framework is essential for fostering the long-term investment required to build a resilient payments infrastructure. It must provide a clear and consistent set of standards that ensure all stakeholders—businesses, innovators, financial market infrastructure providers, banks, and regulatory authorities—can operate with confidence. This framework should not only establish appropriate value returns for these entities but also create an environment conducive to investment in innovative solutions that enhance transaction efficiency and consumer value. By clearly defining roles, responsibilities, and protections, a strong regulatory foundation will mitigate risks, encourage collaboration, and ultimately drive productivity gains across the economy, ensuring that the payments landscape evolves in a secure and effective manner. Furthermore, robust regulation can help foster and support innovation in a way that may help to simplify the payments landscape, addressing the risk of overwhelming the industry with numerous parallel activities. Coordination between regulators and industry is key to ensuring progress while allowing space for the private sector to lead innovation that will ultimately benefit consumers.

The use of stablecoins and tokenised deposits has largely been driven by private actors, but significant legal uncertainty remains around their regulatory treatment in the UK given the lack of progress in embedding the concept of these new forms of money in the existing legal framework. As legal and regulatory frameworks provide more legal clarity, we anticipate that these payment methods will see broader adoption and spur further innovation. In this context, the Bank must keep in mind the principle of "same activities, same risks, same rules" to ensure that regulatory frameworks mitigate risks while remaining flexible enough to encourage experimentation and the development of new use cases. We support the rapid development of additional regulatory sandboxes, such as a digital payments sandbox, to explore use cases for both retail and wholesale CBDCs, stablecoins, and tokenised deposits. These sandboxes would enhance payment functionality and the use of central bank money, contributing to the growth of the wider economy.

Retail payments

We broadly agree with the outcomes that the Bank is seeking to achieve concerning retail payments, particularly given the significance of payment innovation for the wider economy, in delivering both benefits for consumers and enhanced efficiencies for financial institutions. In addition, we see space for the use of bespoke payment methods to meet customer needs. For example, the UK has operated an electronic money framework for close to a decade, despite there being an argument that the credit risk that applies to the holder of electronic money is higher than the credit risk such a person would have to their deposits with commercial banks. This has not resulted in a negative impact on the wider economy. If users are informed of and understand the specific risks of, the relevant payment methods, including the protections they benefit from by using certain payment methods, there should not be a barrier to the use of novel payment methods (such as stablecoins).

We recognise the Bank has done significant thinking on the design of the digital pound sterling and encourage this work to accelerate in collaboration with the industry to address the potential interplay with private solutions which have arisen to address digital payments, including stablecoins. We believe that the Bank's objectives for a rCBDC could be achieved through a public-private partnership, with the private sector taking the lead on innovation and delivery. The Regulated Liability Network (RLN) led by UK Finance is a powerful example of how this approach can succeed, and we encourage continued partnership to build on these existing efforts.

We note the Bank has developed a framework to address the use of systemically important stablecoins. We welcome this and encourage the regime to be finalised and made effective as soon as is practicable, noting that the EU's equivalent regime under the Markets in Crypto-assets Regulation (MiCA) took effect from 30 June 2024. It is critical that the Bank and FCA regimes complement and work effectively together.

The Bank has stated that it "considers that the presence of a central entity assuming the role of payments system operator and regulated as such (subject to HMT recognition) is necessary to mitigate risks in a comprehensive way" for systemic stablecoins and accordingly only stablecoins issued on centralised platforms will sit within its framework. However, this does not reflect the way that many stablecoins are and are likely to continue to be issued in practice. Many stablecoins are issued using public blockchains where there is no centralised payments system operator and therefore would not fall under the Bank's framework.

The FCA regime is much broader and does not have the same requirements for centralised issuers. This is a more flexible approach but means that it is unclear how many stablecoins would be able to develop and grow and graduate from the FCA regime to the Bank regime at the appropriate stage. The design of any stablecoin framework must also account for and operate effectively alongside existing regimes (such as the electronic money framework) and existing payments systems without under or overlap. It is important that novel payment methods find a place in the wider economy and that the Bank supports their use.

From a financial reporting perspective, understanding how stablecoins are recognised, measured, presented, and disclosed under applicable accounting standards is crucial. The contractual arrangements between issuers, custodians, wallet providers, and stablecoin holders play a pivotal role in determining their classification as inventory, intangibles, or financial assets and whether they meet the definition of cash and cash equivalents. Because of the varying custody scenarios, in many cases, a stablecoin holder's rights or ability to redeem backing assets may be obstructed such that it is not likely that the holder will be able to recognise these assets as cash or cash equivalents, nor in most cases, a financial instrument and instead may have to classify them as an intangible asset. This would be detrimental to adoption by both banks - who may face regulatory capital deductions – and businesses, which would be unable to include stablecoins in cash for financial reporting purposes.

Wholesale payments

We welcome steps by the Bank to develop a wholesale settlement asset. While significant progress has been made to store and deliver securities 'on-chain' (i.e. on DLT networks), currently payment typically occurs separately and subsequently 'off-chain'. This secondary payment step minimises the potential efficiencies offered by DLT. Therefore, we agree with the Bank's observation that "DLT-based transactions need a settlement asset that is compatible with DLT-based infrastructure." Allowing all elements of the transaction to be settled on-chain is key to reducing settlement times, as well as minimising counterparty risk. This will be an important consideration as firms progress through the DSS, which has just opened to applications in the UK.

The Bank has reported a low-risk appetite for a significant shift away from the settlement in central bank money towards private settlement assets, pointing to *"a strong case for policymakers to take steps to preserve the role of central bank money as an anchor for confidence in the financial system."* Efforts to develop and explore innovations in central bank money and ensure this remains a viable settlement asset for DLT-based transactions are welcome. We would welcome a wCBDC settlement solution. However, the Bank stated in the DSS Policy Statement it could not provide any indication of when a wCBDC might be viable. Given that the development of a wCBDC would likely take an extended period of time, the Bank must facilitate the safe exploration of private alternative solutions in the meantime, including tokenised deposits and stablecoins. This would be aligned with current practice under Principle 9 of the Principles for Financial Market Infrastructures (PFMI) which states central bank money should be used for settlement only when "practical and available". Otherwise, commercial bank money may be used (and is used by CSDs) as an option to manage settlement risk.

As outlined above, we support the Bank's development of a robust regulatory regime for systemic stablecoins alongside the FCA's broader regime and encourage that the Bank and FCA continue with strong collaboration taking into account their respective policy positions to develop frameworks that work effectively in unison and that can be introduced in a timely manner to bring clarity on the regulatory treatment of stablecoins in wholesale transactions.

<u>Interoperability and standards</u>

We note there are important initiatives focused around interoperability both led from the private sector, including the RLN, and as public-private collaborations, including the Bank's involvement with Project Agora. We strongly support these initiatives and would encourage the Bank to support efforts on this front, including learning from the private sector-led initiatives. Outside of these collaborative projects, there is currently no single platform for the facilitation of payments. Instead, several individual market participants are developing their own commercial solutions. Fragmented individual and private explorations of DLT with a lack of standardisation have led to disparities between initiatives. These disparities between different DLT platforms and between DLT with traditional financial market infrastructure can make it difficult for systems to interact and scale. This also creates additional costs which undermines the appeal and potential benefits of DLT for market participants and limits adoption rates.

However, rather than mandating a single solution, the focus should be on establishing clear and consistent regulatory standards that promote interoperability while leaving space for the private sector to innovate. This approach will allow multiple players to continue developing diverse solutions, but with an aligned vision and standards set by the regulator. Common standards will ensure these solutions can interact effectively, helping the industry scale efficiently, without stifling innovation or forcing consensus on each initiative. This balance between regulation and innovation is key to reducing complexity, lowering costs, and encouraging broader adoption of DLT-based solutions across the market.

Ultimately, establishing industry-wide standards and interoperability will only result from collaboration between industry, policymakers and regulatory bodies in strong public-private sector collaboration. As noted above, further regulatory and legal clarity is key to wide-scale industry adoption. Despite ongoing initiatives such as the projects mentioned above, an argument can be made that interoperability will only fully be achieved to the extent that platforms are mandated to collaborate by legislation. Further clarity would reduce uncertainty from participants and enhance cross-platform interoperability. The Bank alongside the FCA should work with the industry to promote the development and adoption of common standards that meet industry demands and comply with regulatory structures while continuing to enable private sector innovation delivery aligned to the standards and regulatory vision.

International collaboration

International collaboration is crucial to the Bank's approach to driving innovation in money and payments, and the Bank's commitment to working with international partners underscores the importance of a globally coherent regulatory environment and ultimately an effective and efficient framework for cross-border payments.

We recognise the significant investment the Bank has made in updating the RTGS system and would agree that for domestic interbank payments, a technologically advanced system provides no tangible benefits to wCBDCs. However, wCBDCs can become more attractive when wholesale payments rely on payment schemes other than the RTGS system and, more importantly, in the context of cross-border payments. In that context, it is important that the UK remains competitive and explores the use of payment corridors using DLT technology similar to Project mBridge, an exploratory wCBDC project led by the Bank for International Settlements (BIS) and others. Again, we support the Bank's involvement with Project Agora on this front. The availability of payment corridors with other jurisdictions is, in our view, one of the most effective ways of creating efficiency in the correspondent banking and cross-border payments FX markets. These developments also require significant regulatory considerations, including the way financial market infrastructure safeguards should be applied to multijurisdictional payment platforms (for example, concerning settlement finality, netting and collateral arrangements).

Contact address:
IRSGSecretariat@cityoflondon.gov.uk