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A New Regime Governing Stablecoins

On 6 November 2023, the Bank of England (the UK's central bank) issued a discussion paper on the regulation on stablecoins, alongside another paper by the UK Financial Conduct Authority (FCA) (DP23/4) and a "Dear CEO" letter from the UK Prudential Regulation Authority (PRA) addressing the topic of tokenised deposits (together, the Discussion Papers). This series of publications sets out an approach and framework for the regulation of stablecoins in the UK. HM Treasury (HMT) first announced this programme of work (referred to as Phase 1 of the UK's new cryptocurrency regulatory regime) on 4 April 2022. The Discussion Papers now confirm that:

- Activities related to "fiat-based stablecoins" will be subject to FCA authorisation and supervision.
- Stablecoins that become widely used for payments will be designated by HMT as "systemic payment systems using stablecoins" and will become subject to FCA, Bank of England and Payment Systems Regulator (PSR) supervision.
- Activities related to "tokenised deposits" remain within the PRA's and FCA's existing remit to regulate UK-based credit institutions.

Background

Currently, stablecoins are used primarily to convert fiat currency (*e.g.*, pound sterling or US dollars) into cryptoassets and vice versa (as "off-ramps" and "on-ramps") and to facilitate transactions between cryptoassets. To date stablecoins have not been widely adopted as a means of payment. The Discussion Papers set out a fulsome framework through which UK regulators are seeking to balance the aim of encouraging sustainable innovation of cryptoassets with safeguards against consumer harm and financial instability. Regulators have designed the framework in accordance with a "same risk, same regulatory outcome" principle.

At the time of the announcement of Phase 1 in 2022, the scope of the potential stablecoin regime was ambiguous, raising questions about whether such a regime would be fit for purpose because there are no major GBP-based stablecoins, and those that do exist would not fall within the scope of the proposed regime, as they are issued outside the UK. The HMT announcement stated that stablecoin custody would become a regulated activity, which could potentially cover those exchanges providing custody. This would have meant that exchanges would be subject to custody requirements only in relation to stablecoins, and so subject to full UK authorisation in respect to only a limited subset of their business activities.

Activities That Will Be Regulated Under the Stablecoin Regime

Issuance and Custody of Fiat-Backed Stablecoins

In summary, the FCA is proposing to subject the following activities to UK regulation:

- Issuance of stablecoins that are based in, or from, the UK.
- Custodial activities for stablecoins carried out from the UK or for UK customers.

Issuers will be subject to stablecoin backing requirements (requiring issuers to hold the equivalent in fiat currency or short-dated government bonds), remuneration requirements and redemption requirements. Issuers will be required to hold assets backing stablecoins in a statutory trust in favour of underlying customers. Custodians will be subject to rules for asset segregation, safeguarding (based on existing CASS rules for traditional financial instrument custodians), auditing and reporting requirements. Both issuers and custodians will also be subject to the FCA's consumer duty obligations, which arrangement confers several duties: *inter alia*, to act in the best interest of customers, to ensure fair treatment of customers and to communicate clearly. This will represent a significant increase in regulatory requirements on stablecoin issuers within the scope of the regulation.

Ancillary Activities to Cryptoasset Custody

The FCA is also consulting on requiring cryptoasset exchanges to establish separate legal entities for all custody-like activities. Regulators note that cryptoasset exchanges offer a range of integrated services such as trading, brokerage, market-making and lending, requiring clients to transfer assets to an exchange's wallets for pre-funded transactions (akin to margin deposit requirements in traditional finance). These services facilitate on-chain real-time settlement but can blur the lines between client and custodian assets, potentially leading to conflicts of interest. Further complexity arises when exchanges also provide stand-alone custody services, and the lack of clarity in terms and conditions can lead to confusion about asset ownership.

This proposed restriction would cover exchanges that provide custody of stablecoins, which exchanges will be subject to FCA authorisation and to segregation requirements across all custodial activities. Custodians that only provide custody of non-stablecoin cryptoassets may remain outside of the proposal's scope. Again, if introduced, these proposals would result in increased regulatory requirements on in-scope custodians, including potential structural changes to their current operating structures.

Payment Arrangers

The FCA is also proposing to regulate certain "payment arrangers" that initiate or arrange payments using stablecoins under the payment services framework.[1] Currently, the UK payment services regime only covers the transfer of "funds," which excludes the transfer of value using stablecoins.

This regime would cover both (i) hybrid business models (where stablecoins are used as an entry or exit point for transactions that are ultimately settled in fiat through conventional payment systems) and (ii) pure stablecoin models (which involve direct on-chain stablecoin transactions between payer and payee).

Firms that use either of these models will require authorisation under the payment services regime, requiring them to, among other obligations, disclose information about payment services, rights related to transaction execution and remedies for defective or unauthorised transactions, as detailed in the guidance.

Further, this regime would also subject overseas stablecoin issuers to indirect UK regulation where an overseas stablecoin is used in UK payment chains: The payment arranger will need to evaluate the overseas stablecoins according to FCA standards. Public information will be considered insufficient for this assessment, so the FCA expects payment arrangers to liaise with issuers directly.

Regulation of Systemic Payment Stablecoins

UK regulators have outlined a two-tiered approach to regulating stablecoins. The first approach relates to fiat-based stablecoins, falling solely in the FCA's remit. The second approach relates to stablecoins that are widely used for payment, which will be recognised by HMT as stablecoins used in systemic payment systems and become regulated by the Bank of England.[2] Certain payment systems may also be deemed "systemic at launch" due to their scale and user base at launch.

Systemic payment stablecoins will be subject to enhanced requirements in comparison to fiat-based stablecoins. We summarize the key requirements and differences in the below chart.

[1] The Payment Services Regulation 2017 and the Electronic Money Regulation 2011.

[2] This is the framework used to regulate payment systems such as Faster Payments, CHAPS, Visa and Mastercard, which was expanded under the Financial Services and Markets Act 2023 (FSMA 2023) to include digital settlement assets.

A New Regime Governing Stablecoins

Fiat-Backed Stablecoins	Stablecoins Used in Systemic Payment Systems (SSPSs)
Definition	
Digital assets that are developed to maintain a stable value relative to a fiat currency and supported by assets backing the issuance.	Fiat-backed stablecoins that are used as digital settlement assets by a payment system recognised as systemic by HMT.
Backing	
The FCA's proposals would require the assets backing the stablecoins to be stable and sufficient in value, while liquid in nature. The FCA favours that regulated issuers back their stablecoins with only cash and short-term government bonds.	The Bank of England does not consider assets giving rise to credit, liquidity or market risks to be appropriate backing for the stablecoins. The Bank of England favours the use of central bank deposits to back stablecoins issued by SSPSs. This approach enables: i. Stablecoins to keep their value constant. ii. Greater certainty in making or receiving payments. iii. Straightforward currency exchanges. iv. Perfect redemption. This option is intended to preserve the "singleness of money."
Remuneration	
The FCA proposed a prohibition on the payment of income or interest by issuers to their customers in relation to stablecoin holdings. The FCA noted that this would draw a bright line between traditional deposits and stablecoins. The FCA also noted that it is a stablecoin's underlying assets that generate returns for issuers, rather than the stablecoins themselves. The FCA expressed no objection to this revenue stream persisting under the regime.	The Bank of England expects issuers to derive income in exchange for providing a payment service, and not to offer interest to the holders of stablecoins in a systemic payment system.
Regulation of Issuers	
The FCA's objective is to ensure holders of a fiat-backed stablecoin can redeem their tokens at par value. The proposal would require issuers to ensure the right to redemption at par by the close of the business day following the date of request, subject to the completion of any customer regulatory checks. The FCA expects redemption: i. To be disclosed in an accessible policy on a website. ii. Not to carry disproportionate fees. iii. To require AML checks. iv. To reflect the stablecoin's denominated currency.	The Bank of England would require issuers not to impose any unwarranted barriers to redemption under the proposed regime: Redemption should be effected in real-time as far as practicable, and by the close of day on the date requested. The Bank of England is considering either banning redemption fees outright or restricting them to a cost-based sum. In relation to such fees, the bank noted the risk of incentivising disposals via secondary markets rather than redemption, which could impact the ability to redeem at par.

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Fiat-Backed Stablecoins	Stablecoins Used in Systemic Payment Systems (SSPSs)
Safeguarding	
The FCA proposes a safeguarding regime in which assets would be segregated and held in a statutory trust. Under such a structure, the issuer's customers would stand as beneficiaries. This arrangement would prevent losses and claims arising from an issuer's possible insolvency because trust assets would not form part of an insolvent estate. Because the FCA's regime stipulates a par redemption rate, the authority proposes requiring issuers to either add or deduct assets from the pool to recalibrate the coin-asset value ratio. Issuers would be required to do this within a business day where a discrepancy exists. The FCA is further considering requiring issuers to have a CASS oversight officer responsible for supervising the assets. Under the proposed regime, the FCA would impose the same requirements on such an officer as are required in traditional financial contexts. The FCA also proposes a custody model in which an independent custodian would hold assets directly for coinholders.	The Bank of England proposes safeguarding rules that would require backing assets to be held in a segregated account and insulated from the claims of creditors. The bank also favours the use of trust arrangements. To ensure that the value of assets and issued stablecoins correspond, the central bank proposes a requirement that issuers conduct reconciliation as frequently as necessary to maintain equivalence, and at least daily. Additionally, the Bank of England proposes further requirements related to reporting, auditing and disclosure. The Bank of England also sets out its expectations for a custodian of assets backing SSPSs, which include coinholder verification; securely held authentication records; management of coinholders' control of and legal entitlements to their stablecoins; segregation of assets; holding records; and maintenance of strict risk management and consumer compensation arrangements.
Capital Requirements	
The FCA's proposed capital requirements for stablecoins largely reflect those found in the Investment Firms Prudential Regime (IFPR). Specifically, the requirements would be based on the higher of: i. A permanent minimum requirement (PMR). The PMR would be the minimum sum needed to qualify for FCA authorisation and would be set according to the type of cryptoasset activity conducted. ii. A fixed overhead requirement (FOR). The FOR is in place to cover expenditures incurred in a period to ensure sufficient capital to enable an orderly winding down, and would be largely based on the previous year's expenditure. iii. A risk-based "K-Factor" requirement (KFR). The KFR would vary according to the stablecoin activities and the size of the business. The amount of the issuer's stablecoins in circulation would largely determine the KFR.	The Bank of England proposes subjecting issuers to capital requirements that extend beyond coverage of asset-backing and safeguarding requirements and requiring issuers to provide for alternative risks that might threaten a firm's asset pool or solvency. The bank has not explicitly set out what these capital requirements would be.

'Dear CEO' Letter Regarding Tokenisation, Innovation and Deposits

In a "Dear CEO" letter, the PRA addresses issues related to innovations in deposit-taking, e-money and stablecoins. The letter mentions that innovations in digital money and similar instruments present opportunities for enhanced payment and settlement systems efficiency, yet bring potential risks to the financial stability and safety of institutions. The PRA has issued guidance that outlines expected risk mitigation strategies, particularly emphasising the avoidance of confusion among retail consumers due to the simultaneous offering of deposits and digital money-like instruments such as e-money and regulated stablecoins.

The PRA urges deposit-takers to separate the issuance of e-money and stablecoins from their deposit-taking activities, employing distinct and nonconflicting branding to preclude consumer misapprehension regarding the varying levels of protection afforded by different instruments. Furthermore, deposit-takers contemplating the adoption of new technologies such as "tokenisation" must align with the PRA's rules, ensuring depositor protection under the Financial Services Compensation Scheme (FSCS). Extending depositor protection to holders of stablecoins would represent a significant extension of the current protections available to holders of cryptoassets as well as increased operating costs for issuers. Deposit-takers must engage proactively with the PRA regarding plans to innovate or restructure their offerings, adhering to the highest governance standards and involving senior management in risk assessment of new technologies in critical business services. The PRA encourages firms to transparently communicate with their designated supervisors regarding significant plans or developments in their use of digital money.

A Prospective Central Bank Digital Currency

As part of a broader project to develop and regulate cryptoasset markets in the UK, HMT and the Bank of England have also been exploring the introduction of a "digital pound."

In a speech on 26 October 2023, Sir Jon Cunliffe, until recently the deputy governor for financial stability at the Bank of England, discussed the impact of Facebook's announcements about its creation of a new multicurrency stablecoin, which energised the approach of central banks and financial regulators to digital currencies. Work undertaken on the digital pound exemplified this renewed ethic of innovation.

Sir Jon reiterated that proposals are not yet finalized to introduce a digital pound in the UK. Thus far, an HMT consultation paper explored the concept without proposing its introduction. The document assessed the likelihood of a need for a digital pound by the end of the decade and detailed a model for potential implementation, and HMT invited public commentary on the proposals. The decision on whether to proceed with the digital pound will only come following further testing, which is expected to occur over the next two to three years.

The digital pound is anticipated to be a joint venture between the Bank of England and private entities that operate under a "platform model." The central bank would be responsible for creating the digital pound and its core infrastructure, while various firms would develop interfaces, such as wallets and payment services, for user interaction. Overall, the digital pound initiative aims to enhance the credibility of digital currencies and promote a more competitive digital economy.

Feedback from the consultation paper, however, raised issues concerning privacy, the sustainability of cash and the technical facets of a digital currency. To address the privacy concerns, once the digital pound is created, the central bank will refrain from accessing personal data, leaving that aspect to individual payment companies. Additionally, the bank has committed to maintaining physical currency as long as public demand for it exists. Were the digital pound to be widely adopted, preliminary models suggest a gradual introduction strategy to prevent disruption in the banking sector.

Next Steps for Stablecoins in the UK

The UK's regulatory authorities are laying a comprehensive foundation for the safe and innovative integration of digital currencies into the financial landscape, balancing the need for innovation while maintaining consumer protection and financial stability. The approach by UK regulators in relation to stablecoins contrasts significantly with the approach by regulators in other jurisdictions, in particular the approach of the SEC in the United States. The coordinated approach between the UK regulatory authorities will be welcomed by market participants. The deadline for responses to the Discussion Papers is 6 February 2024.