



connecting the future

Regulating cryptoassets

Phase 1: Stablecoins

DP23/4

FCA

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Response from
The Payments Association

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Introduction

The Payments Association welcomes the opportunity to contribute to the FCA Discussion Paper *“Regulating cryptoassets Phase 1: Stablecoins”*.

The community’s response contained in this paper reflects views expressed by our members and industry experts recommended by them who have been interviewed and who are referenced below. As The Payment Association’s membership includes a wide range of companies from across the payments value chain, and diverse viewpoints across all job roles, this response cannot and does not claim to fully represent the views of all members.

We are grateful to the contributors to this response, which has been drafted by Riccardo Tordera, our Head of Policy & Government Relations and Robert Courtneidge, Advisor to the Board. We would also like to express our thanks to the FCA for their continuing openness in these discussions. We hope it advances our collective efforts to ensure that the UK’s payments industry continues to be progressive, world-leading, and secure, and effective at serving the needs of everyone who pays and gets paid.

Tony Craddock
Director General
The Payments Association

Members' "responses to the questions" set out in the consultation:

The section numbering below corresponds to the numbering of the 'questions for respondents' in this paper.

- 1. Should the proposed regime differentiate between issuers of regulated stablecoins used for wholesale purposes and those used for retail purposes? If so, please explain how.**

Our members are clear that there should be differentiation for stablecoins used for retail and wholesale. Retail should be consumer focused and include customer duty responsibilities whilst wholesale stablecoins being for things like interbank settlement would really just focus on keeping their peg and financial stability. Indeed, by differentiating them, institutions would be able to better assess and accept risks, and different backing assets could be used for both wholesale and retail.

The only concern which members see could occur from differentiation is that it could add complexity and further potential risk to singleness of money in the same way that a digital pound could.

- 2. Do you agree with our assessment of the type of costs (both direct and indirect) which may materialise as a result of our proposed regime? Are there other types of costs we should consider?**

Yes, the types of costs are correct and it will be necessary for retail firms with consumer customers to ensure they are made aware of both the risks and protections of buying a fiat stablecoin.

- 3. Do you agree with our assessment above, and throughout this DP, that benefits, including cheaper settlement of payment transactions, reduced consumer harm, reduced uncertainty, increased competition, could materialise from regulating fiat-backed stablecoins as a means of payment? Are there other benefits which we have not identified?**

The benefits suggested may arise as a result of the advent of regulated stablecoins in the UK market, but it will only be once a number of issuers are registered and their stablecoins are being used in the market that we will know for sure. The key at the moment is to create a regulatory environment in which commercial gains for the issuers are possible to make it worthwhile for them to come into the market and to ensure the public are suitably educated to understand the benefits of such regulated stablecoins.

- 4. Do you agree with our proposed approach to regulating stablecoin backing assets? In particular do you agree with limiting acceptable backing assets to government treasury debt instruments (with maturities of one year or less) and short-term cash deposits? If not, why not? Do you envision significant costs from the proposal? If so, please explain.**

Our members feel that limiting the acceptable backing assets will be an impediment to issuers wanting to run a stablecoin in the UK. Making returns on the funds backing a stablecoin is one of the key revenue drivers for potential issuers and so more flexibility is needed. The current proposal is more restrictive than e-money. To make this work there needs to be the ability for issuers to be innovative and to create backing solutions that are acceptable to regulators but also revenue-generating for issuers.

We note the backing assets are required to be “equivalent in value to the circulating supply of the regulated stablecoin” (para 3.5). It is not clear what “value” this refers to: is it the face or “stable” value of the stablecoin (e.g. £1), or is it the market price of the stablecoin (e.g. as traded on an exchange)? We assume that this refers to the face/stable value of the stablecoin as that seems to be what the “backing” is intended to cover, but confirmation would be helpful. Also, does the value of the backing assets include the implied cost of purchase/redemption of the backing assets? Finally, a change in coins supply should surely be reflected in change of backing assets but how does settlement timeframe of backing asset purchase fit? The coin will settle instantly but the backing assets are unlikely to be “made-up” till days later.

From our greater understanding of wholesale users than retail users, we believe that flexibility of backing assets for wholesale coins may be acceptable, but greater flexibility for retail coins comes with additional complexity to explain to less educated retail users. Hence, for retail users a simple backing regime may be more appropriate.

5. Do you consider that a regulated issuer’s backing assets should only be held in the same currency as the denomination of the underlying regulated stablecoin, or are there benefits to allowing partial backing in another currency? What risks may be presented in both business as-usual or firm failure scenarios if multiple currencies are used?

If we are looking at “same risk, same regulatory outcome”, then under e-money and payment services multi-currency funds are used to back GBP e-money held provided it reconciles. As such, there is no reason why this should not apply to stablecoin regulation. Provided any fx risk is covered, then we see no reason to restrict backing assets to GBP.

6. Do you agree that regulated stablecoin issuers should be able to retain, for their own benefit, the revenue derived from interest and returns from the backing assets. If not, why not?

We believe that issuers will need to create viable commercial models to be able to enter this new area of payments and hence any return from backing assets will be part of that.

7. Do you agree with how the CASS regime could be applied and adapted for safeguarding regulated stablecoin backing assets? If not, why not? In particular:

- i. Are there any practical, technological or legal obstacles to this approach?**
- ii. Are there any additional controls that need to be considered?**
- iii. Do you agree that once a regulated stablecoin issuer is authorised under our regime, they should back any regulated stablecoins that they mint and own? If not, why not? Are there operational or legal challenges with this approach?**

The addition of CASS requirements means this Discussion Paper departs from some of the core principles outlined in HM Treasury’s consultation, which suggested simply amending the 2011 EMRs and 2017 PSRs. However, it is clear that consumers need to be educated on the risks as well as the protections afforded by stablecoins. In respect of the three sub-queries:

- i. Overall the controls are sensible and proportionate, but it will be necessary to set these out clearly in any rulebook or guidance to support firms to adopt these in a uniform manner. We also think record-keeping may need to be overseen initially to ensure it is operating as expected and is accurate.

- ii. A post-implementation review would be sensible to consider what worked well and what may need altering to ensure the new regime remains proportionate and operates well.
 - iii. Whilst this seems correct as with ii, above, a post implementation review should be considered. Indeed, all minted coins should be backed regardless of whether issuers own them, but it would be interesting to know how this would work operationally, as it implies backing assets must be in place (ie bought and settled) before coins can be minted.
- 8. We have outlined two models that we are aware of for how the backing assets of a regulated stablecoin are safeguarded. Please could you explain your thoughts on the following:**
- i. **Should regulated stablecoin issuers be required to appoint an independent custodian to safeguard backing assets?**
 - ii. **What are the benefits and risks of this model?**
 - iii. **Are there alternative ways outside of the two models that could create the same, or increased, levels of consumer protection?**

Assuming safeguarding is a given:

- i. Larger regulated coin issuers may find it useful to outsource this to an independent custodian but we are not sure it should be mandatory. The concern appears to be the credit risk of the independent custodian. If this is an issue, how are such entities rated and supervised? The stablecoin model might require them to handle the custodianship in a different way and the custodian may need time to adapt its processes and procedures.
- ii. *Benefits:* the custodian role develops and could add value to regulated issuers;
Risks: added costs; need for liaison. How well will a custodian be able to fulfil (e.g. if a swift pay-out of a regulated issuer fails)?

- 9. Do you agree with our proposed approach towards the redemption of regulated stablecoins? In particular:**
- i. **Do you foresee any operational challenges to providing redemption to any and all holders of regulated stablecoins by the end of the next UK business day? Can you give any examples of situations whether this might this be difficult to deliver?**
 - ii. **Should a regulated issuer be able to outsource, or involve a third party in delivering, any aspect of redemption? If so, please elaborate.**
 - iii. **Are there any restrictions to redemption, beyond cost-reflective fees, that we should consider allowing? If so, please explain.**
 - iv. **What costs associated with our proposed redemption policy do you anticipate?**

In general this mirrors regulation 39 of the EMRs, in which e-money holders have the right to redeem the monetary value of their e-money (i.e. the payment from the e-money issuer to the e-money holder of an amount equivalent to the remaining balance) at any time and at par value. However, in practice there have been many cases where the ability to redeem has taken a lot longer.

Also, do we want stablecoins to be the same as e-money as they are fundamentally different in their usage being 'in circulation' whilst e-money redeems on use, hence there may not be many redemption requests. More often than not, the stablecoin would be traded on the market and kept in continuous circulation. This is different to e-money. Whilst e-money users may not redeem directly from the issuer, they would likely spend it which would then be redeemed to merchants (so the safeguarded money would be paid out and leave

safeguarding). But the stablecoin issuer would need to keep all the backing assets at all times (assuming the stablecoin is largely being traded on the market). If the purposes of backing assets are to ensure confidence, then should a percentage should be allowed rather than one-on-one backing at all times? After all, banks are not required to have one-on-one backing with the Bank of England for all the commercial money they issue.

It would be helpful for the FCA to model 'redemption' scenarios, i.e. is redemption from the issuer expected to be BAU or just backstop (like an ATM).

We have a concern that, if the purchase of the stablecoin is from secondary market, legally the purchaser is also, we assume, buying the right of redemption from the issuer. This will, however, have a friction barrier as the holder will be required to set up an account with the issuer to do so. Furthermore, if issuers are allowed to charge cost-effective fees for redemptions, this could potentially disadvantage users only wanting to redeem small amounts.

We also have a concern that, if redemption is within 24 hours but settlement of backing assets is two days, then there is a risk that redemption brings imbalance to the pool of assets.

Finally, we believe that redemption policies should be required to be published on exchanges websites to ensure users are fully informed.

- i. If we now move into the space of digital currencies, depending on the issuer's infrastructure (e.g. hot vs cold wallets), there will be many situations whereby next-day redemption is operationally challenging. For example, in the event of a mass redemption/run on the coin. How can this be covered off when it is already not working in the case of e-money?
- ii. If a regulated custodian is already appointed, it might be able on the instruction of the regulated issuer to provide redemption.
- iii/iv. We'd propose that the valid costs of the regulated issuer or the valid charge of a third party are covered. Other costs that may be proposed should only be included if linked to redemption.

10. What proof of identity, and ownership, requirements should a regulated stablecoin issuer be gathering before executing a redemption request?

It would make sense for the regulations here to follow current practice in line with existing AML/KYC/due diligence rules that already exist for customers and hence a regulated stablecoin issuer should complete KYC on a party redeeming but query whether there should be a minimum threshold before it is required – perhaps in line with the UK's implementation of FATF Travel Rule?

11. Do you agree with our approach to the Consumer Duty applying to regulated stablecoin issuers and custodians. Please explain why.

We agree with the approach. Stablecoin issuers and custodians should be mindful of a consumer's awareness of what they might be buying and their ability to understand the product and its risks. However, we believe there should be reviews and reasonable milestones post implementation, to ensure the Consumer Duty framework remains appropriate and any further guidance on changes required is carried out.

12. Do you consider that regulated stablecoins should remain as part of the category of 'restricted mass marketed investments' or should they be captured

in a tailored category specifically for the purpose of cryptoasset financial promotions? Please explain why.

We do not agree that regulated stablecoins should be simply bolted on in the definition of 'restricted mass marketed investments' as they are neither an investment nor mass marketed. It would be preferable for them to be placed in a tailored category which covers other cryptoassets and their promotions.

13. Should individual client wallet structures be mandated for certain situations or activities (compared to omnibus wallet structures)? Please explain why.

This is an area which will need to be monitored and developed over time once stablecoins start being issued and will need to follow on from industry feedback. Where omnibus wallet structures are permitted, the holdings of the wallet 'owner' should be separated. Omnibus wallets offer efficiency and security benefits and hence their use should be permitted, subject to ensuring that client assets are fully segregated from house/proprietary assets. Equally a custodian holding its own and client assets should have these separated, with individual client assets separately identifiable. Whilst these arrangements may take time to put in place, they provide a clearer audit trail whilst live and, if the regulated issuer were to fail, a simpler way to identify the client holdings.

14. Are there additional protections, such as client disclosures, which should be put in place for firms that use omnibus wallet structures? Are different models of wallet structure more or less cost efficient in business-as-usual and firm failure scenarios? Please give details about the cost efficiency in each scenario.

Omnibus wallets enhance security and operational efficiency because they reduce the number of on-chain addresses and transfers, which reduces overall security exposure (the 'attack surface') while also reducing operational risk. Indeed, omnibus structures have precedent in traditional financial services for similar reasons (i.e., because they increase operational efficiency while reducing operational risk).

15. Do you foresee clients' cryptoassets held under custody being used for other purposes? Do you consider that we should permit such uses? If so, please give examples of under what circumstances, and on what terms they should be permitted. For example, should we distinguish between entities, activities, or client types in permitting the use of clients' cryptoassets?

By "other purposes" this means being used for something other than a payment, then this needs those engaged in how clients use their cryptoassets in custody for other purposes. This will enable the FCA and the industry to consider whether or not to permit such uses and to assess what guidance may be required.

16. Do you agree with our proposals on minimising the risk of loss or diminution of clients' cryptoassets? If not, please explain why not? What additional controls would you propose? Do you agree with our proposals on accurate books and records? If not, please explain why not.

We support the approach and would advocate taking into account both on and off chain transactions, but there will be a need to define what is beyond a custodian's control in a way that is specific to crypto. Other additional controls will develop over time based on how the market develops.

17. Do you agree with our proposals on reconciliation? If not, please explain why not? What technology, systems and controls are needed to ensure compliance with our proposed requirements?

Whilst we agree in principle, technical controls and systems would need to be properly assessed to give an accurate assessment in such an evolving market.

Note: on chain is the record of truth, as whatever is held off-chain is simply a reconciliation to the on-chain state (transaction confirmations aside). Indeed, it would be helpful to have the different models described so that the risks are clearer; eg full on-chain reconciliation model, hybrid, fully off chain.

18. Do you consider that firms providing crypto custody should be permitted to use third parties? If so, please explain what types of third parties should be permitted and any additional risks or opportunities that we should consider when third parties are used.

Firms should be allowed to use third parties for custody activities, subject to significant due diligence in the selection, appointment and review processes. This includes global entities affiliated with local custodian license holders (i.e. group entities), subject to appropriate supervisory scrutiny around governance and terms and conditions of the agreement in addition to sub-custodian rules. End-to-end custodianship should be subject to the operational resilience requirements, with added requirements on due diligence of third party providers and separate identification of assets. We would expect this to be subject to an overarching agreement between the parties. Given the different skillsets, it may be necessary for a firm providing crypto custody to use a third party to provide a role they cannot support. We agree that the lead crypto custody entity should remain responsible for the performance of the third parties it uses. Indeed, if the custodian is not able to use a third party, then risks may be increased because they will need to provide services themselves and they may not have sufficient expertise (e.g. authentication services).

19. Do you agree with our proposals on adequate governance and control? If not, please explain why not? What (if any) additional controls are needed to achieve our desired outcomes? What challenges arise and what mitigants would you propose?

We support the governance proposals for the provision of a statement of account, with information on their crypto assets holding and transactions. Details of what should be provided by a custodian to a client should be agreed with the custody community with input from clients. The provision of a 'statement of account' potentially implies an off chain reconciliation model. If a reconciliation model is on chain, then any user should be able to get a 'statement of account' in real-time (e.g. API ping that would immediately highlight any discrepancies).

20. Should cryptoasset custodians undertaking multiple services (e.g. brokers, intermediaries) be required to separate custody and other functions into separate legal entities?

We think that a split by activity is logical and would make it easier for a custodian to manage its service range.

21. Are there any practical issues posed by requiring cryptoasset exchanges to operate a separate legal entity for custody-like activities? Specifically, please could you explain your thoughts on the following:

- i. **Would these issues differ between institutional and retail clients?**

- ii. **What would be the operational and cost impact?**
- iii. **What are the benefits to clients of cryptoasset exchanges prefunding trades? Can these be achieved if there is legal separation of entities?**
- iv. **Would separating custody and exchange functions impact the way clients' accounts are managed and structured (in omnibus and individual client wallets)?**
- v. **Do you agree that the conflicts of interest we have identified exist? Are there other conflicts of interest we should consider?**
- vi. **Are there alternative ways to ensure the same level of consumer protection?**

There may be cost and other issues which make it impactable for an exchange to operate a separate legal entity for custody-like activities and therefore use of third party providers become more likely.

In answer to the specific queries:

- i. We would expect institutional and retail client data to be kept separate and be covered by relevant terms of service.
- ii. This is likely to depend on the exchange and their current arrangements.
- iii. Permitting customers to pre-fund their cryptoasset trading on exchanges is a core element of the industry's disintermediation promise and user experience. Exchanges should however provide customers with clear information on the legal status of their assets at all times and the protections which apply.
- iv. No comment.
- v. Given the complex structures and the emerging nature of this payment method, it is likely that there are conflicts of interest, which need to be identified and assessed to ensure that the future regime is clearer for all parties.
- vi. We are sure the Industry will come up with options over time. Whilst the risks could be managed without a separate legal entity using one for retail gives the cleanest assurance for users that risks being managed.

Note: Institutional clients are better equipped to understand risks of cryptoasset custody being performed by the same legal entity as the exchange. Hence, if there is a business benefit to an institutional client using a combined exchange/custodian then this should be allowed.

22. What role do you consider that custodians should have in safeguarding client money and redemption? What specific safeguards should be considered?

If a custodian is appointed to support a regulated issuer, they will need to keep the issuer informed of assets held, including funds held by a client to acquire cryptoassets, but which at redemption remain their funds.

23. Do you agree that our existing high-level systems and controls requirements (in SYSC) should apply to the stablecoin sector? Are there any areas where more specific rules or guidance would be appropriate?

Whilst we agree that they should apply where appropriate, there may be certain rules or guidance which might need change to reflect any different requirements, and this may need to be worked through with the industry in due course. One such area would be where the regulated entity operates in other countries or offers custody services for non-UK stablecoins.

24. Do you agree with our proposal to apply our operational resilience requirements (SYSC 15A) to regulated stablecoin issuers and custodians? In particular:

- i. **Can you see how you might apply the operational resilience framework described to your existing business (e.g. considering your important business services and managing continuity)? Please set out any difficulties with doing this.**
- ii. **What approach do you take when assessing third party-providers for your own internal risk management (such as responding to, testing and managing potential disruption)?**
- iii. **Are there any minimum standards for cyber security that firms should be encouraged to adopt? Please explain why.**

It makes sense to apply operational resilience requirements to both regulated stablecoin issuers and custodians. We believe it should be possible for both issuers and custodians to define their important business services and assess how they might apply the framework. This may need further engagement with the industry to clarify new terms and consider whether there are variances which apply to cryptoasset firms and technical providers that might necessitate a separate section in SYSC 15A. However there are a couple of scenarios where this may not be practical:

- **the risk of a hard fork has the potential consequence of additional assets being created (e.g. one coin on one chain and another coin on the fork); and**
- **blockchain risks where the regulated stablecoin issuers and custodians don't operate the blockchain.**

25. Do you agree with our proposal to use our existing financial crime framework for regulated stablecoin issuers and custodians? Do you think we should consider any additional requirements? If so, please explain why.

It makes sense to follow existing ML/CT framework for this. As with other areas of our response, we believe this will develop over time once the stablecoin market has started and it is seen how they are being used in practice.

26. Do you agree with our proposal to apply our existing Senior Managers and Certification Regime to regulated stablecoin issuers and custodians? In particular:

- i. **Should we apply the current SMR and requirements to issuers and custodians of regulated stablecoins? Are there additional SMFs or requirements needed to capture the nature of regulated stablecoin business services?**
- ii. **Should we create additional criteria to determine when the 'enhanced category' of the regime should apply to regulated stablecoin issuers and custodians?**
- iii. **Should we apply the current certification functions and requirements to regulated stablecoin issuers and custodians? Are there any additional functions needed to capture the nature of regulated stablecoin issuers and custodians business services?**
- iv. **Do you agree that we should apply the existing Conduct Rules to regulated stablecoin issuers and custodians?**

Yes but any point if it becomes clear gaps exist, then regulators need to consider best way to ensure protections are in place for consumers.

- i. Yes, but with consideration of whether there are any elements which may need clarification of meaning.
- ii. This is an aspect which may need additional criteria to make clear when the 'enhanced category' should apply.

- iii. If the current certification functions are agreed as relevant to issuers and custodians.
- iv. Yes.

27. Do you agree with our consideration to apply our Principles for Businesses and other high-level standards to regulated stablecoin issuers and custodians? Are there any particular areas you think we should apply detailed rules regarding information to (other than those for backing assets set out in Chapter 3)?

In general our members agree. One member feels certain activities like exchanges and stablecoin issuers should be split into separate entities. Whilst we understand this view, we believe we need to revisit it once the stablecoin market is more mature to see if it is necessary.

28. Do you consider that we should design more specific conduct of business rules to regulated stablecoins issuers and custodians? In particular what approach should we take to applying rules on inducements and conflicts of interest management to regulated stablecoin issuers and custodians?

Again it is too early to understand what rules should be brought in. It may be that consumers and businesses need inducements to take the first steps into using stablecoins and hence inducements will be needed. It will be necessary to consult further with the regulated firms to agree the proposed standards after a suitable period.

29. Do you agree that the dispute resolution mechanisms provided in traditional financial services (i.e. the application of the DISP sourcebook and access to the Ombudsman Service) should be applied to the business of regulated stablecoin issuers and custodians? Have you identified any gaps or issues in relation to dispute resolution? Please explain.

To make it easier for customers and ensure the right protections are in place, existing mechanisms should be extended to cover all payment types, in this case, stablecoins. As we have seen from the growth of open banking, the lack of a good dispute resolution (DR) has led to a growth in APP fraud and hence defining a proper DR solution for stablecoins is going to be key to its success and adoption.

30. Do you agree that the FCA should not be proposing to extend FSCS cover to the regulated activities of issuing and custody of fiat-backed stablecoins? If you do not agree, please explain the circumstances in which you believe FSCS protection should be available.

It is difficult to apply FSCS at this nascent stage of the cryptoasset market as it is unclear what the size of the market will be and how many issuers will seek authorisation in the UK. It is therefore impossible to calculate levies and conduct a cost-benefit analysis. We therefore believe that the FCA should revisit this in the future. However, until then, it is essential that the lack of FSCS protection is made clear to consumers so they understand the product, risks and outcomes.

31. Do you agree with our proposed prudential requirements for regulated stablecoin issuers and custodians? In particular, do you agree with our proposals on any of the following areas:

- i. Capital requirements and quality of capital
- ii. Liquidity requirements and eligible liquid assets
- iii. Group risk

- iv. **Concentration risk**
- v. **Internal risk management**

Whilst we agree with the concept of applying the above, we believe there is a requirement to revisit them on the basis of the differences between stablecoins and every other form of money. This is the UK's opportunity to create a fertile environment to bring stablecoin issuers to the UK so before simply dropping it all into existing framework impact proper assessments should be carried out.

32. Do you agree with applying the existing CASS rules on postfailure treatment of custody assets to regulated stablecoin issuers and other firms holding backing assets for regulated stablecoins, as well as CASS pooling events? If not, why not? Are there any alternative approaches that should be considered? If so, please explain.

Given the focus on the CASS regime, we think it sensible to apply its rules on the failure treatment of custody assets to regulated issues and other firms which hold backing assets. The potential pseudo-anonymity of holders is something which issuers may need to consider, given the risks of not knowing who the holder is or where funds may have come from.

Note: The approach to return backing assets would fall under 3 scenarios, but we wonder if there is a 4th scenario - failure of the DLT/blockchain (or some hard fork scenarios eg where the forking devalues the coin or makes it hard to see where the value of the coins lies eg what chain?).

33. Do you agree with our thinking on how the CASS rules can be adapted for returning regulated stablecoin backing assets in the event of a firm failure or solvent wind-down? If not, why not? Do you foresee the need for additional protections to ensure prompt return of backing assets to consumers or otherwise reduce harm in firm failure (e.g. strengthening wind-down arrangements, a bespoke resolution regime)? If so, please explain.

Again it is early days to be looking at this hypothetically. Based on the current arrangements, our members anticipate that there will need to be additional protections to ensure that consumers receive a prompt return of backing assets, as well as the need for firms to strengthen their wind-down initiatives. But as stated earlier, there is no real equivalent in commercial bank money and e-money today so perhaps the industry should be looking at alternatives. Could regulations enable backing assets to be returned in a different form such as a different regulated stablecoin if this sped up the redemption process?

Note: our members are keen to learn more about this point from the discussion paper: 'We are also exploring whether the DLT could be used to send electronic notifications directly to wallet holders. We understand that technology enabling this is currently being developed and trialled in industry, which will allow customers to send and receive messages through their wallet.'

34. Do you agree with the proposed overall approach for postfailure trading? If not, is there anything else that should be considered to make the approach more effective? If so, please explain. Are there any arrangements that could avoid distribution of backing assets in the event an issuer fails and enters insolvency proceedings?

This is a complex issue to discuss theoretically and hence needs further consideration to ensure there is effective protection for consumers during an insolvency process. If, as we state in our response to 33 above, backing assets can be returned in the form of a different regulated stablecoin, then potentially these could be sent to the same wallet address (if the blockchain is the same). That wallet would then have one defunct stablecoin value 0 in

secondary trading and one replacement stablecoin value 1 i.e. par. Furthermore, secondary trading by retail users to sell the defunct stablecoins at a loss would need to be properly risk-managed.

35. What challenges arise when stablecoins are returned to consumers, particularly with respect to their entitlements? Do you foresee the need for additional protections to facilitate the prompt return of regulated stablecoins to consumers or otherwise reduce harm in firm failure (e.g. introducing distribution rules within CASS for cryptoassets, strengthening wind-down arrangements, or a bespoke resolution regime)? If so, please explain.

Due to the fact that stablecoins will be in circulation and hence, in most cases, will not be with the consumer they were originally issued to, returning stablecoins is problematic. Therefore, it will be necessary to safeguard, through third party custodians, all relevant assets until distribution can take place. An appropriate regulatory regime will be needed as will clarity on what firms are expected to have in place to support any potential future wind-down.

36. Do you agree that this approach to integrating PSR safeguarding requirements and custody requirements will secure an adequate degree of protection for users of stablecoin payment services?

Yes it will clearly help but until we can see how this new stablecoin market develops it will be difficult to predict the best solution.

37. Do you agree that the custody requirements set out in chapter 5 should apply to custody services which may be provided by payment arrangers as part of pure stablecoin payment services?

This seems like a sensible approach.

38. Are there additional risks or opportunities, not considered above, of different stablecoin payment models that our regulation of payment arrangers should seek to tackle or harness?

As stated throughout, at this early stage in the regulation of different stablecoin models whilst the current proposals cover key risks/opportunities these should be reviewed and as needed built on as awareness develops.

39. What are the potential risks and benefits of the Treasury's proposal to allow overseas stablecoins to be used for payments in the UK? What are the costs for payment arrangers and is the business model viable?

Whilst we agree with the desired outcomes of the proposal, we are concerned that the conditions attached could undermine the stated goal. Indeed, the fact that overseas stablecoins may not be subject to the same level of regulation could put users at risk or expose them to challenges that they would otherwise be unaware of. However, we also believe that the FCA's *'risks, harms and benefits'* section (11.13) is overweighted on risks when opening the UK to globally significant stablecoins will help to make the UK payments sector internationally attractive and encourage investment and innovation, especially as the world pivots towards Web3.0.

Key issues on the proposal:

- **It is likely that no major global stablecoins would qualify.** The requirement for overseas stablecoins to meet the very narrow confines of the FCA regime will disqualify the likes of Tether and Circle, which account for around 85% of the stablecoin market. Global merchants are likely to gravitate towards these well-known global brands which a lot of crypto payment rails are being built on.
- **Payment approver conditions are likely to be operationally challenging and disproportionate.** This includes not only the ongoing monitoring but also the need for third party auditing of assessments.
- **There is a strong case for the FCA to play a more active role in this process,** for example by assuming the role of verifying assessments made by payment arrangers.
- Does overseas stablecoin mean non-GBP or just overseas issued in any other currency including GBP?

40. What are the barriers to assessing overseas stablecoins to equivalent standards as regulated stablecoins? Under what circumstances should payment arrangers be liable for overseas stablecoins that fail to meet the FCA standards after approval, or in the case where the approval was based on false or incomplete information provided by the issuer or a third party?

Under the proposal, regulated payment arrangers would need to assess that those stablecoins respect the requirements set by the UK law. A UK PSP wanting to offer its clients a service using US stablecoins, for example, could do this but it would be their responsibility, as a UK PSP, to assess if the US stablecoins meets the FCA's requirements. Our members believe that it should be the regulator's job to assess whether the foreign issuer is compliant. Furthermore it appears that the FCA won't hold a UK PSP responsible if the foreign stablecoin provider fails, as long as the UK PSP has followed the FCA rules. This is not fair for end consumers and is likely to create confusion. On the other hand, why would a firm choose to be a UK stablecoin issuer when it could simply use a foreign stablecoin and UK standards without having to sustain all the relative costs for being a UK stablecoin issuer? Generally we believe that the FCA will need to monitor the market, its development, the numbers of overseas stablecoins, and how the market is developing. Alongside this, will be a need to determine when a payment arranger becomes liable – this may be difficult to determine given the emerging market elements.

Finally, some thoughts from Japan who have already set up their stablecoin laws. They have a requirement that the exchange/custodian distributing the foreign stablecoin in Japan sets aside a reserve of highly liquid assets (held in Japan) equal to the amount of customer stablecoins in its custody to enable it to repurchase them at par in the event of the issuer going insolvent or the stablecoin significantly losing its peg. This may be an option whereby the other controls could be relaxed as the customer is always protected.

About The Payments Association

The Payments Association (previously the Emerging Payments Association or EPA) is for payments institutions, big & small. We help our members navigate a complex regulatory environment and facilitate profitable business partnerships.

Our purpose is to empower the most influential community in payments, where the connections, collaboration and learning shape an industry that works for all.

We operate as an independent representative for the industry and its interests, and drive collaboration within the payments sector in order to bring about meaningful change and innovation. We work closely with industry stakeholders such as the Bank of England, the FCA, HM Treasury, the Payment Systems Regulator, Pay.UK, UK Finance and Innovate Finance.

Through our comprehensive programme of activities for members and with guidance from an independent Advisory Board of leading payments CEOs, we facilitate the connections and build the bridges that join the ecosystem together and make it stronger.

These activities include a programme of monthly digital and face-to-face events including our annual conference PAY360 and PAY360 Awards dinner, CEO round tables and training activities.

We run seven stakeholder working Project groups: Inclusion, Regulator, Financial Crime, Cross-Border, Digital Currencies, ESG and Open Banking. The volunteers within these groups represent the collective view of The Payments Association members at industry-critical moments and work together to drive innovation in these areas.

We also conduct exclusive industry research which is made available to our members through our Insights knowledge base. These include monthly whitepapers, insightful interviews and tips from the industry's most successful CEOs. We also undertake policy development and government relations activities aiming at informing and influencing important stakeholders to enable a prosperous, impactful and secure payments ecosystem.

See www.thepaymentsassociation.org for more information.

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