

**Finance Watch response  
to the Financial Stability Board's public consultation on addressing  
the regulatory, supervisory and oversight challenges raised  
by "global stablecoin" arrangements**

Brussels, 15 July 2020

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Its 109 civil society members from 20 different European countries include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit [www.finance-watch.org](http://www.finance-watch.org).

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We agree to the publication of this response.

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**Q1. Do you agree with the analysis of the characteristics of stablecoins that distinguish them from other crypto-assets?**

We would recommend a very restrictive definition, and use, of the term ‘stablecoin’. In the eyes of most consumers, the word ‘coin’ evokes the image of a physical coin, i.e. an official means of payment and, bearing in mind that, historically, coins were frequently minted of precious metal, a genuine, widely accepted store of value. Stablecoins, by contrast, have no physical form and therefore no material value whatsoever, i.e. they could hardly be more different from an actual ‘coin’. That applies, in particular, to stablecoins that do not grant their users any redemption or conversion rights. Retail users, particularly groups with limited financial literacy and populations in EMDEs, who are targeted specifically by some of the proposed offerings, should not be exposed to this level of semantic ambiguity.

The consultation document points out, in our view correctly, that the term ‘stablecoin’ is currently not defined or regulated, and is used loosely by market participants for any *‘crypto-asset that aims to maintain a stable value relative to a specified asset, or a pool or basket of assets’*. The main distinguishing feature of a ‘stablecoin’, vis à vis other crypto-assets, appears to be the presence of a ‘stabilisation mechanism’ that *‘aims’, ‘attempts’ or ‘purports’* to maintain a stable value. We should remind ourselves, however, that where such ‘attempts’ fail, there is risk: market risk related to the underlying assets, solvency, liquidity and management risk related to the manager and the reserve fund. This risk is ultimately borne by users or, in the (still hypothetical) case of a global stablecoin, the general public.

The key concept that lies at the heart of this discussion is, in our view, redeemability. From a retail user’s perspective, any instrument that is styled as a ‘coin’ must either be issued (‘coined’) as legal tender by the relevant authority or, at the very least, be redeemable, or convertible, instantly into legal tender at its face value. It is critical therefore, in our view, for regulators to formulate clear expectations and requirements for ‘stabilisation mechanisms’ to be deemed adequate and fit for purpose to guarantee redeemability.

A taxonomy for stablecoins proposed in a recent European Central Bank paper<sup>1</sup>, which categorises stablecoins based on their stabilisation mechanism, could serve as a useful point of departure. It distinguishes between

- stablecoins that are *‘backed by funds, which an issuer or custodian needs to hold for safekeeping, implying a commitment to their full redeemability’* (‘tokenised funds’);
- stablecoins that are backed by assets (‘collateralised stablecoins’) – either traditional asset classes that require a custodian for their safekeeping (‘off-chain’) or backed by (crypto-)assets, which can be recorded in a decentralised manner and do not need either an issuer or a custodian; and
- ‘algorithmic stablecoins’ that are *‘backed by users’ expectations about the future purchasing power of their holdings, which does not need the custody of any underlying asset’* – or, in the FSB’s own definition of ‘algorithm-based stablecoins’ – stablecoins that *‘attempt to maintain a stable value via protocols that provide for the increase or decrease of the supply of the stablecoins in response to changes in demand’*. (We appreciate the nuances between the two definitions, which are, in our view, not fundamental and reconcilable.)

If we accept that redeemability at face value, rather than the mere presence of a ‘stabilisation mechanism’, is the defining criterion of a ‘stablecoin’, we will most likely conclude that only stablecoins’ that are pegged

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<sup>1</sup> Bullmann, D. / Klemm, J. / Pinna, A., In search for stability in crypto-assets: Are stablecoins the solution?, ECB Occasional Paper No. 230, August 2019; (<https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op230~d57946be3b.en.pdf>)

to official fiat currencies at a fixed rate, and backed, in full and at all times, by an equivalent amount of funds (cash, bank deposits, and electronic money) denominated in that currency, should be admitted to the market as 'stablecoins'. This interpretation would, effectively, restrict the label of 'stablecoin' to a 'tokenised' version of electronic money ('e-money'). Stablecoins 'A' and 'B' described in Annex 1 to the consultation document would likely conform to that model, except that both appear to have redemption thresholds/limits that would not appear compatible with the concept of 'e-money' or a 'coin'. Whether stablecoins could be pegged to a fixed basket of official ('fiat') currencies could be left open for discussion at this stage. We can see the potential benefits of such an arrangement, e.g. as a way of facilitating cross-border trade or remittances, but are concerned about the implicit need for constant readjustment of the underlying holdings of funds, which may prove challenging in times of stress.

Stablecoins that do not fulfil these criteria, e.g. 'collateralised' and 'algorithm-based stablecoins' should not qualify as 'stablecoins' for regulatory purposes and should not be admitted to the market as such. 'Algorithm-based stablecoins' are, a priori, not designed to be redeemable against fiat currency. The value of collateralised stable coins, both 'on-chain' and 'off-chain', is susceptible to fluctuations in the market value of the underlying asset and liquidity risk in times of financial stress. 'Collateralised stablecoins' are, in essence, financial instruments and should therefore be classified as such (i.e. as 'investment or security tokens').

This would also be the case for 'stablecoins' that are backed with government securities, as opposed to funds. Libra, the 'stablecoin' proposed by a consortium around Facebook, would be the digital equivalent of a money market fund, with users of the 'stablecoin' effectively investing in a 'reserve fund', managed by the Libra Association, that consists of short term government debt securities. Libra 'tokens' should therefore be considered as units in a collective investment fund, the Libra Reserve Fund, with the Libra Association as its regulated managing entity. Similarly, 'stablecoins' that are linked to a basket comprising currencies and other assets, such as commodities, should be treated as 'tokens' representing underlying financial instruments. From the point of view of retail users, it is important to bear in mind that the sale of such products in the European Union, is usually subject to strict suitability assessment rules, which ought to be applicable regardless of the format in which the investment is sold.

**Q3. Does the FSB properly identify the functions and activities of a stablecoin arrangement? Does the approach taken appropriately deal with the various degrees of decentralisation of stablecoin arrangements?**

We agree with the FSB's analytical description of stablecoin arrangements. In the light of our comments to Q1. we would suggest that many aspects of regulating these arrangements, in particular governance and the management and custody of reserve assets, could be largely derived from existing frameworks, such as the Principles for Financial Market Infrastructures (PFMI) issued by the Committee on Payments and Market Infrastructures (CPMI).

The decentralised nature of Distributed Ledger Technology (DLT) is, in our view, the most innovative aspect of stablecoins and, as a corollary, poses the most questions for users and regulators alike. DLT is currently being tested, and deployed globally for many different applications and it would be highly desirable, therefore, to embed the specifics of any forthcoming regulatory framework for global stablecoins within a broader set of general principles governing the cross-border deployment of DLT infrastructures.

In the context of stablecoins, we believe that the roles of the issuer, the manager and validators require particular attention from regulators. These roles differ, of course, depending on the typology, and specific design of the individual arrangement. Specifically, we observe that

- Issuance may be handled by one or more designated issuers or occur automatically by way of an algorithm. The latter approach, associated most prominently with Bitcoin, does not, however, ensure redeemability and should therefore not be accepted as a method for issuing 'crypto-assets' that qualify as 'stablecoins'.
- The requirement for full and instant redeemability, which we believe should be central to the definition of a 'stablecoin', implies that the roles of issuer, manager and custodian, which are more commonly associated with asset management rather than payment systems, may be difficult to separate in practice. The arrangements, and attendant legal framework for stablecoins, and other 'payment tokens' should, in our view, be modelled more closely on the setup of a retail payment system. In any event, roles and responsibilities, in particular the ultimate responsibility for guaranteeing solvency and liquidity, must be clearly assigned to participating entities. Prudential and operational requirements should be defined for each role.
- In a 'permissioned' DLT architecture, 'validator nodes' are limited in number and, usually, controlled by the initiators/sponsors of the system. In a stablecoin arrangement based on 'permissioned' DLT it would appear entirely reasonable, therefore, to assign ultimate responsibility for the proper operation of these nodes to the issuer and/or manager of the arrangement, whose 'duty of care' should include the selection, permissioning and continuous monitoring of node operators. The same principle could be applied, mutatis mutandis, to DLT architectures based on Directed Acyclic Graph technology, which are, nominally, 'permission-less' but in practice rely on centralised features, such as central co-ordinators or 'witness nodes,' to protect the integrity of the consensus process.
- In a 'permission-less' or 'open' DLT architecture, the process of validating DLT entries is externalised to a potentially unlimited number of nodes, which participate without need for permission. This adds to the difficulty of attributing responsibility, recovering damages and administering sanctions in the event of an operational failure or malfeasance. These shortcomings could be addressed, potentially, by the adoption of 'proof of stake' consensus algorithms, combined with the requirement for a security deposit (such as, e.g., the Casper protocol on Ethereum), which would provide for a dedicated, albeit distributed funding base within the system.

#### **Q4. What criteria or characteristics differentiate GSC arrangements from other stablecoin arrangements?**

We support the proposal by the FSB of developing a framework for assessing the global systemic importance of a stablecoin arrangement (Annex 5). We note, however, that such a framework ought to be viewed within the wider context of the existing financial architecture, and consistent with existing regulatory frameworks. As mentioned previously, stablecoins are, for the most part, digital 'tokens' that represent existing financial instruments and (payment) services. Operators of 'collateralised stablecoin' arrangements – with the possible exception of 'validation nodes' – largely replicate roles that already exist, and have been regulated for a long time for institutional asset managers. In order to maintain regulatory consistency, and to prevent large-scale regulatory arbitrage it would be critical, in our view, to ensure that entities involved in operating 'collateralised stablecoin' arrangements conform to the same regulatory framework, mutatis mutandis, as established institutions in the same line of business. We therefore endorse the findings of

IOSCO's recent report on Global Stablecoin Initiatives<sup>2</sup> in this respect. We note, however, that this principle should indeed be applicable for all stablecoin arrangements, regardless of type or scope, and not be limited to arrangements that are deemed global systemically important.

In respect of global stablecoin arrangements, we note that the FSB, with the support of IOSCO, has been working since 2011 on a framework to designate and regulate non-bank non-insurer global systemically important financial institutions (NBNI G-SIFIs). In view of the fact that the manager of a reserve fund for a global 'collateralised stablecoin' would be no different, in substance, from a manager of a very large fund, we would look for the FSB to revive this effort, which has not progressed significantly since 2015, with a new sense of urgency, and an expanded and updated scope that accounts for the potential emergence of global systemically important operators of GSCs.

**Q5. Do you agree with the analysis of potential risks to financial stability arising from GSC arrangements? What other relevant risks should regulators consider?**

We broadly agree with the risks to financial stability as described in the consultation document. These risks are, for the most part, typical of 'collateralised stablecoins' which, as set out in our response to Q1., should not be designated, and marketed to retail users, as 'stablecoins' at all. In substance, the description of a collateralised arrangement in the consultation document closely resembles a money market fund, more precisely a Constant Net Asset Value (CNAV) money market fund. 'Stablecoins' issued under such an arrangement should therefore be viewed as digital 'tokens' representing units in a collective investment scheme. As mentioned previously, entities that operate a 'stablecoin' arrangement with the characteristics of a CNAV money market fund should, of course, satisfy the requirements that apply to this activity, regardless of whether 'units' in such a vehicle are distributed in traditional ways or in the form of 'digital tokens'.

Whereas governance, management and prudential risks could be derived from, or addressed on the basis of existing regulatory frameworks for operators of large collective investment schemes, i.e. asset managers, 'tokenisation' of units and the use of distributed ledgers is likely to pose specific legal and operational risks. These are, however, likely to be common to all adaptations of these technologies, i.e. not limited to the financial sector or stablecoins, in particular. We recognise that there is a need to regulate these aspects, ideally on a global scale and would welcome a concerted initiative by the FSB and other relevant international standard-setters, including IOSCO, the Basel Committee on Banking Supervision, and the ITU, among others.

**Q8. Do you agree with the characterisation of cross-border issues arising from GSC arrangements?**

We broadly agree with the description of cross-border issues in the consultation document. We would like to emphasise, in this context, the potential exchange rate risk, in particular for retail users/investors in EMDEs. While we understand the potential benefits of stablecoins linked to major global currencies for users in jurisdictions with high inflation and/or strongly fluctuating currencies we are equally mindful that these users are very often not financially literate and may not be in a position to fully appreciate and assess the potential impact of exchange rate risk on the value of their 'stablecoin' holdings. The wider issue of monetary sovereignty, and the question of democratic control and legitimacy of a scenario where a country's national currency is replaced with a foreign, privately-controlled substitute, goes beyond the scope of this consultation but is, of course, extremely relevant for this discussion.

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<sup>2</sup> IOSCO, Global Stablecoin Initiatives. Report, International Organisation of Securities Commissions OR01/2020, March 2020; (<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD650.pdf>)

**Q9. Are the proposed recommendations appropriate and proportionate with the risks? Do they promote financial stability, market integrity, and consumer protection without overly constraining beneficial financial and technological innovation?**

We believe that the proposed recommendations are appropriate and proportionate given the very significant risks to financial stability and consumer protection associated with the potential emergence of inadequately regulated operators of GSCs. We welcome, in particular, the explicit recognition of users'/investors' needs in Recommendations 8 and 9. We would suggest to further expand these recommendations to include, or emphasise the following points:

- Use of the term 'stablecoin' (Recommendation 2): in the interest of protecting retail users we would suggest to regulate the use of the term 'stablecoin' and to restrict its use to 'stablecoins' that conform to the characteristics of e-money, as discussed in Q1. above.
- Protection of personal data (Recommendation 6): Operators of stablecoin arrangements, such as wallet providers, in particular, continuously process large amounts of personal data of their users. Due to the inherently global reach of crypto-assets, in general, and stablecoins, in particular, this data may be processed in locations other than the home jurisdiction of the user. Participants in a stablecoin arrangement should be explicitly obliged to set up systems and controls to ensure that users' rights to data protection, e.g. under the European Union's GDPR<sup>3</sup>, are fully observed.
- Investor protection (Recommendation 8): protecting retail users against investing in unsuitable financial instruments is of prime importance. To the extent that a 'stablecoin' effectively represents a 'tokenised' security, e.g. a unit in a collective investment scheme (see Q4. above), relevant legal disclosures and safeguards, such as key investor information documents and suitability assessments<sup>4</sup>, should apply accordingly.
- Legal redress for users and indemnification (Recommendation 9): given the distributed structure of stablecoin arrangements it is of paramount importance to clearly assign responsibilities for compliance with user/investor protection provisions and suitable arrangements for effectively applying and enforcing infractions across borders. Every stablecoin arrangement should clearly identify the role and responsibilities of each participant, including, e.g., liability for losses to investors from management fraud or for compensation of damages from fraudulent mis-selling.

We recognise that the proposed recommendations primarily address 'collateralised stablecoin' arrangements and, to a lesser extent, 'tokenised funds'. While we maintain that only the latter should be considered as 'stablecoins' for regulatory purposes, and be marketed to retail users as such, we fully agree that the proposed recommendations should also apply for 'collateralised stablecoins'. We would also support expanding their application to encompass 'algorithmic stablecoins' and other crypto-assets, such as 'virtual currencies' (i.e. Bitcoin), to the extent practicable. We note, in particular, that authorities should have the powers and capabilities to prohibit 'products' and services that pose demonstrable risks to users in their jurisdiction.

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<sup>3</sup> General Data Protection Regulation (Regulation (EU) 2016/679)

<sup>4</sup> e.g. as implemented in the European Union under the UCITS Directive (Directive 2009/65/EC) and MiFID II (Directive 2014/65/EU)

**Q10. Do you think that the recommendations would be appropriate for stablecoins predominately used for wholesale purposes and other types of crypto-assets?**

We refer to our response to Q9. above.

**Q11. Are there additional recommendations that should be included or recommendations that should be removed?**

We refer to our response to Q9. above.

**Q12. Are there cost-benefit considerations that can and should be addressed at this stage?**

Yes. We note that the balance of costs and benefits in connection with financial innovation is often borne by consumers and taxpayers. Recent examples include, for instance, the financial innovations of sub-prime mortgages, Collateralised Debt Obligations (CDOs), and many of the first generation of 'cyber-assets', which were launched between 2014 and 2018, primarily through Initial Coin Offerings (ICOs). We are very supportive, therefore, of the FSB's initiative to promote a harmonised global framework for stablecoins at a still comparatively early stage. Given the potential cost to the public, both in economic terms – in the event of a systemic crisis triggered by a GSC operator – and in terms of lost monetary sovereignty – if a privately-owned GSC were to substitute a country's own official currency – we believe that the public interest to introduce robust and consistent regulation should more than compensate the cost of applying regulation (that already exists, to a large extent, for very similar activities) to participants in this market.