# Call for Evidence: Central Bank Digital Currencies (CBDCs)

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Digital Currencies Governance Group (DCGG) is an international industry body with the aim to provide regulators with unbiased information, best practice knowledge and expert industry-related insights on policies concerning crypto-assets.

DCGG represents the full spectrum of key stakeholders in the ecosystem, including Tether – the biggest stablecoin issuer worldwide, Hermez – pioneer Layer 2 technology for scaling payments, Bitfinex – top tier digital assets exchange, Iden3 – avant-garde player in blockchain-based identity management, and others.

DCGG creates an open dialogue and encourages the communication between political representatives and digital currencies experts to ensure that legislation supports scale and innovation in the crypto-asset space.

# GENERAL CONSIDERATIONS

The Digital Currencies Governance Group (DCGG), a trade body representing digital assets issuers and service providers, including Tether token, supports developing a sound regulatory framework for stablecoins and other digital currencies. Yet, we do not recommend the creation of a UK-issued CBDC, as there exists insufficient evidence as to its benefits and we believe that there are more effective ways of bringing the benefits of digital assets to business, individuals and the wider economy. This paper aims to present evidence as to why a GBP CBDC could bring drawbacks that outweigh the benefits of issuing such a currency and why the UK should therefore focus on creating the right regulatory environment for private sector solutions:

- The apparent benefits of CBDCs, such as settlement finality, liquidity and integrity, are already provided to the public through stablecoins (i.e., digital assets whose value is pegged to a fiat currency) which are offered by private sector entities.
- The key question to consider is if stablecoins issued by the Bank of England (i.e., CBDCs or the so-called Britcoin) offer any additional benefits to those secured by the private sector.
- The Bank of England, in their publications on Central Bank Digital Currencies from March 2020, acknowledge that it would incur costs in building and running the core ledger required, and these would need to be recovered by transaction fees. Given the expense, the evidence of need for CBDCs needs to be stronger.
- The public needs to be thoroughly consulted and engaged in this process. Its demand for 'Britcoin', as per survey data detailed below, is at present very low.

DCGG notes that considerable progress has been made towards adopting appropriate regulatory frameworks in the UK. The growth and adoption of stablecoins on Distributed Ledger Technology (DLT) is likely to continue accelerating and to fundamentally transform the payments industry both domestically and internationally. There will be substantial gains for those nation states and regulatory systems that adopt and provide the most successful regulatory systems and infrastructure. Since the UK has now left the EU, there are opportunities for the country to attract both talent and capital to drive faster economic growth through welcoming innovation and competition.

The real opportunity for the UK is to enable and encourage the issuance by FCA authorised e-money tokens pegged to multiple fiat currencies on DLT, backed by reserves and prudentially supervised by the Bank of England (PRA), with the option to hold at least some part of such reserves on the Bank of England ledger, whilst the balance of such reserves might be deployed providing credit and supporting growth in the economy. In order to achieve such a result, we advise the UK Government to promote the continued use and development of the existing FCA provisions on e-money but most importantly to add some key optional permissions and features as suggested below.

## Evidence

### Question 1. What are the main issues driving central banks to explore CBDCs?

**Globally, there have been two main drivers for central banks exploring CBDCs:**

- Competitiveness and efficiency in payments:  this is particularly valid for markets where the speed and cost of digital payments is sub-optimal, and they are looking towards blockchain technology to leap-frog existing solutions. It is less applicable to the UK and Europe.
- Financial Inclusion: similarly, in markets with large unbanked populations, CBDCs have offered the potential to rapidly, safely and cheaply offer digital payment wallets to more citizens.

The balance of these drivers depends on the national context. In the UK, financial exclusion does not typically constitute lack of access to digital payments - while it may constitute lack of access to suitable banking, lending or investment products.

This leaves the question as to how the UK is to ensure its competitiveness in digital payments. In our view, the development of stablecoins is still an emergent and fast-paced area, where the private sector is better positioned to drive competitiveness and competition and to judge the level of risk it is prepared to take within a specified framework. Consumer protection and risk mitigation can be secured through the development of appropriate regulatory frameworks.

## Question 2. What are the main benefits and risks of a CBDC?

**Benefits of stablecoins, including CBDCs**

Prospective CBDCs are often compared to currently existing stablecoins, such as Tether token. Some argue that, for example, that stablecoins improve the economic and monetary resilience by adding another channel to distribute currency and improve the efficiency of transactions, while lowering the transaction costs.

All of the benefits can already be achieved with the existing private stablecoin solutions. For example, Tether token is not a blockchain network itself, but rather exists on numerous blockchain implementations, thus, Tether tokens are interoperable across these blockchains. The existing stablecoin solutions already provide for lower transaction fees and shorter transfer times for cross-border payments, leading to increased global financial inclusion.

Some argue that central bank digital currencies (CBDCs) will restrict illegal activity – that Central Banks would be able to create a "regulatory tent" over their digital currencies in contrast to bitcoin and its siblings, which operate beyond official financial systems. DCGG notes that, firstly, the creation of CBDCs will not curb access to bitcoin and secondly, the development of a regulated market for private stablecoins can be the proverbial "regulatory tent" for those users who engage in digital assets for legitimate reasons.

**CBDC Risks**

An improper or incomplete design of the CBDC infrastructure would result in inefficient transactions and end user solutions. Additionally, if a CBDC is entirely centralised, it could create vulnerabilities to external factors, thus increasing systemic risk. This would be an area where privately issued stablecoins would have an advantage and would create less systemic risk as there are multiple private stablecoins of differing structure making it easier to diversify in and mitigate such risks.

A risk that also comes with CBDCs is operational resilience and the impact they could have on monetary policy and financial stability in relation to spillovers in the international monetary system. While there are some benefits of CBDCs that could come from use in cross-border payments, there is a risk that significant use of any CBDC by residents of a foreign country could result in currency substitution, thus limiting control of monetary policy for both the issuing and foreign country. This risk of currency substitution could occur with CBDC's based on strong, resilient, and stable currencies that seem desirable to residents of other countries, including those experiencing macroeconomic volatility.

A final issue with CBDCs relates to their accounting treatment - whether, for instance, the issuance of CBDC is considered as adding to the national debt, or whether it is perceived as such by external actors even if remaining off the balance sheet. This could have a profound impact on how UK macroeconomic policy is judged.

## Question 3. Could the proposed benefits of a CBDC be achieved through improvements to existing payment systems?

Stablecoins were originally developed and issued to meet a demand that was not being met by the existing payment systems. Stablecoins provide a solution to a wide variety of payments-related issues ranging from privacy to making international transactions and participation in peer-to-peer financing markets that would not otherwise be easily addressed. Furthermore, due to the competitive nature of the payments market, private sector stablecoins can address these and any new emerging issues by constantly upgrading their technologies to offer best-in-class solutions for the consumers as well as businesses.

Consequently, the proposed issues and benefits that the CBDC seeks to achieve or solve are already being addressed by the private stablecoin solutions. Implementing the functionalities that the consumers and businesses would expect to have in a GBP CBDC will be a complex and multi-layered undertaking that will take years. The public sector also risks to fall back on the technological advancements that have developed in the market with a risk of playing catch-up.

Thus, the regulatory regime should rather focus on allowing for innovative private multicurrency stablecoin solutions to develop on open public blockchains. These would in turn offer the best solutions in the market, improving the existing payment systems and solving their weaknesses.

## Question 4. How should the Bank of England and HM Treasury address concerns over privacy and traceability of payments when exploring CBDC design?

In an ever-growing digital ecosystem, concerns with privacy and security remain pressing. The concerns over data ownership and privacy have guided research into innovative tools and mechanisms facilitating the digital economy and minimizing privacy risks.

Private stablecoins are therefore exploring the adoption of Zero-knowledge Proof (ZKP). ZKP can essentially serve as a "notary on the blockchain", which significantly reduces transaction costs and increases transparency when investigating potential Money Laundering and Terrorist Financing. ZKP assigns cryptographic codes to users over a long period of time, meaning that Customer Due Diligence (CDD) does not need to be conducted by each institution separately. This is both cost-effective and secure since personal information is prevented from being spread across multiple institutions. However, if a transaction is suspicious, law enforcement can be granted access to the identities in minutes.

Striking the right balance between privacy and traceability is one of the main design challenges for developing a CBDC, in the UK, but also in the EU and other markets. In our view, a constructive approach would be to enable a competitive, private sector driven approach to this challenge.

Specifically, it is possible and it would be advantageous for the Bank of England to, firstly, supervise the public and interoperable blockchains on which private stablecoins are traded and secondly, develop and maintain a ledger for storing and managing fiat. The two types of ledgers could interoperate.

## Question 5. What effects might a CBDC have on the financial sector?

One significant risk of a CBDC is that rather than interoperating with financial sector products, namely private stablecoins, it cannibalises demand for them, stifling growth and innovation.

CBDC could have a detrimental impact on incentivising private stablecoins from entering the market. This would diminish the UK's ability to capitalise on the benefits of the new financial sector that is related to stablecoins and crypto assets.

Technologists are designing advanced capital markets instruments in decentralized environments. These novel instruments can be further developed, scaled and launched by traditional and new financial institutions, but it is imperative that these stablecoins allow for continued engineering and innovation through decentralized means.

This would allow for the UK to benefit from the decentralized innovation provided by stablecoins.

## Question 6. What effect might a CBDC have on competition and innovation in the payments and fintech sectors?

The current payments landscape is already increasingly competitive due to the high number of actors present and incoming. As the numerous actors active on the payments market need to consistently compete with each other, new technologies and solutions continuously emerge and the best-in-class solutions are offered to the consumers and businesses. Thus, there is not a competition or innovation issue to be solved in the current payments market. Developing a GBP CBDC might lead to curbing the innovation in the UK payments market, as new start-ups will not be incentivised to enter the payments market to develop new solutions and thus competition would decrease.

Innovation is best served by the UK government providing an enabling environment for privately issued multicurrency stablecoins on open public blockchains backed by fiat reserves supervised by the Bank of England. By focusing its efforts on building an innovation-friendly regulatory framework, the UK can encourage strong innovation and send a signal to the world that Britain is open to entrepreneurship, particularly in the face of upcoming EU regulations of virtual assets. Competitive and supportive virtual asset framework can make the UK the global hub of financial digitization.

An argument has been that CBDCs “would break big banks’ stranglehold over the payment system”. To this legitimate objective, DCGG believes that encouraging private sector entries in the stablecoin space, building an open and interoperable ecosystem, cannot be matched in impact towards innovation.

## Question 8. How might a CBDC change the Bank of England’s role and responsibilities?

By introducing a new payment mechanism to complement fiat, CBDCs would dramatically and unnecessarily expand the role of the BoE, both in scope and responsibilities. For example, the BoE would include being responsible for constructing and maintaining the infrastructure required for the CBDC. It will need to monitor and control the supply of CBDC that is in circulation according to monetary policy. It will need to monitor any potential risks to financial stability that may be identified. Also, the BoE will need to initiate legislative actions regarding design decisions around the CBDC infrastructure. Depending on the CBDC design, legislative change may be needed.

Instead, The BoE's and the FCA's involvement in the regulation of private stablecoins will be important. It can position the UK as a pioneer in providing regulatory certainty, while incentivising continuous innovation, hiring and economic growth in the industry. Thus, it may benefit from digital assets experts to consult the competent authorities on how to (i) ensure regulatory clarity and compliance and (ii) provide appropriate guidance so as not to stifle the potential benefits of innovation.

A better use of BoE resources would be to consider maintaining a fiat ledger so as to allow a prudential role executed by BoE.

## Question 9. How should HM Treasury and the Bank of England engage with the public on the research and development of a CBDC?

DCGG believes that, apart from the current Call for Evidence aimed at the industry, the HM Treasury and the BoE could directly engage further with experienced stablecoin issuers to provide best practices to respond to the public's potential concerns regarding CBDCs, such as security and GDPR compliance.

Opinion polls are an efficient method to understand the public perception of CBDCs and their interest in the development of a UK-issued CBDC. Opinion polls, as recent as August 2021, highlight the lack of support by the British public towards the issuance of central bank-backed digital currencies.

According to a survey of 2,500 adults carried out for POLITICO by Redfield & Wilton Strategies in mid-August, British citizens do not support BoE in the development of a national CBDC. Another example is the 2019 Bank for International Settlements Survey which states that: "motivations for issuing a CBDC are largely idiosyncratic and very few central banks see issuance of a CBDC as likely in the short or medium term. At this stage, most central banks appear to have clarified the challenges of launching a CBDC but they are not yet convinced that the benefits will outweigh the costs."

## Question 10. How might CBDCs affect the economic foreign policies or geopolitical influence of different countries and economic areas? Are there implications for the effectiveness of economic sanctions?

DCGG suggests that a GBP CBDC at this stage will enter an uncharted territory due to the very narrow CBDC market that currently exists worldwide. A premature issuance could potentially lead to a cycle of 'trial and error' where the GBP CBDC would be exposed to high amounts of scrutiny DCGG believes that the Bank of England must wait until CBDC issuance and circulation is set in stone in a larger number of national economies. The UK can thus learn from any possible mistakes made in countries like China and Canada which are currently paving the way for the entrance of CBDC into an ever-growing digital currencies market. Issuing a GBP CBDC too early and without a substantial amount of input from other countries' pilot projects can lead to a risk of potentially negative effects to existing payments systems, credit allocation and financial stability within the UK economy. This is especially important in a post-Brexit climate where the UK has the tools to establish itself as an innovative cryptoasset hub. DCGG therefore stands by the opinion expressed by BoE that the 'use case' for a UK issued CBDC, needed further research, refinement, and articulation, to inform a deep comprehensive assessment of the risks of such an introduction.

# Conclusion

In summary, DCGG suggests considering all risks associated with the issuance of a GBP CBDC. We also advise the UK to increase the prudential role of BoE by explicitly permissioning e-money stable token issuance within the current e-money provisions and making available the Bank of England ledger as a fiat custodian with appropriate prudential supervision of reserves, the UK would become the pre-eminent, safest and most sought after digital-assets regulatory jurisdiction worldwide.