

Stablecoins: what's old is new again



Christina Segal-Knowles talks about stablecoins. She looks at how they could be regulated if they are used as a form of payment

I'm going to focus on what is sometimes billed as the next big thing in digital payments - stablecoins - digital tokens issued by the private sector which aim to maintain a stable value at all times, primarily in relation to existing national currencies.

And to be clear from the start, I will touch only on those stablecoins that aim to be used widely as means of payments.

Stablecoins and other new forms of innovation in payments potentially offer benefits. They could reduce cost and offer new convenience and functionality. They could increase the resilience of payments – by offering alternative new ways to pay. And there could be potential long term financial stability gains from new forms of digital money. But these opportunities can only be realised if new forms of digital money are safe.

So I am not going to focus on what's new about stablecoins. Instead, I am going to focus on why – even if the technology they are using is new - the basic elements of a stablecoin are very old. In fact, as old as money itself.

This means that as financial regulators, stablecoins are not launching us off into some brave new world. We know what is required to ensure private money¹ is safe for wide-scale use. The key here is to ensure that just because something is packaged in shiny technology we don't somehow treat the risks it poses differently.

Private money: the basics

Before I turn to stablecoins I want to spend a minute on one of the reasons why the idea of private money feels innovative and flashy. Even though most money we use every day is already private money, the vast majority of us don't think about it. Luckily, regulation means we don't have to.

Popular culture often simplifies our ideas around what form our money takes and can reinforce the idea that banks are simply storing our sterling issued by the central bank for us, and that when we pay electronically, what is being moved is central bank-issued money. For example, remember those iconic scenes from *Mary Poppins* and *It's a Wonderful Life* which feature people demanding that banks give them back their money.

But in reality, when you tap your debit card in a shop or pay your friend back via a bank transfer, the money you are paying with isn't sterling issued by the Bank of England with a promise to pay the bearer – it's a bank deposit. Those are just a record of how much a private company – here, the commercial bank - owes its customers. Think of it as an IOU from the bank.

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When we say that we are “*withdrawing our money*” from an ATM - what we are actually doing is converting our IOUs from our bank, ie. commercial bank money, into banknotes issued by the Bank of England.

So even though we don't think about it, we're already using private money all the time. Ninety-five percent of the funds households and businesses hold that are typically used to make payments are now held as commercial bank deposits rather than cash². The pandemic has prompted a further decrease in cash usage, accelerating a longer-term decline that is likely to continue³.

Private money: why do we care?

Today in the United Kingdom we don't generally pay attention to whether we are using private or public money. We can assume that the value of the money we use will be more or less stable. Shops don't need to scrutinize which bank holds your deposit before you pay – and they are generally as willing to receive private money in the form of card or smartphone wallet payments as they are cash.

The fact that commonly used private money is interchangeable with cash anchors it to national currencies and, as a result, promotes financial stability. The fact that bank deposits can be exchanged for cash on demand guarantees uniformity – ensuring that bank deposits from one bank can be used interchangeably with cash and with bank deposits from another bank.

While banks do fail, regulation and liquidity backstops makes that relatively rare. And deposit protection schemes ensure that transactional balances up to £85,000 remain interchangeable with cash even if that happens. This model is relatively recent. It was not ever thus.

And as we think about new forms of digital payments, it is important that we do not take this for granted.

A large number of financial crises of the last century have featured a loss of confidence in the reliability and safety of the money people rely on for transactions.

Money that is usually considered safe. Money that people normally do not think about very much.

In the emerging market financial crises of the 1990s and early 2000s, people and businesses lost faith in the state's ability to maintain the value of their local currency against the dollar⁴.

Other crises have had at their heart a loss of confidence in the ability of private issuers – commercial banks – to fulfil their IOUs with depositors and lenders and maintain the interchangeability and reliability of the money they issued.

Think of the Great Depression-era bank run depicted in *It's a Wonderful Life*. Think of the Northern Rock example – where worries about the Northern Rock's funding led to a crisis of confidence; first from wholesale lenders and then from retail depositors – who suddenly worried that their deposits would no longer be interchangeable with cash or other bank deposits.

Remember the queues outside of branches in 2007, as depositors rushed to exchange their deposits before – they believed – it might be too late⁵. Confidence in the credibility and stability of private money are fundamental components of financial stability.

Innovation

But let us go back to stablecoins and innovation in payments. Stablecoins are digital tokens that aim to maintain a stable value vis-a-vis existing forms of money⁶. Their origin stories generally trace back to the crypto world. Most forms of crypto-assets, like Bitcoin, are too volatile to be attractive as a widespread means of payment.

We have seen time and time again that if money is not reliably stable most people will not want to use or accept it as payment. There is no reason to think this time is different⁷.

To solve this, stablecoins have turned to the age-old solution of anchoring their value to national currencies, often with a promise to ensure that the value remains 1 for 1 at all times. Stablecoins therefore could potentially serve as a substitute for a commercial bank deposit.

Both stablecoins and banks are offering a representation of what a private company owes its customers – an IOU - which can be transferred as a means to pay for things. Both are promising (or at least aspiring to) stability against and interchangeability with money issued by central banks.

It is possible in this context that stablecoins could scale up and grow rapidly, and become widely used as a trusted form of sterling-based retail payments. To be clear - I don't know if this will happen. Stablecoins and other new forms of private non-bank money might be the next big thing. Or they might be a flash in the pan.

I don't have a bet here - I am a central banker not a venture capitalist. My job, as a central banker and regulator - in all of this – is to ensure that financial innovations, including new forms of digital money, do not impair the Bank of England's ability to maintain monetary and financial stability.

This shouldn't be confused with preserving the status quo. Financial stability isn't about protecting incumbent banks or other existing firms from competition. Instead financial stability seeks to ensure that people and businesses can rely on essential financial services – like the ability to make a payment or the ability to get a loan - in bad times as well as good.

A regulatory framework

Earlier this week, the Bank of England published a Discussion Paper that examines the implications of stablecoins for its financial and monetary stability mandate. In it we present an illustrative scenario to examine the implications of the emergence of stablecoins and other new forms of digital money.

The discussion paper models what would happen if a large number of households and businesses moved their deposits from banks and into a stablecoin or Central Bank Digital Currency (CBDC). Contrary to some press headlines, even such a dramatic shift does not inherently constitute a financial stability risk as long as it happens in an orderly manner.

In fact findings show that the implications of this in the long term for the ability of households and businesses to get a loan are relatively modest – although there is considerable uncertainty around this result.

As such, while other risks may arise during a transitional phase, the most significant risk arises from the potential for stablecoins in particular to undermine confidence in money and payments, and hence in the wider financial system.

As we discussed, the risk of a loss of confidence in the credibility and stability of private money is not theoretical. Loss of confidence in private money can be a major threat to financial stability.

But it is equally true that private money can be made acceptable as a widespread means of payment – indeed, as I covered earlier, the vast majority of money held for transactions in the United Kingdom is already private. So, with the right regulation, a stablecoin could potentially be made safe for wide-scale use.

Our existing regulatory framework seeks to ensure that the public is able to trust the reliability and stability of the money it uses every day. Banks are subject to extensive rules and requirements to ensure that consumers can use privately-issued money with confidence and interchangeably with cash.

These core rules and requirements were developed over time – in many cases via trial and error, with new rules introduced following financial crises.

Financial market infrastructure firms are also regulated to ensure that the assets they use for settlement – the underpinnings of our financial transactions, whether we're buying milk or clearing a derivative – are public money issued by a central bank wherever possible. Where that's not possible they are permitted to settle in money deemed to be a close substitute – commercial bank money.

If stablecoins seek to be acceptable widespread substitutes for commercial bank deposits as a means of payment, it stands to reason that stablecoins will need to meet the core elements of our existing regulatory framework for private money which underpins confidence that it is interchangeable with cash⁸.

These are:

- A legal claim – to allow for prompt redemption at all times, for the amount initially deposited, and at no cost to the depositor; In other words – the little boy's right in *Mary Poppins* to demand that the bank 'give him back his money.
- Capital requirements – to lower the risk of insolvency, these are calculated based on the nature of the risks

issuers undertake (credit, operational, market risks); they act as a cushion to absorb losses, reducing the chances that a firm fails.

- Liquidity requirements – to ensure redemptions can be met in most circumstances – supported by eligibility for central bank facilities where relevant, to meet firms' liquidity needs in extremis. This ensures that temporary liquidity issues arising from difficulties selling assets backing the value of stablecoins don't result in firm failure; and
- A backstop to compensate depositors – or in this case coinholders – such as the Financial Services Compensation Scheme (FSCS) (or in other countries deposit insurance), in case of failure. This ensures that, even if a firm fails, transactional deposits up to a certain amount remain exchangeable for central bank money. Notably – one of the key responses to the Northern Rock episode was to increase FSCS coverage in the United Kingdom.

This is not to say the regulatory model for stablecoins needs to be identical to banks. It could include different applications of the above features. For example, if stablecoin operators are restricted to backing themselves in high quality liquid assets they won't need regulation to cover credit risk.

If they only back themselves in central bank reserves, which are inherently liquid, they don't need liquidity facilities. Ultimately, the specific requirements may well be different from those applicable to banks, but the outcome will be the same – that systemic stablecoins used as money will offer the same protection to coin holders as commercial bank money.

Conclusion

The title of this article is a cliché: everything that is old is new again. But I am going to end on a different cliché: the definition of insanity (widely – and inaccurately – attributed to Albert Einstein) is doing the same thing over and over again but expecting different results.

As I mentioned earlier, stablecoins may be innovative in the technology they use, but the fundamental questions they pose are not new. We as central bankers and regulators need to look at them as what they propose to be – a new form of private money.

This means that we will hold them to standards similar to those applicable to existing private money. It doesn't matter what type of technology you're using or the legal form of the firm. If a firm is offering private money on a systemic scale then it should be regulated as such.

Our core rules and requirements came through trial and error, often following financial crises. Our work on a regulatory regime for stablecoins builds on this learning process - rather than starting at square one and expecting different results.

I recognise that the themes here sound curmudgeonly. But this is not an anti-innovation message: quite the opposite. Establishing a secure regulatory environment for new forms of digital money to operate within the UK will lay a foundation for sustainable innovation.

As I said at the outset, if new forms of digital money can be made safe, they could potentially contribute to faster, cheaper and more efficient payments with greater functionality. They could increase the resilience of payments. And they could even have long-term benefits for financial stability.

But these opportunities can only be realised if new forms of digital money are safe – which means recognising and properly regulating the elements that are age-old. ■

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Endnotes

1. Private money mainly takes the form of deposits held in bank accounts. The only form of public money accessible to the general public is cash, in the form of coins and notes.
2. This is based on the amount of cash held by the public as a share of total cash and sight deposits. See Part V of '[A millennium of macroeconomic data](#)', Research dataset, Bank of England.
3. See LINK News and media contact, '[Coronavirus Crisis means cash use down but UK still withdrawing £1 billion from ATMs each week](#)'; See '[Statistics and trends](#)'; See chart A in '[New forms of Digital money](#)' DP, June 2021. Moreover, in practice, the UK authorities remain committed to ensuring access to cash to those that need it. The Bank, HMT, FCA and the PSR have been working together on the Joint Authorities Cash Strategy group to monitor the use of cash, ATM availability, and ensure cash remains available despite the impacts of Covid.
4. See the example of the Corralito in Argentina. (BBC, 02/12/2002: "[Argentina lifts cash restrictions](#)").
5. See: "[The financial crisis – 10 years on](#)" (Bank of England, 2018)
6. Stablecoins are different from CBDC. While stablecoins are a privately issued form of digital money, CBDCs are a form of digital money issued by the central bank. The Bank of England is exploring the case for a CBDC but has not made a decision yet.
7. In March 2018, the [FPC noted](#): "[Crypto-assets] should be considered as assets rather than currencies. However, as

assets, they establish no claim on any future income streams or collateral. They have no intrinsic value beyond their currently limited potential to be adopted as money in the future, and hence could prove worthless.”

8. In December 2019, the [FPC](#) noted that: “Where stablecoins are used in systemic payment chains as money-like instruments they should meet standards equivalent to those expected of commercial bank money in relation to stability of value, robustness of legal claim and the ability to redeem at par in fiat.”

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