EMA response to House of Lords Economic Affairs Committee Inquiry into CBDCs

Introduction

As the domestic and European trading body representing the payment services industry including FinTechs, BigTechs but also a large number of smaller firms engaging in the provision of alternative electronic and digital payment services, including the issuance of e-money the EMA[1] takes strong interest in the research and development of Central Bank Digital Currencies (CBDCs) by the Bank of England (BoE) and central banks worldwide. We therefore welcome the opportunity to respond to the call for evidence by the House of Lords Economic Affairs Committee's on CBDCs.

The EMA fully acknowledges that central banks need to respond to technological innovation and the fundamental change the new technologies bring about for how payments underpin our increasingly digitalised economies. As Augustin Carstens, General Manager of the Bank for International Settlements (BIS) put it: "Central bank public goods need to move with the times"[2]. At the same time, we take much comfort from his assurance that "central bankers … tread cautiously into new territory. … Before we open up the patient for major surgery, we need to understand the full consequences of what we're doing."[3] Fortunately, also central bankers understand that it is surgery requiring more than their expertise. We're quoting again Carstens emphasizing that "it is vitally important for the public sector to identify issues well in advance and address them with the private sector in a timely fashion".[4]

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

A recent BIS survey among 60 central banks provides a good overview of the current state of play (BIS Papers No 114; Ready, steady, go? – Results of the third BIS survey on central bank digital currency; January 2021). The survey also addresses the motivations of central banks to engage in research and development of CBDCs. Regarding wholesale CBDCs and

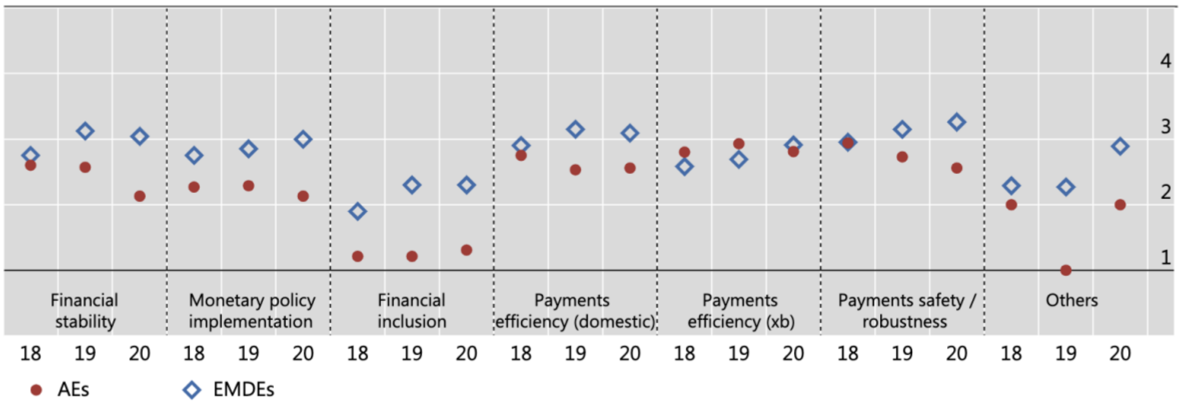
[1] for further information on the EMA and its members see https://www.e-ma.org/our-members
[2] in "The future of money and the payment system: what role for central banks", 2019, p. 11
[3] in "The future of money and payments", 2019, p. 2
[4] in "The future of money and the payment system: what role for central banks", 2019, p. 12

distinguishing between Advanced Economies (AEs) and Emerging market and developing economies (EMDEs) the survey’s findings are summarized in the graph reproduced below (graph 4, p. 8):

Motivations for issuing a wholesale CBDC

Average importance

Graph 4



(1) = "Not so important"; (2) = "Somewhat important"; (3) = "Important"; (4) = "Very important".

Source: BIS central bank survey on CBDCs.

Broadly in line with the motivations covered in the BIS survey, the BoE’s “Discussion Paper: Central Bank Digital Currency Opportunities, challenges and design” (published March 2020) presents 7 key opportunities for CBDCs to support the BoE’s objective of achieving monetary and financial stability:

- Supporting a resilient payments landscape
- Supporting competition, efficiency and innovation in payments
- Meeting future payment needs in a digital economy
- Improving the availability and usability of central bank money
- Addressing the consequences of a decline in cash
- Avoiding the risks of new forms of private money creation
- As a building block for better cross-border payment

However, the arguably most important driver of the BoE’s and other central banks’ efforts to explore and develop CBDCs is missing from the list. It was the payment services industry, providers of alternative payment instruments, issuers of e-money, and FinTechs and BigTechs developing new payment products, new technologies (e.g. DLT) and new business models for improved payment services responding to client needs and the rapidly progressing digitalisation of our economies. The innovative pressure from the most dynamic payment markets was instrumental in the push for central banks to launch of CBDC initiatives.

Accordingly, we urge the BoE and other leading central banks to develop and implement wholesale and retail CBDCs in such a way as to promote the dynamics of payment markets, competition and the innovative impetus they provide. Market-driven innovation delivered a successful overhaul of how payments and money underpin our evolving economies in particular during this ongoing pandemic crisis. The risk of slowing down and fettering future developments driven by the innovative momentum of markets should be avoided.

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

Regarding the potential benefits of the introduction of CBDCs we agree with the BoE assessment that future payment needs in a digital economy have to be met and CBDCs may well assist that objective. More importantly, we also concur with the BoE's analysis of the dire state of cross-border payments. They still are "for many users … expensive, slow, and opaque" (DP, page 19). Here again CBDCs may assist and as the above graph from the BIS survey shows, payments efficiency, both at domestic and international level, ranks high among the motivations of central banks to explore and develop CBDCs.

Accordingly, there appears to be unanimity across all private and public stakeholders that remediation of the persisting flaws of today's payment systems and serving future payment needs are key objectives and key benefits to aim for. However, we are not convinced that it needs CBDCs, more specifically retail CBDCs, to fix the problem. The payments industry has been very successful in meeting rapidly evolving demands of retail and wholesale clients and even the BoE acknowledges "if well designed, stablecoins may be able to meet a clear need for better cross-border payments".

We also concur with the BoE's statement that "… they … introduce risks".[5] However, we are not convinced that it is necessary - in order to contain these risks - to introduce competing retail CBDCs, on top of stringent prudential regulation of evolving payment products currently under consideration combined with new layers of competition rules, interoperability requirements and further tightened supervision and central bank oversight of payment providers and systems (e.g. the ECB's PISA framework).

Central banks in cooperation with other relevant regulatory authorities should prepare for the challenges ahead including those related to the rapid advances of payment technology. However, so far, the tightly regulated payments industry with its particularly strong foothold in the UK has delivered safe and efficient services even during the enormous surge of demand for online payments triggered by the pandemic crisis. There is no evidence that

[5] DP, page 19; discussed in more detail in the BoE's recent paper on "New forms of digital money", published in June 2021

in the absence of competing CBDC products the industry will fail to meet customer demands in the future and further improve domestic and cross-border payment services. We acknowledge that BigTechs entering the payments market may well benefit from swift scale up drawing on their existing client networks. However, stablecoin products are still in their infancy and as the BIS survey found, “most central banks continue to see cryptocurrencies as niche products”.[6]

Given the current state of play, we would remind policy-makers to adhere to regulatory discipline. In the past the test for regulation to be introduced was market failure. In the case of CBDCs so far, neither the market has failed nor any prudential, conduct of business, or competition regulation responding to it. The policy response to the emergence of new payment technologies and stablecoins, in particular, should go step by step and not jump to the issuance of competing CBDCs aimed at “avoiding the risks of new forms of private money creation”. Policymakers should have more trust in their regulatory powers, and the effectiveness of supervision and central bank oversight, but they should also use these powers carefully and based upon fully informed decision-making.

In our view a comprehensive and balanced assessment of all related risks is still missing from the debate. We would highlight in this regard in particular how the issuance of CBDCs would change the role and responsibilities of the BoE. Issuance of retail CBDCs would effectively do away with centuries of traditional central banking, with the strictly two-tier banking and payment systems where central banks are serving as banker to commercial banks. It would require building a new payments infrastructure run by, and under the responsibility of, the BoE. We are grateful that the call for evidence raises the issue in question 8 (for further comments on this issue see our related response).

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

As highlighted before, market-driven innovation delivered a very successful overhaul of how payments and money underpin our economies. Nothing suggests that the pace of market-driven innovation will slow down. The CBDC initiatives centrals banks have been developing over recent years seem to be heavily inspired by the fear that it will and not the concern that it will not. We already quoted the BoE acknowledging that “if well designed, stablecoins may be able to meet a clear need for better cross-border payments”. Fixing the current problems with cross-border payments neither

[6] BIS Papers No 114, Ready, steady, go? – Results of the third BIS survey on central bank digital currency, January 2021, p.12

requires, nor is it a compelling reason for, central banks to issue retail CBDCs.

Further in-depth analysis is needed to assess whether other benefits that can be safely expected from the introduction of retail CBDCs (e.g. improved transmission of central banks' monetary policy) outweigh the related drawbacks and risks (see more detailed comments in our response to question 8).

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

The BoE as an independent public organisation should be particularly rigid when it comes to privacy and the protection of personal data. In this regard traditional legal tender in the form of banknotes and coins sets the bar very high. In contrast, the technology underlying CBDCs offers traceability of payments to the level the BoE should probably not wish to have, may find difficult to resist and by times be expected, and even come under political pressure, to use.

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

At this stage and despite significant efforts of the BoE other key central banks incl. the BIS and its Innovation Hub, we do not believe that the available analysis is sufficiently advanced to allow for informed decision-making. Important aspects of the possible impact of CBCDs have been identified but do not appear to be fully understood. Concerns have been raised regarding the instability of commercial banks' deposit-funding, the possibility of bank-deposits being moved to rapidly scaling up stablecoin ecosystems, or to retail CBDCs issued by central banks; the impact of this instability upon commercial bank lending; a related surge of market-based financing (partly) replacing it, which may or may not be desirable; as a consequence, weakened or, if retail CBDCs are being widely used, possibly strengthened transmission of central banks' monetary policy; with, in turn, consequences on the workings of financial markets. All these aspects of possible, partly contradicting effects of CBDCs on the financial sector have been discussed in the scenario-analyses undertaken so far but a coherent picture of the likely impact has not yet emerged.

Little more than a month ago Benoît Cœuré, Head of the BIS Innovation Hub, a former member of the ECB Board, and hence a most prominent representative of the European and global central banking community, noted: “Central banks need to know where they want to go as they embark on their CBDC journey."[7] A noteworthy statement, which we read as a note of caution. Cœuré is in the lead of the BIS work on the subject and doesn't seem to believe that central banks already know where they want to go or have completed the work needed to embark on the CBDC journey. We share this view.

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

The question raises an important issue that has received little to no attention in central banks' analytical work so far: The impact of the introduction of CBDCs on the payments sector, in particular on non-bank providers of payment services and FinTechs, who currently contribute significantly to healthy competition and innovation, to the development of new payment technologies, improved payment services and related new business models responding to evolving client needs.

So far the focus of central banks' analyses of CBDCs, including that of the BoE, has been upon their impact on commercial banks, how they (and the emerging stablecoin ecosystems) may affect banks' deposit-funding, their lending practices and, as a consequence, the transmission of monetary policy via commercial banks. Going forward the analysis of the possible impact of CBDCs on non-bank payment service providers and FinTechs, and on their relevance for competition and innovation in payment markets should be pursued as a matter of urgency. This analysis would obviously have to include the role of payment service providers in proposed CBDC offerings, the likely need for related investments, the opportunities that might arise as well as any potential negative impact incl. on competition. At this stage it is obvious that the issuance of CBDCs aimed at "avoiding the risks of new forms of private money creation" will have an intended negative impact upon the creation of private money by private companies.

Question 7: How might a CBDC affect monetary policy?

Please refer to our response to Question 5.

Question 8: How might a CBDC change the Bank of England's role and responsibilities?

[7] Central bank digital currency: the future starts today, speech held at the the Eurofi Financial Forum, Ljubljana, Friday 10 September 2021

As set out before, issuance of retail CBDCs by the BoE would effectively amount to doing away with centuries of traditional central banking and the conventional, strictly two-tier, banking and payment systems based upon the central bank serving as the banker to commercial banks. It would require building a new payments infrastructure run by, and under the responsibility of, the BoE. It would turn the BoE into a large-scale provider of payment services to millions of retail clients, competing directly with private service providers (incl. commercial banks) and become (ultimately) responsible for large parts of the retail payments infrastructure. The BoE's risk profile would change dramatically. It would be exposed to significant operational and reputational risks with potentially important contagious effects if supporting services (e.g. wallet services) provided by private companies cause outages.

As already the report of the G7 working group on stablecoins acknowledges[8], "providing the general public with access to central bank money could take a jurisdiction into uncharted waters." The report highlights "the monetary and financial stability risks of (i) instability in commercial bank deposit funding; (ii) fast and large-scale flight towards a central bank; and (iii) ultimately, a greater role for the central bank in allocating economic resources that could give rise to political risks and prove inefficient for an economy."[9] Accordingly, the report concludes: "These risks need to be considered with more practical matters, such as requirements relating to anti-money laundering and countering [terrorist] … financing …, satisfying supervisory and tax regimes,

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[8] Investigating the impact of global stablecoins", October 2019, p. 29

[9] See in more detail: Central bank digital currencies, report by the Committee on Payments and Market Infrastructures - Markets Committee, March 2018, executive summary p. 2:

"Implications are more pronounced for monetary policy transmission and financial markets, especially if a CBDC was to be designed as, or de facto became, an attractive asset. As a liquid and creditworthy asset, a wholesale variant available to institutional investors that would be akin to interest-bearing central bank reserves or reverse repo facilities, yet widely tradeable, could function as a safe asset comparable in nature to short maturity government bills. A general purpose variant could compete with guaranteed bank deposits, with implications for the pricing and composition of banks' funding.

The introduction of a CBDC would raise fundamental issues that go far beyond payment systems and monetary policy transmission and implementation. A general purpose CBDC could give rise to higher instability of commercial bank deposit funding. Even if designed primarily with payment purposes in mind, in periods of stress a flight towards the central bank may occur on a fast and large scale, challenging commercial banks and the central bank to manage such situations. Introducing a CBDC could result in a wider presence of central banks in financial systems. This, in turn, could mean a greater role for central banks in allocating economic resources, which could entail overall economic losses should such entities be less efficient than the private sector in allocating resources. It could move central banks into uncharted territory and could also lead to greater political interference.

For currencies that are widely used in cross-border transactions, all the considerations outlined above would apply with added force, especially during times of generalised flight to safety. The introduction of a CBDC in one jurisdiction could adversely affect others. Central banks that have introduced or are seeking to introduce a CBDC should consider cross-border issues where relevant.

Any steps towards the possible launch of a CBDC should be subject to careful and thorough consideration. Further research on the possible effects on interest rates, the structure of intermediation, financial stability and financial supervision is warranted. The effects on movements in exchange rates and other asset prices remain largely unknown and also deserve further exploration.

and having the legal authority to issue a CBDC. A CBDC entails huge operational consequences for central banks in implementing monetary policy as well as implications for the stability of the financial system."[10]

In the same vain Benoît Cœuré stated in the recent speech quoted above: "Across the world, central banks are coming together to focus on their common mission. Charged with stability, they will not rush. They want to move fast, but not to break things. … To build a CBDC for the public, a central bank needs to understand what they need, and work closely with other authorities."

Earlier on in his speech he listed some of the key questions that still need to be answered:

"Will the new players complement or crowd out commercial banks? Should central banks open accounts to these new players, and under which regulatory conditions? Which kind of financial intermediation do we need to fund investment and the green transformation? How should public and private money coexist in new ecosystems – … ?"

It's not just the BoE and central banks worldwide that need to know where they want to go as they embark on the CBDC journey. This journey has far-reaching consequences and the CBDC debate needs to engage the UK society at large.

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

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?

The introduction of CBDCs is not just a question of policy-making and better regulation informed ideally by the broadest possible consultation of all relevant stakeholders. Issuing CBDCs will fundamentally change the role

[10] See also Carstens p.7 "The introduction of retail CBDCs would represent a complete sea-change. … Most importantly, retail CBDCs would raise issues similar to those that would arise if ordinary citizens were to gain access to the central bank's balance sheet. Imagine if anybody could open an account at the central bank, and have a debit card for that account. If this were to become widespread, the central bank's footprint on the payment system and the wider economy would widen. In extreme cases, the central bank could become the one-stop banker for almost everybody in the economy. … The risks and operational costs for the central bank could be daunting. If the central bank becomes everybody's deposit-taker, it may find itself becoming everybody's lender too. The question of whether the central bank should provide access to its balance sheet via accounts or by issuing retail CBDCs is secondary. Either way, the central bank could crowd out private intermediaries. …"

and responsibilities of the BoE (and other central banks world-wide). Important parts of the national and international infrastructure for retail payments may end up being run by central banks potentially accumulating considerable power over a digitalized national and increasingly internationally integrated financial and economic system. Such a move would raise fundamental questions regarding the governance to be built around the issuance of CBDCs not least with a view to novel risks of political interference with central bank policies (see above). At the same time CBDCs and competing and/or incompatible CBDC systems may well affect economic foreign policies and open new channels for the geopolitical influence of different countries and economic areas; developments, which are extremely difficult to predict and respond to.

Policy-decisions regarding the introduction and design of CBDCs, including in particular whether an end should be put to the traditional strictly two-tier payments and banking system, require careful consideration and every effort to engage with the public for the broadest possible consultation on all relevant aspects.