ICAEW
REPRESENTATION 16/24

REGULATORY REGIME FOR SYSTEMIC PAYMENT SYSTEMS USING STABLECOINS AND RELATED SERVICE PROVIDERS

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ICAEW welcomes the opportunity to comment on the Regulatory regime for systemic payment systems using stablecoins and related service providers published by the Bank of England on 6 November 2023, a copy of which is available from this link.

For questions or comments on this response, please contact ICAEW's Financial Services Faculty on fsf@icaew.com.

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EXECUTIVE SUMMARY

Tax and financial reporting implications and impact on singleness of money

1. We think it is important for the Bank of England to consider the tax and financial reporting implications that might apply to stablecoins and importantly whether they will impact upon the “singleness” of money. Stablecoin assets or related transactions being different from other forms of money in how they are reported for financial reporting purposes or different tax treatments may be impediments to their fungibility. Taken to its extreme the implications could be significant, impacting upon adoption and uptake, redeemability at par value and the behaviour of holders in times of market stress.
2. From a financial reporting perspective, understanding how stablecoins are recognised, measured, presented, and disclosed under applicable accounting standards is crucial. The contractual arrangements between issuers, custodians, wallet providers, and stablecoin holders play a pivotal role in determining their classification as inventory, intangibles, or financial assets and importantly whether they would meet the definition of cash and cash equivalents. The impact of such classification extends to disclosure requirements, measurement basis (fair value vs. cost less amortization and impairment), and the reporting of gains and losses.
3. HMRC's current position categorises cryptoassets, including stablecoins, as not falling under the definition of cash, money, or currency. This non-currency status has significant tax implications, as stablecoins may not qualify for the tax exemptions associated with traditional currencies. For example, using sterling-pegged stablecoins for day-to-day expenditures could trigger reporting obligations, capital gains tax for UK resident individuals, and potential chargeable gains or allowable losses. This disparity between public expectations and tax obligations underscores the importance of aligning regulatory and accounting treatment to ensure a coherent and predictable financial environment.

Importance of assessing appropriateness of Safeguarding regime for systemic stablecoins

4. Safeguarding regime needs to reflect the unique risks of stablecoins and we believe the Bank should to consider mandating annual assurance by a skilled third party, supported by detailed rules for assurance practitioners.
5. Unique risks include the presence of both a backing asset and minted stablecoins which will be subject to differing frequencies of movement, and circulation between different custodial intermediaries. Furthermore, there is the risk of misappropriation around access to private keys.
6. We recommend further consideration is given to the scope of third party assurance over both the safeguarding of the stablecoins and custody arrangements relating to the backing assets.

Regime constraints and business model feasibility

7. The constraints discussed in the proposals including holding limits, restrictions on seniorage, redemption fees, and backing assets raise questions about the commercial feasibility of business models that look to issue or provide related stablecoin services. Unlike commercial banks that offer free transactional banking to consumers using bank deposits for funding and earning interchange fees, stablecoin issuers may struggle to compete. Restrictions may also limit potential use cases, such as in the settlement and clearing of large trades.
8. That being said, we acknowledge that the introduction of a systemic stablecoin unfettered could pose a significant risk from a financial stability and monetary policy perspective and so a sensible balance needs to be struck. One that moves cautiously at first to understand the fuller implications of introducing potentially systemic alternatives to the current forms of money.

DISCUSSION QUESTIONS

2. Do you have views on further requirements that may be needed to ensure the singleness of money when stablecoins are traded in secondary markets?

Importance of considering tax implications

9. The tax implications of disposing of stablecoins are often overlooked or misunderstood and could impact upon the Bank's objective to retain the singleness of money.

10. Under the current tax rules, as illustrated below, making payments using stablecoins will give rise to a taxable event.

11. Whilst it is for HMRC to determine the tax treatment of stablecoins, the Bank might need to consider whether the tax treatment has any implications on the creation of a regulated stablecoin regime. For example, whether the Bank should require the issuer to highlight in disclosures to holders that there may be tax implications when transacting in stablecoins. Specific consideration may be required as there is a likely expectation that they are treated as cash for tax purposes which might not be the case.

12. While currently there is no specific HMRC guidance, the Bank should consider consulting HMRC to better understand the tax treatment and implications, including if specific tax guidance on the use of stablecoins should be published in HMRC's cryptoasset manual.

13. HMRC's current position is that cryptoassets (including stablecoins) are not cash, money or currency. As stablecoins are not treated as "currency" for tax purposes, any exemptions for currency do not apply. For example, this would mean that disposals of stablecoins would be within the scope of (typically capital gains tax for UK resident individuals) reporting requirements and any gains would be chargeable and losses allowable. Note that "disposal" is a broad term which includes using stablecoins in exchange for goods and services.

14. This means that reporting obligations could arise if stablecoins are used for day-to-day purposes. Despite the fact that a tax change could arise, it is likely that the general public would assume such transactions to be the same as using sterling cash, such that no tax obligations would arise. On the assumption that any sterling based stablecoins retain parity with pounds sterling the risk of a tax charge arising is small (though, as noted) reporting may still be required.

15. However, for non-sterling stablecoins, there is a significant risk that the use of these could give rise to a tax charge as it is common for foreign currency to fluctuate against sterling, giving rise to gains (or losses) due to exchange rate movements. Exemptions from tax that apply to foreign currency cannot apply, including the exemptions for foreign currency bank accounts and for foreign currency acquired for personal use abroad (but not in the UK).

16. The tax reporting position and potential for chargeable gains and allowable losses to arise could have significant impact on individuals. This includes any individual employees who are paid in stablecoins. Where this is the case, the value of stablecoins received as payment for services would be subject to income tax at the time of receipt. There will then be a further disposal (and consequent tax reporting obligations) arising on the disposal of any stablecoins, potentially leading to further tax being payable. For businesses, using non-sterling backed stablecoins this may increase complexity if goods and services frequently need to be repriced due to foreign exchange movements.

Importance of considering accounting treatment

17. The consultation does not include a discussion about the potential accounting treatment of the stablecoins that the DP contemplates and we are unclear if the regulators envisage or desire a particular accounting treatment (whether that be for holders of stablecoins, issuers or others).

18. We would like to highlight the importance of understanding the implications of the regimes design on financial reporting and in particular how stablecoins might be recognised, measured, presented and disclosed under applicable accounting standards.

19. The facts and circumstances of the contractual arrangements in place between issuers, custodians, wallet providers and ultimately the holder of stablecoins would affect the stablecoins being reported as inventory, intangibles, or financial assets (including cash or cash equivalents).
20. Each of these classifications comes with a range of different disclosure obligations, differing basis for measurement (fair value vs cost less accumulated amortisation and impairment) and reporting of gains and losses.
21. It is unknown at this stage whether differing treatment for financial reporting purposes would impact upon its qualities that would make it comparable with fiat or commercial bank deposits and therefore may impact upon the “singleness” of money. For example, where a bank holds stablecoins, recognising them as an intangible asset or a financial asset could have regulatory capital implications, and could also impact collateral considerations such as whether such assets constitute High Quality Liquid Assets (HQLA).
22. Accounting classifications may impact the potential acceptability of stablecoins by merchants and retailers where their financial reporting classification differs dramatically when compared to more traditional forms of fiat or private money. If, for example, a large retailer was forced to account for transactions involving stablecoins as an intangible asset, this would impact reported profits, the make-up of the balance sheet and the mix of cash and other assets. Further where firms are financed through debt there maybe implications depending on how loans are structured and the covenants agreed between lender and borrower.

Risks to redemption

23. The accounting policy implications reveal a far more important point from the perspective of a stablecoin holder. For example, in order to recognise an asset as a financial asset under IFRS 9 Financial Instruments, among other considerations, the holder needs to have an unconditional right to exchange the stablecoin for cash or another financial asset. Therefore, understanding the rights and obligations to exchange for cash / financial assets is key.
24. We understand in the past with some existing stablecoins (Tether and USDC) this right has not been unconditional and has been determined to some extent by whether the stablecoin holder has acquired the stablecoin a) directly from an issuer, or b) on the secondary market. Or alternatively whom the holder is i.e. an individual or an exchange.
25. When the stablecoin has been acquired from the secondary market, the holder no longer has direct recourse to the issuer to redeem the assets backing them (i.e., cash), meaning the holder’s ability to convert it into cash or another financial asset is contingent on the secondary market. This gives rise to additional market risk: the unpredictable behaviour of investors in stressed scenarios who have access to markets rather than the ability to redeem the underlying asset backing the stablecoin.
26. This might arise in cases where the custodian or wallet provider have specified different contractual obligations with the stablecoin holder and so provide for beneficial, rather than legal, rights to the stablecoin.

Stablecoins as cash or cash equivalent

27. It is unclear whether any stablecoins will meet the definition of cash or cash equivalents and this may even be the case where it becomes more accepted as an alternative to legal tender.
28. Challenges to classification as cash include the fact that stablecoins do not have the characteristics of traditional demand deposits, or fiat money such as a claim on a regulated deposit taker or central bank.
29. One determining factor for cash equivalent classification will be whether the stablecoin is subject to insignificant risk in change of value. We believe that this is more likely in scenarios where the assets backing them are reserves held by a central bank. However, even in that scenario, this is not guaranteed because another requirement is the ability to redeem on demand which could be frustrated by the contractual rights stablecoin holders hold.

30. Conditions that mean that redemption is not at the discretion of the issuer would impact the possibility to classify the stablecoin as cash or cash equivalent. If there are contractual limitations on the redemption which are outside of the issuer's control, further legal advice may be required. Stablecoin holders would need to consider the contractual rights of the stablecoin, the ability to redeem the stablecoin and its legal form, laws and regulations, as well as collateralisation and counterparty risk.

31. There are also wider considerations that may directly affect the measurement of stablecoins as a financial asset, for example, cases where there is insufficient collateral or the stablecoin is not pegged 1:1, or where redemption is illiquid. These wider considerations could also affect the classification if, for example, they render the stablecoin not having rights of recourse.

Rights to redemption

32. Considering the above, we would encourage the regulator to consider parameters within the regime that might protect the redemption rights of stablecoin holders. Options should be explored to consider how issuers and intermediaries are prohibited from interfering with the contractual rights to redemption for the underlying assets backing them, irrespective of whether the stablecoin is newly issued or in circulation.

33. We caveat that this may create an onus on intermediaries to construct contracts in such a way that impacts upon particular offerings including omnibus accounts and different types of wallets. We understand that a balance needs to be struck between consumer protections and the ability of the market to innovate.

34. We advocate for the trust model to custody of client assets, reducing the issues that might arise should instead the stablecoins or the underlying assets be classified as the debt of the issuer or a liability of the custodian.

35. The Bank is encouraged to explore all possible frictions to redemption be those operational or legal to ensure all scenarios are considered.

36. We would also encourage further consideration in respect of the ease with which the stablecoin can be exchanged or transferred between different parties as a consequence of the regulatory framework. For example, how might private firms navigate potential holding limits and other restrictions. This might also be relevant when considering proposals for a Digital Pound.

37. Some regulated stablecoins may incorporate governance features that grant holders certain rights, such as the ability to vote on protocol upgrades or changes. We would encourage further analysis to consider how different setups could impact upon legal and beneficial control and ownership rights and obligations as these could give rise to other assets and liabilities that would need accounting for.

38. Should you wish to discuss the accounting implications of the proposals in more detail we are ready to provide whatever assistance you may require.

5. Do you agree with the Bank's proposed approach to the regulatory framework for systemic payment stablecoins, as set out in Section 2?

39. In addressing the Bank of England's effort to establish a regulatory regime for systemic payment systems using stablecoins, it is crucial to advocate for coherence between the regulatory frameworks set forth by the Financial Conduct Authority (FCA) and the Bank. It's important to note that the transition from non-systemic to systemic may not be within the issuers control.

40. A harmonious alignment between the two regimes is essential, one which avoids a substantial shift or abrupt change to firms transitioning from non-systemic to systemic.

41. Furthermore, there is a need for transparency in the assessment process for determining a systemic payment system using stablecoins. Which includes a clear delineation of the steps that firms must undertake when transitioning between the two regimes. Any ambiguity or a

substantial shift in the transition process could create formidable barriers for firms, potentially hindering their ability to move between regimes. Such barriers could have adverse effects on competition, innovation, and may impose unnecessary costs on market participants.

42. The Bank's proposals currently assume the ability to identify systemic characteristics at the inception, predominantly focusing on the use of Sterling stablecoins within a systemic payment system. While these assumptions appear reasonable, it is crucial to recognize the nascent nature of the stablecoin market. Authorities should exercise flexibility in their proposals to accommodate a spectrum of eventualities that may unfold as the stablecoin market matures.

43. As an illustrative example, there is a notable shift observed for firms providing Sterling-based stablecoins. In the scenario where an FCA-authorized stablecoin is later determined to be part of a systemic payment system, the requirement to replace all backing assets with Bank of England reserves, without earning interest, could pose a considerable challenge. This adjustment could significantly impact the business model of a stablecoin issuer, potentially rendering it economically unviable, especially if the primary income stream relies on interest from backing assets.

17. Do you have views on the Bank's proposed safeguarding regime being centred on two key features (statutory trust in favour of coinholders; and safeguarding rules)?

Importance of assessing appropriateness of safeguarding regime for systemic stablecoins

44. One unique aspect of stablecoins, which distinguishes them from traditional client money arrangements, is the presence of two distinct assets that require safeguarding. The first is the backing asset, typically central bank reserves in the case of systemic stablecoins. The second is the issued coin, referencing the backing asset.

45. Movement frequency between counterparties differs significantly for these two assets. Backing assets ideally move in and out of custody only during stablecoin minting and redemption. As markets mature, it is anticipated that these activities will decrease, with stablecoins increasingly adopted for payments and remaining in circulation for longer periods.

46. Conversely, stablecoins themselves are expected to circulate frequently among individuals, businesses, and custodial intermediaries, similar to traditional forms of money in the economy. Consequently, we may find that between the two custodial activities the greater potential risks around misappropriation relate to the stablecoins in circulation.

47. An essential area needing clarification pertains to how the two custody activities and their associated regulatory requirements interact, especially across the stablecoin lifecycle—from issuance and circulation as a payment alternative to redemption back into fiat. We strongly urge the Bank to consider this context when establishing a safeguarding regime.

48. The absence of a clear assurance framework could lead to poorer quality audits that undermine the quality and robustness of assurance engagements. We advocate that the assurance standards for safeguarding are at least as comprehensive as those related to the safe custody of the backing assets.

Client assets audit

49. There is an opportunity here to be more prescriptive about the extent and nature of assurance required. This is to avoid high level analysis which is not fit for purpose being obtained in place of true assurance. System and Organisation Controls 1 (SOC1) and International Standards on Assurance Engagements 3000 (ISAE 3000) would be a good starting point for building out an assurance framework.

50. Whilst we believe that it would be beneficial that a cryptoassets custodian be subject to an annual audit carried out by an independent external auditor, there is no current auditing standard that would provide a basis for the conduct of the audit. In the absence of an

auditing standard there is a risk that any audit is not undertaking to a sufficient standard, and that audits are not undertaken consistently across auditors.

51. The Financial Reporting Council's auditing standard for CASS could provide a good starting point, but the standard would specifically need to include blockchain considerations, and that auditors would need to ensure they have the adequate skills and tools to carry out an audit on a distributed ledger technologies (DLT).

52. We think that a point in time assessment as one component of assurance (similar to CASS) would allow flexibility in using data analytics to validate the point in time as opposed to a purely controls based assessment. This should always be coupled with a governance and controls-based assurance for the period which provides greater comfort over the ongoing systems around the custody services.

53. We think that it is important that expectations are very clear in all areas, especially for technology and security protections around systems and keys. These will be incremental to the existing CASS requirements. It should be acknowledged that this risk is very broad, and it is not possible to have assurance controls covering all of these risks. Which risks are and are not subject to the assurance regime will be key.

54. Controls based requirements are key and a balance between controls-based assurance and data driven analytics would need to be considered.

18. Do you think there are any other features that need to be reflected in the safeguarding regime for systemic payment stablecoins?

Proposals on accurate books and records

55. Sacrosanct is the requirement to maintain accurate books and records. Where on-chain records are used as internal records, finality of settlement is a key consideration. Controls will need to be put in place to identify the point where a stablecoin transaction becomes immutable and is held in custody.

56. If firms are using only on-chain records, it is not clear how they would record ownership for clients. For example, would firms need to maintain an off-chain record in order to reconcile the assets held on chain (where ownership of the asset is shown as belonging to the firm, as the firm holds the private keys) to the firm's books and records (which would reflect the client's ownership of the asset). We will need a regime that deals with offline, hard wallets and all of the other evidential challenges that might be a way for an organisation to try to argue that it's not possible in their specific and no doubt unique environment.

57. We suggest that the CASS 6 Internal System Evaluation Method be used to allow firms to establish a process that evaluates the completeness and accuracy of a firm's internal records for stablecoin custody. The evaluation process would need to address the risk of data flows and interactions between on-chain and off-chain systems from upstream to the ultimate internal downstream books and records system.

Key controls

58. We think that custodians holding clients' stablecoins must establish key controls around their end-to-end systems and processes, especially when external or public (DLT) are used, and that they must have robust internal IT governance controls.

59. Whilst DLT increases the reliability of data, it should be noted that cyber security is still a threat, with custodians facing higher vulnerability to hackers. We suggest there are multiple scheduled data backups be made daily for both on-chain and off-chain records to help manage the risk of potential significant data loss.

60. We are aware that some firms, due to operational reasons, might be using cold wallets for their cryptocurrencies which are not connected to the internet and are used for storing private keys offline. The records from these wallets should be regularly backed up in a routine

manner. Firms should assess and have a framework for monitoring and managing DLT-related operational risks.

61. Additional points that we think should be considered are:
    - that there needs to be clear legislation so that firms cannot avoid their responsibility for loss; and
    - there should be a requirement for stablecoin custodians to have insurance arrangements protecting them against the risk of loss (noting that this is currently being proposed in other jurisdictions' stablecoin custody regimes).

Client disclosures and statements

62. Further disclosures specific to the underlying blockchain technology may be required, such as:
    - the Blockchain security protocols in place (eg. Multi-party computation or multi-party signature); or
    - the Omnibus structure in place.

63. The provision of periodic statements by custodians to each of their clients on the stablecoins held for that client, and providing clients with a statement of account with information on their transactions would be helpful. Providing a proof of reserves as part of this would give clients comfort that the custodian will be able to honour withdrawals at all times, and that their stablecoins are safe because the firm has enough assets of its own to cover client deposits, i.e. it is sufficiently liquid and solvent. There would, however, need to be clarity around how frequent the provision of a proof of reserves would be required, and clarity around the audit methodology required to verify the reserves.

64. In addition to providing this proof of reserves to clients, it may increase transparency further if firms are required to maintain a real-time track of reserves and make this available on their website.