Bank of England publishes discussion paper on innovations in money and payments

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On 30 July 2024, the Bank of England (BoE) published a discussion paper setting out its approach to innovations in money and payments (Discussion Paper). In the Discussion Paper, the BoE sets out its current view on innovations in the payments industry, providing insight into its thoughts on DLT, tokenised deposits and stablecoins. The BoE takes a very cautious view of the development of private money for the wholesale use case, citing threats to financial stability and the singleness of money. At the same time, the BoE expresses a strong view that central bank money continues to have a vital role as a force for stability within the financial system. However, significant questions around the direction of future regulation remain unanswered.

Key takeaways

- Despite increasing levels of digitalisation, the BoE still sees an important role for central bank money in maintaining both the singleness of money and settlement finality as cornerstones of monetary and financial stability.
- However, the BoE recognises that central bank money must keep pace with technological advances in financial markets to avoid a significant increase in the use of private settlement assets.
- To this end, it proposes two developments – further improvements to the Real Time Gross Settlement (RTGS) system as part of its RTGS Future Roadmap, and exploring the issuance of a wholesale central bank digital currency (wCBDC).
- The BoE's attitude towards innovations in private money is very cautious, but it acknowledges that distributed ledger technology (DLT) has the potential to improve markets and highlights tokenised deposits, stablecoins and use of smart contracts as three use cases of particular interest.

What's next?

The Bank would welcome views on both the overall proposed approach and a number of specific areas, as outlined in the Discussion Paper. The deadline for responding is 31 October 2024.

Read on for a more detailed look at the Discussion Paper, including an outline of some unresolved questions resulting from the BoE's proposals.

Overview of the Discussion Paper

The Discussion Paper largely focusses on the critical role that the BoE still sees for central bank money in an economy with increasing levels of digitalisation and different forms of private digital money. The BoE emphasises the importance of preserving the singleness of money and the finality of settlement, whilst also expressing its concerns over the potential use of private money such as stablecoins and commercial bank money as settlement assets. Whilst private money is important for credit creation, fostering innovation and promoting competition in financial markets, the BoE highlights the significant and complementary role which public money plays in promoting financial stability and, by extension, trust in the economy.

Why does this matter?

As a Discussion Paper, the BoE does not make commitments in terms of the future direction of policy in this space. However, the Discussion Paper is a good indication of the BoE's current thinking, and presents an opportunity for industry participants to contribute and to shape the narrative from the ground floor, while the BoE is in relatively early stages of exploring the use of DLT and programmable platforms.

From a broader perspective, the Discussion Paper underscores the need for interoperability to enable DLT adoption at scale within financial services. The BoE expresses the need for central banks to keep pace with technological advances, including the use of DLT and tokenisation, to:

- allow for effective interaction between central bank money and DLT platforms operated by other participants in the financial markets; and
- discourage a shift from settlement in central bank money to private money (thus resulting in financial stability risks and potentially undermining the singleness of money).

The BoE further notes and welcomes feedback on its proposed programme of experiments, one of which involves working with other central banks and private banks as part of the BIS Project Agora to explore a unified global ledger involving multiple currencies, where tokenised bank deposits and central bank money may be exchanged on a single platform.

The significance of interoperability in order for the future financial system to fully benefit from the opportunities offered by DLT is echoed in the vision of the "Finternet" shared in a BIS Working Paper earlier this year—the Finternet envisages a system where multiple financial ecosystems are interconnected with each other, much like the internet, and is made up of "unified ledgers" where types of tokenised assets are brought together into a single programmable platform (see our Engage article for further details on the Finternet). Notably, the BIS Working Paper highlights that although any financial asset can be represented on unified ledgers, "*tokenised money is a core requirement*". Therefore, the proposals of the BoE to explore the topic of synchronisation and other innovations in wholesale central bank money are an encouraging sign of potential development in this space.

Innovation in payments and settlement

The Discussion Paper focuses on innovations in the money and payments space, such as the use of programmable platforms, including those based on DLT — such programmable systems would involve the use of smart contracts in DLT systems to automate certain actions within financial contracts (e.g.

paying bond coupons) and combining such smart contacts to enable a more diverse suite of functionality and/or services.

The BoE acknowledges that DLT has the potential to improve markets by speeding up the process of settlement, which would improve the speed of capital movement and reduce credit risk exposure. It could also lower costs by reducing the need for manual reconciliations and facilitate more fractional ownership of assets, increasing their liquidity.

Additionally, there are two uses of DLT in the context of private money or settlement assets that can be represented on programmable platforms, which the BoE highlights as being of particular interest:

1. Tokenised deposits (i.e. deposit claims represented on programmable platforms); and
2. Stablecoins (i.e. private settlement assets which could be represented on a programmable ledger, which purport to maintain a stable value relative to a fiat currency).

Tokenised deposits

The BoE notes that there are two ways in which tokenised deposits could operate. They could be non-transferable deposit claims, which require settlement in central bank money upon transfer, or transferable deposit claims, which are self-settling and under which transfers lead to the recipient becoming a customer of the issuing entity.

In terms of the regulatory approach to tokenised deposits, in accordance with the 2023 'Dear CEO' letter (see here for our previous Engage article on this development), the PRA has said that it expects deposit-takers who innovate with tokenised deposits to continue to ensure that their tokenised deposits meet the PRA's eligibility rules for the Financial Services Compensation Scheme (FSCS). Where the underlying economics of the deposit are not changed, the PRA will treat the tokenised deposit in the same way as a traditional deposit.

Stablecoins

The Discussion Paper takes a very conservative approach to stablecoins, with the BoE stating that "*current stablecoins do not meet the standards the Bank would expect were they to be used for payments more widely*".

The BoE is particularly concerned about the *"significant financial stability risks*" posed by the use of stablecoins in wholesale transactions. In the event wholesale market participants turn to stablecoins in times of financial stress, this could lead to sudden bank disintermediation at scale, thus further destabilising the financial system. As such, the BoE considers the stability risk of wholesale stablecoins to be an "*order of magnitude greater*" than that of a retail stablecoin. The BoE has published a discussion paper setting out a proposed regulatory regime to facilitate using stablecoins on a systemic scale for retail payments (for further details, see our Engage article here). These include proposed holding limits which would prevent the wholesale use of stablecoins at a systemic scale, as well as requirements on issuers to back 1:1 with central bank money, and not paying interest on central bank deposits backing stablecoins.

Notwithstanding the above, the BoE will continue to explore the financial stability implications of the use of stablecoins in wholesale transactions.

DLT in financial markets

The Discussion Paper sets out the potential benefits of the use of DLT, but also recognises that there are challenges to such technologies being realised at scale in the financial markets. The BoE cites two main reasons:

- Firstly, wholesale financial markets are typically high trust environments, involving regulated institutions and centralised infrastructures, whereas DLT is a technology which primarily facilitates transactions between parties in an otherwise low trust environment. As such, the BoE claims that central banks and market infrastructure would still be necessary to overcome the issues of trust, which restricts the potential gains from using DLT.
- Secondly, DLT requires multiple parties to independently verify the ledger, which may make it less scalable than a ledger held by a single entity. The BoE is unclear on whether financial markets would find the use of programmable platforms more attractive than traditional infrastructures to adopt such technologies at scale.

Nevertheless, the BoE recognises the need to prepare for the potential widespread adoption of DLT.

BoE caution around payment innovations

Throughout the Discussion Paper, the BoE expresses concerns about the financial stability risks it perceives from an overreliance on private money (e.g. commercial bank money) as a settlement asset. There is a strong concern about systemic stress leading to a loss of confidence in commercial bank money (and the singleness of money), as well as the compounding effects of stress to private money systems combined with liquidity pressures likely to be faced by financial institutions at the same time. This would risk a contagion effect that destabilises other participants in the financial system, as well as households and business more broadly.

Conversely, the BoE emphasises the importance of central bank money for settlements, referring to it as an "*anchor for confidence in the financial system*". As a result, the BoE describes itself as having a "*low risk appetite for a significant shift away from settlement in central bank money towards commercial bank money and other forms of private money*".

The continued importance of central bank money

Given that central bank money functions as a claim over the central bank and is effectively risk-free, the BoE stresses the importance of striking an appropriate balance between the use of private money and central bank money as a settlement asset. The BoE has proposed two developments to ensure that central bank money remains competitive and keeps pace with technological developments – further improvements to the RTGS system, and exploring the issuance of a central bank digital currency.

Further RTGS system improvements

The BoE's current programme of work to deliver a renewed RTGS service – including a new core ledger and new features and capabilities - is almost complete. Improving the RTGS system further as part of the RTGS Future Roadmap will involve, among other things:

- extending the settlement hours for the RTGS system; and
- facilitating connection with external ledgers through "synchronisation", including overseas RTGS systems, entities such as the Land Registry, and distributed ledgers. "Synchronisation" is an approach to settlement whereby an asset is transferred from one party to another on an external platform, and the corresponding cash transfer is carried out on the RTGS system. The two legs of the trade are set up to be mutually conditional (or "atomic"). This has already been successfully tested through Project Meridian, with testing in relation to FX transactions planned.

It is also worth noting that the BoE is exploring policies to increase access to central bank money, including by increasing direct participation in CHAPS.

Exploration of a central bank digital currency (CBDC)

The Discussion Paper proposes a programme of experiments in relation to wCBDC, which the BoE envisages as "*a new platform for the distribution of wholesale central bank money*". A wCBDC approach would allow for tokenised assets and tokenised central bank money to be exchanged on DLT rails. The Discussion Paper notes that central banks have provided wholesale central bank money to commercial banks for several decades in digital form through RTGS accounts — accordingly, a wCBDC would be expected to have identical economic status to money created otherwise by the BoE through RTGS systems, and would avoid violating the principle of the singleness of money.

At the same time the BoE and His Majesty's Treasury are also exploring the concept of a retail CBDC, which would complement other payment mechanisms as a new form of digital money. In accordance with the BoE's consultation paper in February 2023 (see our previous Engage article here for further details), a retail CBDC would offer an additional option to the public for holding central bank money for use in everyday payments, while also preserving the singleness of money.

Unresolved questions

- The distinction between wholesale and retail payments. The BoE has yet to decide on the criteria it will use for distinguishing between types of payments – whether it will be determined by the parties (between individuals and businesses vs between financial institutions) or by using a value threshold.
- How the BoE intends to regulation tokenised deposits that "change the underlying economics and fundamental nature of a depositor's claim", and how it will assess whether the economics and nature are sufficiently different from a traditional deposit.
- Whether the BoE intends to issue a CBDC, and if so, what type (e.g. wholesale and/or retail), as well as how such CBDCs would be designed (e.g. whether such a wCBDC would be digitally native, or a tokenised version of units of central bank money in RTGS).

Next steps

- HM Treasury will publish the National Payments Vision in due course, which will set out the government's overall ambitions for payments in the UK.
- The BoE has proposed a number of experiments to test how it could facilitate delivery vs payment securities transactions, payment vs payment foreign exchange transactions, and interoperability with global ledger initiatives. The Discussion Paper contains more detail on some proposals and welcomes feedback.
- The Bank would welcome views on both the overall proposed approach and a specific number of areas, as outlined in the Discussion Paper. The deadline for responding is 31 October 2024.
- As the UK regulators continue their efforts to clarify the regulatory frameworks that will apply to each form of digital money and money-like instrument, we have published a short comparative guide, including what these instruments are and how they may be used in practice, as well as an overview of the relevant regulatory regimes.

For more information, please contact a member of the team or visit the Hogan Lovells Digital Assets and Blockchain Hub.

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