Position Paper

Considerations for a retail Digital Euro

12 January 2021

I. Introduction

The Association for Financial Markets in Europe (AFME) and the Global Foreign Exchange Division (GFXD) of the Global Financial Markets Association (the Associations)[1] welcome the opportunity to engage in discussion on the implications of introducing a Digital Euro for retail payments in Europe.

We note the ongoing analysis into the benefits of Central Bank Digital Currencies (CBDCs) across many jurisdictions, including the European Central Bank (ECB) public consultation on a retail Digital Euro[2]. We want to ensure that the analysis considers the important interplay between retail payments (by individuals and corporates), including payments across geographical borders, and the wholesale financial markets that support this activity.

Based on our own analysis, we have considered several overriding themes that should be upheld in proposing or creating a retail Digital Euro, in order to protect end users and wider financial stability, whilst driving greater efficiencies. We recommend that a retail digital Euro should:

- Be interoperable with existing market infrastructures and processes;
- Identify and mitigate any new or additional risks to the global financial system;
- Not create undue disruption to existing wholesale financial markets, including the provision of liquidity and settlement;
- Provide benefits when compared to using physical cash/electronic transfers; and
- Promote innovation for new services and propositions following implementation.

In this paper, we first provide background on the importance of wholesale financial markets to the wider financial system. We then provide some wider considerations on implementing a retail Digital Euro and on how its use could impact wholesale financial markets. We conclude by emphasising the need for further evaluation and collaboration between the private and public sector to examine unresolved issues in the introduction of a retail Digital Euro, such as implications for intermediaries or practical implementation considerations.

II. Background

Wholesale financial markets play an important role in providing the funding and liquidity needed for retail payments to occur. Very often, wholesale bank-to-bank transfers of a currency encompass payments in respect of both wholesale and retail underlying financial transactions.

Where payments are made overseas, there are also cross-border elements to consider. For instance, a European corporate may need, through their central Treasury function, to fund their firmwide payment obligations globally by accessing the wholesale Foreign Exchange (FX) markets to obtain the local currencies required. Settlement of payments could occur via differing methods, for example through small value faster payments systems or more traditional wholesale high value payment "rails" or settlement models.

Further, FX markets in particular have important interplays with other wholesale financial markets. For example, sovereign entities, central banks and other government-sponsored entities rely on the FX market to be well-functioning and liquid, and corporations and investors regularly participate in the market for important operational needs:

- To reduce risk by hedging currency exposures;

[1] See Appendix A for descriptions of the Associations
[2] https://www.ecb.europa.eu/euro/shared/files/Questionnaire_on_a_digital_euro.pdf

- To pay suppliers and to be paid for services outside their home market;
- To convert their returns from international investments into domestic currencies; and
- To make cross-border investments and raise funding outside home markets.

As such, in order to avoid any unintentional wider impacts to the currently well-functioning wholesale financial markets, including the operation of domestic capital markets, we believe that there is merit in considering any potential wholesale implications in the ongoing retail Digital Euro discussion.

We look forward to engaging with regulators, supervisors and other market participants on these types of considerations and other topics raised in this paper.

III. Considerations relevant to wholesale financial markets with the introduction of a retail Digital Euro

The ECB's Report on a Digital Euro[3] notes there are several potential forms a retail Digital Euro could take. We therefore thought it would be useful to identify a series of parameters which we have used as a basis for determining the possible impacts on wholesale financial markets. Please note these parameters are based on our interpretation of the ECB Report. These are:

- The retail Digital Euro will be used for retail payments only, noting a question remains on whether a retail Digital Euro may be used by a retail market participant to fund the purchase or sale of a financial instrument, or to settle any subsequent cash flows;
- Intermediaries will be used to distribute and store retail Digital Euros (though with the legal claim on the CBDC to the ECB) and administer retail Digital Euro transactions, including performing 'know your client' (KYC) services;
- Intermediaries will segregate any retail Digital Euro they hold for ultimate owners of the CBDC from their own balance sheets;
- The retail Digital Euro will allow for 24/7 immediately-settled payments; and
- The retail Digital Euro will operate in parallel to existing traditional 'paper' Euro infrastructure.

The remainder of Section III outlines potential impacts from the introduction of a retail Digital Euro on market operation and governance of European wholesale financial markets.

<u>Market Operation</u>

First, we believe that consideration should be given to the business case and to who will fund the development, delivery, and any operational costs of a retail Digital Euro. This should include considering how costs would be recouped, and any impacts on intermediaries. It is important that the introduction of a retail Digital Euro does not create any barriers to entry, such as high development or maintenance costs.

Second, there should be an effort to ensure the ongoing safe and trusted operation of the wholesale financial markets. New risks may arise due to the potential introduction of new intermediaries, as noted in the ECB Report, such as payment service providers. New risks may also arise due to the likely more complicated hybrid existence of the traditional 'paper' Euro alongside a retail Digital Euro.

To mitigate these risks and to provide clarity to the market, so the risks and implications can be assessed by intermediaries, the ECB may wish to consider:

- Clarifying whether an intermediary will record retail Digital Euros off-balance sheet or whether they will be recorded as cash is today (i.e. what is the associated capital treatment), as each approach would have different impacts on existing financial intermediaries that may choose to distribute and store retail Digital Euros;

[3] https://www.ecb.europa.eu/pub/pdf/other/Report_on_a_digital_euro~4d7268b458.en.pdf

- How disintermediation driven by a retail Digital Euro could impact the role of the central bank and existing intermediaries, including their functions and the provision of institutional credit;
- The opportunity for technological interoperability between the new CBDC system and existing payment/settlement systems. This may require, for example, common data standards and protocols. Robust interoperability may help with any future wider transition from traditional (domestic and cross-border) Euro payments to full Digital Euro integration, and to help ensure the benefits of using a Digital Euro are realised;
- Whether the application of industry standards, such as those documented in the Committee on Payments and Market Infrastructures-International Organisation of Securities Commissions (CPMI-IOSCO) 'Principles for Financial Market Infrastructures'[4] (a set of international standards for financial market infrastructures (payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories)) should extend to any new infrastructures created to route or settle CBDC transactions;
- Whether the inclusion of a retail Digital Euro, with its new supporting architectures, would introduce elements of opacity, added complexity or disruption, in respect of known network risks in the existing infrastructure. The network risks existing within today's wholesale financial markets are complex but well understood and accounted for, so any added complexity should be weighed against the potential benefits of novel architecture;
- How to design the retail Digital Euro system to mitigate risks arising from any new 'single points of failure', be that in the form of a new financial market infrastructure or a wider systemic infrastructure provider (e.g. electricity supply or telecommunications infrastructure);
- The permitted uses for a retail Digital Euro, including whether it may be used by a retail market participant to fund the purchase or receive the proceeds of sale of a financial instrument, as well as for the settlement of any subsequent cash flows. Such activity may create additional considerations across the full trade lifecycle, relating to system/technology integration, interoperability, settlement (including failures) and the potential spill over into the wholesale markets;
  - For instance, what are the settlement timing considerations should the retail Digital Euro settle on a 24/7 immediate basis, while the financial instrument (e.g. bond, equities, ETFs, mutual funds) settles in traditionally defined market hours;
  - If these types of transactions were deemed out of scope of the retail Digital Euro, allowable transactions would need to be specified. The ECB should therefore clarify how to limit its use by design (including whether limits should be reversible to allow use in wholesale markets at a later stage) and the implications for any intermediaries that may be handling its distribution, or for the individual or corporations that may wish to use it; and
  - During integration of the new and traditional infrastructures, the ECB should evaluate any risks created from connection or security failures between traditional and retail Digital Euro payment rails.
- Whether the settlement of a retail Digital Euro through TARGET2 would impact the use of TARGET2 by existing market participants; and
- The effect a retail Digital Euro could have on the provision of liquidity during crisis events, where banks could see large fund outflows in a very short time, undermining their ability to provide liquidity and ensure efficient markets (i.e. a digital run on the bank).

[4] https://www.bis.org/cpmi/info_pfmi.htm

Governance

Different considerations come into play when introducing any new technology or infrastructure into an existing ecosystem, and whilst there are already many papers and reports discussing these in the context of CBDCs, we thought that there would be value in highlighting the following for consideration by the ECB:

- What governance standards (including digital inclusion/access and limiting the amount of retail Digital Euro available) should apply to the retail Digital Euro network and ecosystem, what roles should each participant play and what are the responsibilities/liabilities attached to those roles, including for theft, loss and fraud;
- What regulations will apply to new intermediaries licensed to handle retail Digital Euro transactions (domestic and cross-border), so that those entities do not introduce undue risk to the system. Where possible, the ECB should leverage existing rules and ensure a consistent approach across the EU Single Market to create a level playing field and provide regulatory clarity to potential intermediaries;
- How will a retail Digital Euro operate and be regulated in conjunction with other jurisdictions' retail CBDCs or other new private forms of digital money such as stablecoins[5,6]; and
- What opportunities exist for greater public/private sector engagement to ensure that relevant expertise is shared, and that the final proposal is delivered at scale, across a vast number of countries and to participants in a seamless fashion? This should also include work on international standards and interoperability frameworks.

IV. Conclusion

Given the interconnectedness of participants in the international financial markets, including those functioning within both the retail and wholesale financial markets, we recommend that the ECB and Central Banks and supervisors in other jurisdictions work together to consider the implications across all aspects of the international financial markets in a full cost-benefit analysis of the development of retail CBDCs, including a retail Digital Euro.

Whilst some of the benefits of retail CBDC are well publicised, many of the real-world implications when it comes to practical implementation and knock-on impacts have yet to be discussed or validated. We believe that global forums, such as the ongoing Financial Stability Board (FSB) analysis, through the CPMI, offer the ability to improve the effectiveness of cross-border payments. They also offer a venue for such domestic and ultimately cross-border implications to be robustly discussed and any necessary solutions proposed.

We appreciate the opportunity to share our views on a retail Digital Euro and look forward to discussing with you in due course. Please do not hesitate to contact Andrew Harvey on + 44 203 828 2694, email aharvey@gfma.org or Madeline Taylor on +44 (0)20 3828 2688, email madeline.taylor@afme.eu should you have questions about our comments or wish to discuss any of the above.

[5] Stablecoins are defined here as tokens designed to minimize/eliminate price fluctuations relative or in reference to other asset(s) which are not issued by a central bank, FMI, bank, credit institution or highly- regulated depository institution. May represent a claim on the issuing entity, if any, and/or the underlying assets. For more detail please see Annex A of the GFMA response to the BCBS Discussion Paper on Designing a Prudential Treatment for Crypto-assets - https://www.gfma.org/wp-content/uploads/2020/04/gfma-bcbs-prudential-crypto-assets-final-consolidated-version-20200427.pdf

[6] We note that some forms of private stablecoins may fall in scope of the recently proposed EU Regulation on a Framework for Markets in Crypto-assets (MiCA). As per Recital. 7, a crypto-asset issued by central banks acting in their monetary authority capacity or by other public authorities will not in scope of MiCA - https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52020PC0593

Appendix A – About the Associations

About AFME

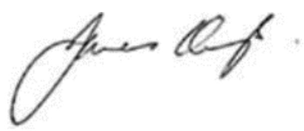
The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

About the GFXD

The Global Foreign Exchange Division (GFXD) of the Global Financial Markets Association (GFMA) was formed in co-operation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 24 global foreign exchange (FX) market participants, collectively representing the majority of the FX inter-dealer market. Both the GFXD and its members are committed to ensuring a robust, open and fair marketplace and welcome the opportunity for continued dialogue with global regulators.



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