Note

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To HM Treasury

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HM TREASURY - DIGITAL CURRENCIES: CALL FOR INFORMATION - PAYMENTS COUNCIL AND BBA RESPONSE

1 ABOUT PAYMENTS COUNCIL AND BBA

Payments Council and BBA welcome the opportunity to collaboratively respond to HM Treasury's Call for Information on digital currencies. Our response follows the subsections in the Call for Information document and considers both the benefits and the risks associated with digital currencies.

Payments Council is the body with responsibility for ensuring that payment services work for all those that use them in the UK. We work with payment service providers in the payments industry as well as other stakeholders to drive innovation in payments and implement change so that individuals and businesses have access to payments for their current and future needs.

BBA is the leading trade association for the UK banking sector with more than 230 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Three quarters of global systemically important banks are members of the BBA. As the representative of the world's largest international banking cluster the BBA is the voice of UK banking.

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2 GENERAL COMMENTS

It is clear that the use of digital currencies and in particular their underlying infrastructure and functionality is growing, and we support the approach of HM Treasury in issuing this Call for Information, as this provides a basis for further discussion on the UK position in respect of this emerging market.

Governments and regulators in a number of countries are in the process of assessing whether, and how, such currencies and related service providers, including exchanges, should be recognised and regulated. International consistency and cooperation (where feasible) at a global level is important to ensure that users of digital currencies are not displaced into jurisdictions that do not have formal regulation.

Internationally, a range of positions have already been declared on the status of digital currencies. For example:

- The European Banking Authority (EBA) delivered an opinion in June 2014 on virtual currencies.[1] While identifying several potential benefits, the EBA also identified 70 risks associated with virtual currencies, including risks to users, non-user market participants, financial integrity, payment systems in fiat currencies, and regulatory authorities. In order to mitigate such risks in the short term and protect the regulated financial services sector, the EBA recommended that national supervisory authorities discourage credit, payment, and e-money institutions from buying, holding, or selling digital currencies.
- While rules have not been finalised at state level in the United States, the New York Department of Financial Services published a proposed a BitLicense regulatory framework for digital currency businesses in July 2014, which included requirements for compliance and capital, customer protection, anti-money laundering and cyber security, and reporting and financial disclosures.[2]

Digital currencies represent an innovative payment method with many potential benefits. In particular, there are real opportunities for the banking industry and other industries in the underlying technology, such as the 'distributed ledger'. However, it is important to strike an

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[1] EBA Opinion on 'Virtual Currencies', 4 July 2014, http://www.eba.europa.eu/documents/10180/657547/EBA-Op-2014-08+Opinion+on+Virtual+Currencies.pdf

[2] NY DFS proposed Bitlicense regulatory framework for virtual currency firms, 17 July 2014, http://www.dfs.ny.gov/about/press2014/pr1407171-vc.pdf

appropriate balance that supports innovation, while preventing illegal activity and offering protection to consumers.

When contemplating the aspects of the digital currency ecosystem that HM Treasury might intervene, we note that in Europe for example, Lord Hill suggests that digital exchanges and other digital currency service providers, rather than the underlying infrastructure providers, be brought into the scope of the Fourth EU Anti-Money Laundering Directive (AMLD4) as "obliged entities" and hence authorised to operate. Given that the exchanges are more likely to be physically located, or at least have connection with a particular nation state (for the purposes of cashing out) this seems to be a logical approach to take.

Similarly in the US, FinCEN activity has focused on developing approaches to regulating companies that offer to exchange, administer, or maintain digital currencies. An administrator or exchanger that accepts and transmits a convertible digital currency or buys or sells convertible digital currency for any reason is a money transmitter under US federal regulations and therefore should be registered as a money services business (MSB). Working with its EU, US and global counterparts, the UK might wish to take a similar practical approach of intervening in those areas and with those participants that it can reasonably expect to influence.

2.1 Definitions

We recognise that one of the challenges in the digital currencies space is to achieve consistent definitions. It is useful that the consultation paper has included definitions in its scope section, although we note that there are differences between the terminologies HM Treasury has chosen to use, and that previously found in the FATF report on Virtual Currencies in June 2014.

We also note there is a question around the status of digital currency, and whether it should be classified as a currency, a commodity, or something different. For example, Germany has classified Bitcoin as 'private money', Finland recognises Bitcoins as payment instruments and imposes capital gains tax, and Denmark considers Bitcoin neither a currency nor an asset. In the UK, the Bank of England referred to digital currencies as 'digital commodities' in its Q3 2014 Quarterly Bulletin.[3]

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[3] BoE Q3 2014 Quarterly Bulletin, 'The economics of digital currencies', p3.

3 BENEFITS OF DIGITAL CURRENCIES

3.1 Potential Benefits

Digital currencies may offer a number of potential benefits to legitimate users including reduced transaction costs, faster transaction speeds, financial inclusion, competition and innovation. However, as noted in the June 2014 EBA Opinion, pending EU regulations and directives are explicitly addressing some of the issues that the benefits of digital currencies may be able to address. Similarly, in the UK domestic market, Faster Payments offers many of the same benefits as digital currencies. Both are real-time, irrevocable, credit push and low cost, and in most cases Faster Payments are free to consumers. Faster Payments also conform to all AML and related regulations and operate under a supervised consumer protection regime. In cross-border payment scenarios, though, where many current competitors are not conventional financial institutions, digital currencies may indeed provide lower costs and other benefits to some customers.

Ultimately, provided that the risks identified in section 4 of this submission are addressed appropriately, potential benefits for the wider UK economy might include:

- Positioning the UK as the centre for digital currency expertise and introducing an additional channel of tax revenue and investment.
- Recorded transactions leaving a public audit trail, which could support financial crime control with effective international co-operation
- Fewer barriers to cross border trade.
- Faster settlement time for payments.
- Lower transmission charges, and lower charges for cross-border e-Commerce and money remittance.
- Enhanced ability to carry out 'micro-payments', for example paying a nominal amount to access a news article online.

We consider that, where digital currencies offer benefits through services comparable to that of other participants in the payments system, then appropriate intervention would ensure consistency for payment systems participants and also support existing payments systems principles such as consumer protection, stability, and anti-money laundering and counter-financing of terrorism. Ultimately, consumers should be provided with the payment option choice where it is safe and secure to do so.

3.1.1 Ledger Technology

One of the most innovative aspects of digital currencies is the use of distributed ledger that supports decentralised payments. Currently, there are a range of centralised and de-centralised digital currencies operating on variations of this distributed ledger technology. The ledger technology offers potential opportunities to fundamentally change the way many value transactions both within and outside of the payments system are made, including the distribution and communication of assets, company shares, and securities. The ledger presents an opportunity for the industry to explore how this technology can be used to improve and enhance the existing fiat UK payment systems , or make use of the technology in a more structured way, similarly to that used in the commodity (such as gold and silver) markets. Given that the distributed ledger technology is open source and still in the early days of its development, it might be better for any 'intervention' on the core technology itself to be light touch, so as to support continuing innovation in a positive way.

4 RISKS OF DIGITAL CURRENCIES

4.1.1 Consumer Protection

In the UK and Europe, consumers are protected by a wide-range of regulatory measures when it comes to making and receiving payments in fiat currencies. Payment Services Providers (PSPs) in the UK are regulated and authorised by the Financial Conduct Authority (FCA). PSPs are also required to employ a range of consumer safeguarding measures, as specified primarily in the Payment Services Regulations 2009 (PSRs), which support consistency in respect of consumer rights and responsibilities. The existing regulatory framework for the payments system ensures that consumers are able to enjoy a high level of confidence and rely on basic protections when transacting. However, this same level of consumer protection is not offered when dealing with digital currencies, and there is a risk that consumers may incorrectly assume they are protected by the same safeguards that they are afforded when transacting with fiat currencies under the existing payments system.

In fact, there have already been numerous instances where consumers have suffered loss when engaging with digital currencies and associated service providers. Consumers have lost access to the digital currency held in their digital currency account (wallet) due to insufficient security measures allowing the digital currency to be stolen, a lack of consumer understanding of security risks, or because they have simply lost the necessary information needed to access their wallet. Furthermore, providers of digital currency services have perpetrated fraud against consumers, digital currency service providers have not been appropriately insured to provide adequate recourse for consumers, and incorrect transactions have been irreversible.

Digital currency exchanges have also not been subject to registration or licence requirements, and consumer detriment has been suffered where digital currencies and digital currency exchanges have been used to fund illegal activities. Legitimate customers of digital currencies have been unable to access their digital currency where their exchange is shut down as part of a criminal investigation or for other reason such as fraud or inadequate management leading to suspension of trading.

As digital currencies are not backed by a government or central bank with appropriate fiscal controls, they can demonstrate high volatility with the potential for complete loss of value. This may affect investors as well as consumers using digital currencies as a means of payment. Digital currency volatility may make security offerings tied to these currencies unsuitable for most investors.

We consider that it is essential that support for the introduction of digital currencies is subject to ensuring the same standards of consumer protection and confidence are maintained. Given that digital currencies are an emerging development and perhaps not understood well by a majority of consumers, we believe consumers would benefit from simple and neutral educational information that explains digital currency payments and how they differ (including the different protections) from fiat payments.[4]

4.1.2 Crime

Digital currencies have a number of features which could be exploited by criminals, terrorists and states seeking to launder illicit funds and evade sanctions. Any intervention in digital currencies in the UK should seek to mitigate these risks to allow consumers and businesses to use digital currencies for legitimate purposes.

In contrast to transactions made through the existing regulated payments system, the anonymity offered by digital currencies can facilitate transactions with the purpose of laundering money, financing terrorism, or purchasing illegal goods and services. Furthermore, users may unknowingly

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[4] For example, with regard to the UK fiat payment systems, Payments Council maintains the 'Pay Your Way' website, which "*provides impartial and clear information which will help you compare payments speed, cost, reliability and security*".

be committing criminal offences, such as money laundering or terrorist financing, through their interactions with digital currency. At present, wallets can be obtained without providing any meaningful identification (although this is true of some other payment offerings, e.g. prepaid), there is no requirement for centralised currency operators to verify, collect and share user details, and decentralised currencies have no central authority from which to request information.

There are also additional technologies that can be utilised to provide even greater levels of anonymity, notably The Onion Router and tumbling services. This anonymity becomes even more potent when combined with high risk money laundering sectors, such as gambling. This anonymity can make it difficult for law enforcement to target and identify perpetrators of crime for investigative or asset seizure purposes. In fact, FATF report there is currently no specific digital currency AML software available to monitor and identify suspicious transaction patterns.

Currently PSPs are under a range of regulatory obligations to carry out anti-money laundering and fraud checks, sanctions checks, identification of PEPs, and customer due diligence checks. Ultimately, PSPs need to be able to demonstrate that transactions are legitimate and that they are not supporting criminal or terrorist activity. At present, PSPs are unclear on their responsibilities with regards to servicing those working with, paying or receiving digital currencies. Coupled with the transnational nature of digital currencies, user anonymity creates significant difficulties in sanctions screening. If these significant compliance risks are not addressed, it may hinder the ability for digital currencies to become main-stream as PSPs and other financial institutions may not be able to reasonably satisfy their on-boarding and monitoring processes.

Payments Council has been engaging with The Bitcoin Foundation to explore their request to be assigned a global currency identifier to standardise its unit of measure. We therefore note that any regulatory initiative could also investigate the extent to which standardisation in this space could increase transparency and unambiguous identification of digital currencies as they are traded or indexed.

4.1.3 Monetary and Financial Stability

The stability and integrity of the UK payment systems is of paramount importance, not only to the financial system but to the UK economy as a whole. Accordingly, regulation should attempt to limit unintended consequences.

A characteristic of many digital currencies is an uncontrolled currency issuing process. However, the impact that digital currencies can have on monetary or financial stability currently is limited given the size of the digital currency market (global Bitcoin transactions are currently estimated at 60,000 per day, 300 of which occur in the UK). However, if 'convertible'[5] digital currencies were to reach mass adoption in the UK, there is a possibility that this may have an increasing effect on sterling. The Bank of England has noted that it is monitoring this.

5 CONCLUSION

Digital currencies and the distributed ledger functionalities that enable them are an innovative technology that can potentially offer benefits to consumers, businesses, government, and the wider economy. However, in order to realise these benefits, appropriate regulation should be considered in order to mitigate the associated risks. In particular, regulation should aim to support consumer protection, prevent crime and ensure the digital currencies and transactions are being used for a legitimate purpose, and provide certainty about the regulatory compliance requirements that are required for those businesses engaging with digital currencies.

We appreciate the opportunity to offer our comments on this consultation, and we would welcome the opportunity to engage further with HM Treasury and other relevant government departments on this subject.

[5] Definition taken from "FATF Report: Virtual Currencies – Key definitions and potential AML/CFT risks", June 2014