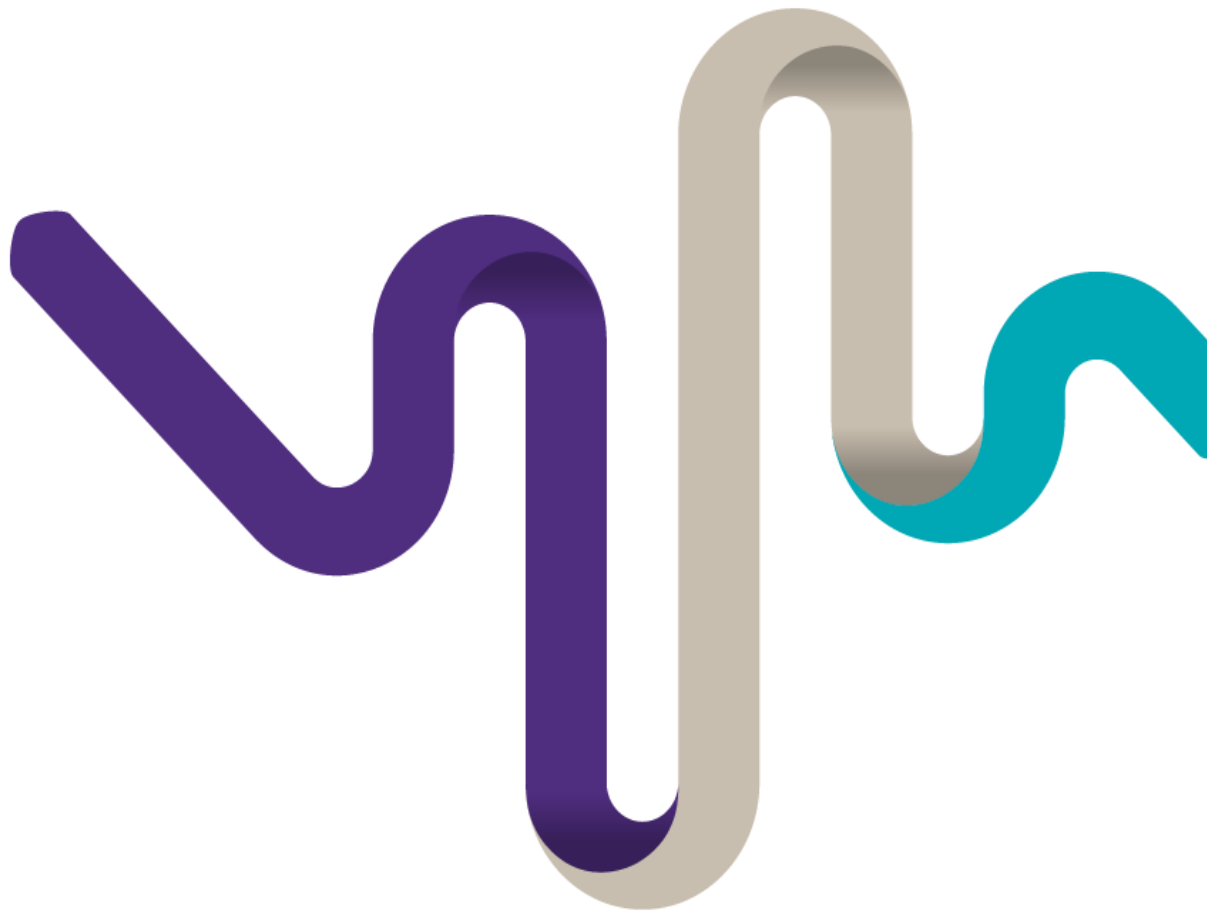


Submissions on the RBNZ issues paper

The Future of Money – Private Innovation



The Future of Money – Te Moni Anamata
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140

Grant Thornton New Zealand
L15, Grant Thornton House
215 Lambton Quay
PO Box 10712
Wellington 6143
T +64 4 474 8500
www.grantthornton.co.nz

To be emailed: futureofmoney@rbnz.govt.nz

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Submission on RBNZ Paper - The Future of Money – Private Innovation

Enclosed is our submission in response to the Issues Paper - Future of Money, which outlines our views on the issues and proposed approaches discussed in the paper. Our submission provides specific responses to the questions outlined in the paper.

We would like to draw your attention to our direct involvement in the liquidation of the Christchurch-based cryptocurrency exchange, Cryptopia Limited. Through this experience, we have been exposed to the challenges of a deregulated market. We recognize the potential significance to private money that stablecoins could have in the current financial landscape.

We remain advocates of the potential benefits of Distributed Ledger Technology (DLT) that could revolutionize the financial industry. We also acknowledge that proper regulation and risk management are essential to ensure the protection of New Zealand's monetary sovereignty and the maintaining of trust in the global monetary system. Given the global nature of stablecoins, we believe that a coordinated, international approach is necessary to effectively address these risks. This view is reflected in our submission.

If you have any questions regarding our submission, please contact either of us on david.ruscoe@nz.gt.com or tom.aspin@nz.gt.com.

Yours sincerely



David Ruscoe
Partner



Tom Aspin
Senior Manager

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Section 2: Stewardship of Money

- 1 *Do you agree with the core drivers, assumptions and high-level approaches that we have described in relation to our work on private innovation in money?*
- 2 *Is there anything else we should consider?*

We provide feedback below based on the outlined objective statement, core drivers, assumptions and the proposed high-level approach.

2.1 *Defining our role and objectives as the steward of money*

“New Zealand has a reliable and efficient money and payments systems that support innovation and inclusion”

- We broadly agree on objective statement above, the New Zealand payments systems is highly efficient, on a domestic level. The introduction of 7 day a week payment processing and settlement from May 2023 will improve this. The leading area of inefficiency stems from legacy overseas payment systems which New Zealand forms part of. This in our view is the main area of improvement and innovation that could benefit from distributed ledger technology adoption.

2.2 *Core drivers for considering innovation in private money*

- *concerns about existing inefficiencies in private money (e.g. in cross-border payments), and calls by some for wholesale ‘disruptions’ in money;*

Agree that international legacy payments systems could benefit from the adoption of distributed ledger technology.

- *the perceived need for and benefits offered by new forms of money in an ever more digitalised economy (e.g. web3 and the metaverse);*

There is a need for better education about the actual benefits of this technology. We believe that a level of industry maturity needs to be reached before categorising some of the concepts as being interchangeable with the term “money”. A digitized economy underpinned by Web3 could be beneficial but need to see growth beyond the metaverse being a marketing-driven term. It is important to keep money as simple as it can be. We believe any private money needs to be regulated to ensure the asset backing exists to allow confidence in it.

Global failures have shown this technology can still be very fragile, this is reflective of the participants and not necessarily the actual technology or the networks. For example, centralised exchange failures such as FTX or Cryptopia and algorithmic stablecoins like Terra.

2.2 *The assumptions that guide our approach*

We agree with the assumptions that guide the approach. However, the “same risk same regulation” needs to be carefully balanced to foster innovation.

Section 3: Captured by our stewardship interests

3. *What do you see as the biggest issues with private innovation in money?*
4. *Do you agree with how we frame the focus on stablecoins? Are there other forms of innovations we should be looking at?*

- As the RBNZ rightly identifies the current use case for consumers is for investment rather than being a replacement for actual money (if we ignore stablecoins). The attraction of cryptocurrency to investors is its volatility and the opportunities for large profits in a short amount of time. However, this volatility means that even though countries have tried to adopt cryptocurrencies as legal tender price is always converted to a fiat currency rather than quoting in the actual cryptocurrency, which is why even when Bitcoin is adopted as legal tender it is always converted to its proportional value in USD. This raises questions about how cryptocurrencies can currently meet the economic definition of money specifically “unit of account” and “medium of exchange”.
- This is also why we believe the RBNZ is right to focus its regulations on stablecoins rather than other cryptocurrencies. Most asset-backed stablecoins are underpinned by real-world assets that are generally regulated by a central bank. For example, government bonds, treasury bills, and cash. These assets lend their credibility by being included in the reserves of Stablecoin. Cryptocurrencies generally do not claim to have this level of credibility by being an alternative to fiat currencies eg: bitcoin. Stablecoins are the only cryptocurrency which appear to meet the definition of being interchangeable with actual fiat issued New Zealand.
- The origin of Stablecoins stems from the lack of traditional banking appetite to provide banking services to those involved in Cryptocurrency and the need for investors to address price volatility. We agree that this maturity of the cryptocurrency markets will be further strengthened by the regulation of these operators. As identified, there is the potential for these private entities to create their own currencies or payment systems that could undermine the stability of the NZD and pose a threat to financial stability. As there is currently significantly less regulatory oversight compared to traditional financial institutions, we believe the RBNZ is right to consider regulating these operators to maintain trust and transparency in the financial system.
- For the RBNZ to effectively regulate stablecoin operators, they need to design a framework that focuses only on stablecoins which are 1:1 backed with high-quality of reserves. This framework should avoid algorithmic stablecoins at this stage given the example of Terra, which shows the risk of artificial uneconomic cryptocurrency markets. We believe it is important to ensure that stablecoins are properly backed by sufficient reserves to prevent any potential destabilization of the financial system should their adoption become more mainstream.
- While transparent blockchains underpin stablecoins, external assurance is still a significant challenge. The current standard is for operators to provide an attestation report that details the reserves that back the stablecoins in circulation. An independent auditor generally completes this limited assurance engagement by producing an independent opinion. This assurance only covers the stablecoins issued and nothing about the actual standing of the operator including looking at whether there are liabilities pledged against these assets. This is needed to improve risk in private money.

Section 4: Greater competition and further innovation

5. *Do you agree that there is a significant opportunity to enhance competition and further innovation in a New Zealand context?*

- The question has also got to be why New Zealand has not already innovated? Our view is it's because our domestic settlement system is already highly efficient and meets the current requirements of consumers combined with effective regulation of NZ banks. We do not have the issue of other nations' domestic payment systems such as the USA where transferring money can take taking days and that is seen in the lack of adoption in NZ of mobile payment services like Cashapp or Venmo.
- While token-based stablecoins operate on “trustless” based technology. The public need to have trust in private money. “Don't trust, verify” is a common phrase used to describe the benefits of distributed ledger technology. In this context, verification needs to be on the stablecoin operator so that these centralised entities can be trusted. Centralised refers to the fact that stablecoin operators control the issue of new coins rather than the networks they operate on like Bitcoin does through mining and Ethereum does through staking. The blending of opaque operations between centralised and decentralised over the past 2 years has led to a number of failures in the cryptocurrency industry. This is needed to ensure that a NZD stablecoin issued as “Money” can be trusted.

- There are questions about the demand and scale for an NZD-backed stablecoin. According to Etherscan (at the date of this submission) NZDS has only 80 wallets on-chain which pertain to holding NZDS.
- Cryptopia while it operated issued its own stablecoin NZDT (New Zealand Dollar Token) and from our experience, NZDT was used predominately to on-ramp NZD to the Cryptopia exchange to buy Cryptocurrency rather than any other utility like 3rd party payment or FX trading.
- The challenge that is mentioned is weighing up the risk that supports safe innovation. In terms of a balancing of regulation and fostering innovation in terms of not overly burdening new participants.
- Regarding box 3 we believe that Crypto-based payment solutions provide a unique opportunity for innovation, particularly in the area of cross-border payments. Most Stablecoins operate as tokens on other networks because they can leverage the uniformity of the underlying payment network, which eliminates the need to comply with a particular country's legacy payment system like SWIFT.
- The area of potential innovation in a domestic context is in regard to merchant/card services. While transactions per second outputs as quoted in 32 are comparable between Visa and the other crypto networks quoted. The difference is around actual settlement in terms of receiving funds. Generally settlement to merchants for both Visa and Mastercard only occurs daily. In contrast, a stablecoin operating on a layer two scaling solution can achieve settlement within the time it takes for cryptographic confirmation to occur on both the scaling solution and the layer one network that the operator is utilizing likely seconds or minutes. This scaling will often come at the sacrifice of decentralisation but so will regulation.
- Figure 5 is interesting in terms of reflecting the fractional reserve banking, but the question is why should a stablecoin scheme not be able to invest its own deposits and would current New Zealand retail banks want to bank such a provider given the competition of deposits. The alternative model also raises the question on how you would evaluate the run risk, if a stablecoin operator was to experience another bank run like UST/LUNA and assets were locked into long-term wholesale debt how would the scheme be able to handle such withdrawals?

Section 5: Private innovation in money

6 Do you agree with the key risks to the stewardship of money identified here?

Risk to holders and users of money

We agree with the RBNZ identifying AML/CFT, cyber Risks, value stability, redemption, and solvency as the key risks to the user and the answer to addressing these risks come back to the regulation and accountability of those who look to issue this form of private money specifically. We agree that balancing “buyer beware” and implementing fair and unintrusive regulation will help improve the creditability of stablecoin operators. The issue is once you start to try and implement regulations to protect consumers this private money starts to look a lot like a CBDC.

Some examples of regulation that could be used:

- Money laundering and financing terrorism risk is considered inherent due to most cryptocurrencies operating using pseudo-anonymity, for example, the wallet address being the only requirement in order to transact currency. The focus of regulation could be on the on/off ramp redemption and or/settlement of such stablecoins whereby users need to identify themselves in order to redeem stablecoins into the underlying currency.
- Crypto asset generally operates on a censorship-free basis in line with the belief of decentralisation. The two largest Stablecoins USDT and USDC depart from this by operating blacklists whereby addresses are banned, and currency is essentially blocked from being transacted. Blacklist additions often come from law enforcement whether this is due to a hack/compromise or due to the funds being associated with proceeds/funding of crime. Requiring the stablecoin to operate a blacklist would be one way of addressing the AML/CFT and cyber risk.

- In regard to addressing cyber risk, The issue at hand is the value of stablecoins and how it is derived from the underlying reserves. Since blockchains cannot be reversed or rolled back, it is essential to establish clear policies and procedures regarding stolen or blacklisted tokens and determine who governs any changes or decisions made by stablecoin operators. One potential way to address and ensure transparency is requiring, stablecoin operators to disclose this information in a Token Disclosure Statement (TDS), which could mimic a Product Disclosure Statement (PDS) used for financial products. A TDS could address the risks of investment and how the stablecoin operator intends to address these including managing cyber risk in a manner that helps maintain the integrity of stablecoins and ensure the protection of investors.
- Value stability & solvency - proof of reserves, focusing on stablecoins they need to be “stable”. This is why the proof of reserves is so important in terms of confirming that traditional deposits line up with issued tokens. The past 6 months have seen Stablecoin’s lose peg such as USDC (due to a more traditional bank failure rather than anything cryptocurrency related) and news reports of some stablecoins like BUSD having a shortfall of over US\$1 billion between assets issued by the world’s largest centralised exchange and its assets held in reserve. Ensuring that on-chain issuance is backed 100% by its reserves is a good first step. However, on top of this liabilities needs to be monitored also. Blockchains are great at showing that assets exist but not who would have first claim to them if something went wrong like the stablecoin operator being insolvent and also showing how deposits are being used. So that the public has confidence in the stablecoin operator and gets the full picture of the issued “private money”. Some example ways this could be regulated are below:
 - Requiring the issuer of stablecoin to undergo an annual external independent audit and include related stablecoin assets/liabilities to be included on its balance sheet.
 - Mirroring some requirements that are enforced on traditional retail banks through Banking Prudential requirements imposing requirements such as capital ratio’s etc and also the regular disclosure of these by Stablecoin operators.
- Redemption – This will be a question of how the stablecoin operator wants to govern its arrangement with account holders. However, enforcing specifics around who can redeem and how this mechanism will work in practice. In terms of quality of reserves and clear concise terms and conditions.

5.2 Risk to competition with new dominant providers of money

No different to the regulation of banks but important to ensure that fiscal policy is effective and impactful.

5.3 Risks to trust across the monetary system.

We agree with the current absence of disclosure and external accountability there is a risk should stablecoin mass adoption and a need to understand and address Trust in “Trust-less” DLT systems.

7. Are there any other risks that we should consider? How significant are they?

Focussing only Stablecoins as the form of private money we believe most of the risks are covered.

The other risk that RBNZ should consider is the overall regulatory risk to these operators. What we mean is that any legislative and regulatory changes of actions at a government level or internationally could adversely affect a stablecoin tokenisation that underpins these operations. For example, if Legislation was introduced that stops New Zealanders from holding Stablecoins or if regulators stop the ability for operators to earn interest on stablecoin-linked deposits.

The other issue is enforcement risk, currently, the largest stablecoin Tether is tethered to a country’s currency that it maintains no physical presence. While it is registered in the USA it operates from a Caribbean Island and has an Italian accounting firm attested to its stablecoin reserves with banking services being provided by a bank from another Caribbean Island. Such arrangements highlight the need for a global approach to effectively regulate stablecoins and address the risks they pose to monetary sovereignty and trust in the global monetary system. Consequently, global cooperation is essential.

Section 6: RBNZ proposed response

8. Do you agree with our proposed monitoring approach? Is there anything else we should monitor?

We agree with the proposed monitoring approach and believe the RBNZ should have a continued focus on retail use and the impact adoption of crypto assets in New Zealand monetary system.

9. Do you agree that we should be open to alternative models of money? Can they work in a New Zealand context?

We agree that alternative models of money need to be considered but risks need to also be considered and integrated into the regulatory model.

DAO's are provided as an example of regulatory design challenges however, currently these have had even lower adoption than stablecoins. Any centralised government regulation would be a departure from their purpose. Decentralised referring to the fact that governance of a DAO operates using algocracy with members operating across the world voting on decisions. Autonomous meaning these members have the freedom to govern themselves/overall arrangement without the input of Central Government. So, the question is why a DAO and its members would want/need to be regulated by a centralised entity like the a central bank? DAO's regulation are not something we see as particularly relevant to RBNZ at this stage.

Section 7: Conclusion

10. What issues do you think we should prioritise in developing further regulatory response? For example, should we prioritise issues about the rights of stablecoin holders, or the use of DAOs, or something else?

As the closest thing that resembles money, we believe it makes sense for the RBNZ to look to regulate Stablecoin operators. The beginning of regulation would be a positive development as the maturity of crypto-assets develops. The first tokenization of New Zealand-issued currency as stablecoins could pave the way for the tokenization of other real-world assets. Tokenization refers to converting ownership or investment rights into digital tokens that are recorded on a blockchain. These tokens can then be traded and provide investors with liquidity and flexibility. By having a developed and thorough framework for stablecoins it won't be a stretch for NZ regulators to theoretically extend these to other assets such as real estate, stocks, livestock, and other physical assets.

What is important is Appendix 1 and intersections of agency interests, this hypothetically shows who could be responsible for what in the "future of money". The tokenisation of real-world assets is starting to grow and first by moving first regulating private money, the RBNZ could be seen as having a first-mover advantage on how other Government agencies are to address this potential adoption.

While the issues paper includes summarised regulatory initiatives in the EU, UK and US. The RBNZ should look at Australia regarding virtual asset regulation. The Digital Assets (Market Regulation) Bill 2023 introduced on 29 March 2023 proposes to introduce a licensing regime for Cryptocurrency exchanges, Custodians, and Stablecoin issuers. On the subject of Monetary sovereignty, the bill also looks to introduce certain disclosure requirements for banks and financial institutions regarding the use of any domestic and foreign CBDC's in Australia.

The proposed licensing of Stablecoin Issuers includes the following requirements: quarterly filings to the regulator and the public, reserves to be held in only authorised deposit-taking institutions, and external audit requirements by any issuer/license holder. All regulatory requirements we have suggested in section 5 of this submission.

