

3 December 2024



STAKEHOLDER LETTER

Re: Consultation Paper – "*Digital Asset Business Single Currency Pegged Stablecoins (SCPS) Guidance*"

The Bermuda Monetary Authority (Authority or BMA) would like to thank its stakeholders for their continued engagement and support in furthering the development of Bermuda's regulatory framework and critical strategic initiatives. On 10 May 2024, the Authority issued a draft guidance for consultation entitled *Digital Asset Business Single Currency Pegged Stablecoins (SCPS) Guidance* (Guidance).

The draft Guidance detailed the expectations applicable to Digital Asset Businesses (DABs) qualifying as Single Currency Pegged Stablecoins Issuers (SCPSIs), including governance, risk management, market-making due diligence, backing assets, attestations and disclosures. The draft Guidance also clarified the Authority's expectations to ensure that SCPSIs will conduct their operations prudently, thus enhancing consumer protection, financial stability and market integrity within the digital asset ecosystem.

The Authority appreciates all the feedback received on the draft Guidance. It is committed to working closely with its stakeholders to ensure that Bermuda's regulatory regime is effective, proportionate and aligned with international standards.

This letter summarises the key substantive feedback on the draft Guidance that the Authority received from several stakeholders and the responses to these comments.

RESPONSE TO INDUSTRY FEEDBACK

I. Scope

Feedback Received:

Industry stakeholders sought clarity on which DABs fall under the scope of the Guidance.

Authority Response/Action:

In response to this feedback, the Authority has provided additional details and encourages all stakeholders to refer to the Frequently Asked Questions (FAQ) section to gain a clearer understanding of the DABs that are included within the scope of this Guidance.

II. Backing assets

Feedback Received:

Industry stakeholders supported the BMA's proposed guidance on acceptable backing assets, such as government treasury debt instruments (with maturities of one year or less) and short-term cash deposits. However, some stakeholders expressed concerns about achieving diversification among banking partners due to the structural elements of some banking systems.

Industry stakeholders agree that backing assets in a currency other than the SCPS's pegged currency involves additional risk; however, they believe that controls and diversification could mitigate this heightened risk.

The industry stakeholders supported the Authority's proposed criteria for determining the quality of backing assets while also encouraging a risk-based approach that would allow for some proportionality based on the nature, scale, complexity and risk profile of the firm. Some participants also referenced the use of some banking regulations (i.e. Basel III) as a means to estimate any need for over-collateralisation for longer-term backing assets. .

Authority Response/Action:

The BMA appreciates stakeholders' feedback and has adjusted the Guidance to refine expectations regarding acceptable backing assets and risk management. While the Basel III regulations primarily discuss over-collateralisation in terms of credit risk mitigation strategies, the Authority continues to maintain a risk-based approach concerning any over-collateralisation requirements.

III. Attestations

Feedback Received:

Stakeholders welcomed attestations as an effective tool to confirm the composition of SCPS's backing assets. However, they also highlighted the difficulty in finding reputable third parties that provide this service at an affordable price for start-up firms. With regard to frequency, stakeholders

unanimously supported conducting the backing assets' attestations monthly and yearly for financial audits.

Authority Response/Action:

The BMA has noted and considered all the feedback received. The Authority acknowledges the difficulties some firms face in securing the services of independent third parties to produce attestations. However, these remain a critical tool for providing customers with important and timely information about the entity they are dealing with. The Guidance has been updated to explain expectations about the frequency and the information to be included in the backing assets' attestations.

IV. Disclosures

Feedback Received:

Stakeholders mostly agreed with the proposed disclosures; however, some respondents highlighted concerns about disclosing their custody arrangements publicly due to their confidentiality. Stakeholders were divided on the need for SCPSI to provide a whitepaper. Supporters indicated that a whitepaper should disclose risks, smart contract audits, security resources and official media accounts (to reduce the risk of impersonation of the issuer and protect users). All stakeholders agreed that additional disclosures should be implemented if a SCPSI (i) does not guarantee redemptions at par or (ii) wishes to impose any conditions or restrictions on redemptions.

Authority Response/Action:

The Authority has noted and considered all the feedback received. The relevant section of the Guidance related to the disclosure of custody arrangements has been revised to mitigate the concerns raised by the respondents.

V. Stress testing

Feedback Received:

Stakeholders agreed with the importance of conducting stress testing. They provided feedback suggesting that it should be performed whenever an investment policy is updated and even more frequently, depending on certain factors. These factors include market volatility, redemption patterns and significant changes in business models or economic conditions.

Metrics such as Value at Risk (VaR), Conditional Value at Risk (CVaR), Redemption Coverage Ratio, Liquidity Gap Analysis and analysis of historical redemption patterns were specifically recommended for managing redemption risk.

On this latter point, it was recommended that historical redemption patterns had been recommended to be analysed with an emphasis on segmenting data according to market conditions. This should involve statistical analysis, examining the impact of specific events, and (when possible) applying machine learning models to predict future redemption behaviours based on historical data.

Respondents considered that the outcome of the stress testing should lead to

actionable insights and be used to create contingency plans to address identified vulnerabilities.

Authority Response/Action:

The BMA acknowledges the respondents' suggestions and has noted all the feedback received. The Authority has amended the stress testing section of the Guidance to include further considerations on the frequency and outcomes of the stress testing exercise.

VI. Bankruptcy remoteness

Feedback Received:

The BMA did not receive material feedback on this section of the Guidance other than stakeholders agreeing on the importance of segregating the backing assets from the firm's funds. Some feedback also included suggestions that traditional finance-tested structures, such as Orphan Special Purpose Vehicle (SPV) or Segregated Account Company (SAC), be considered for more complex foreign subsidiaries.

Authority Response/Action:

The Authority acknowledges that SPVs and SACs can be effective bankruptcy-remote structures (where appropriate). As the feedback received is in line with the intent of the draft Guidance, the Authority has not made any amendments to this section of the final Guidance.

VII. Interoperability

Feedback Received:

Stakeholders emphasised that the difficulties faced by SCPSIs when integrating stablecoin payment systems into multiple blockchains present unique challenges, particularly concerning liquidity and the synchronisation of proof-of-reserve systems across different networks. Addressing this multifaceted problem has highlighted the crucial importance of considering the technical risks associated with cross-chain bridges and the inherent characteristics of individual blockchains during the pursuit of achieving optimal interoperability.

Authority Response/Action:

The BMA has noted and considered all the feedback received. The Authority has amended the Guidance to reflect the potential challenges referenced above when operating on different blockchains, specifically on synchronisation across blockchains.

VIII. Recovery and Resolutions Planning

Feedback Received:

Stakeholders emphasised the importance of stability and resilience in recovery and resolution planning for SCPSIs. Key objectives cited included ensuring the continuity of critical functions, preserving the firm's asset value, ensuring transparency, complying with regulatory requirements, being prepared operationally and regularly reviewing and updating plans.

Authority Response/Action:

The BMA has not made any amendments to this guidance section, as the feedback received is in line with the draft Guidance.

IX. Liquidity Requirements

Feedback Received:

When assessing liquidity requirements for SCPSIs, stakeholders suggested considering factors such as redemption volatility, market conditions, the liquidity profile of backing assets, stress testing results, market sentiment and exposure to external shocks. The proposed core liquid assets, such as short-term deposits, assets guaranteed by sovereigns and money market funds, were considered appropriate due to their high liquidity and low credit risk. In addition, money market funds provide high liquidity, diversification, and stability, even though they carry some degree of market risk, especially in extreme market conditions, and may be affected by regulatory changes.

Lastly, for net asset requirements, respondents agreed that it would be prudent to discount assets that cannot be quickly liquidated or that are inherently illiquid, such as intangible assets like goodwill and know-how, in assessing stablecoins' ability to cover a specific asset or its risk.

Authority Response/Action:

The Authority welcomes the suggestions of stakeholders and has noted all the feedback received. The Guidance has not been amended as the Authority does not consider other forms of liquidity, such as money market funds, to offer an acceptable level of risk compared to the liquidity instruments included in the Guidance.

As a result of the consultation, a final, revised Guidance will be published. The Authority would like to thank its stakeholders for their feedback and remains committed to working with them and other interested parties to further its regulatory objectives. Any stakeholder seeking further clarification or additional information on these matters should contact the Authority directly at fintech@bma.bm.

Sincerely,

The Bermuda Monetary Authority