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WHAT DOES THE EUROPEAN COMMISSION'S DIGITAL EURO PROPOSAL MEAN FOR THE FUTURE OF MONEY IN THE EU?

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On 28 June 2023, the European Commission published its proposals for a digital euro as part of a 'Single Currency Package'. The proposal shows what the potential scope of the currency and some of its key features might be. However, much has still to be confirmed, including whether a digital euro will ever be issued.

We will consider some of the proposed key features of the digital euro and the next steps in the EU legislative process.

Context

The EU's Single Currency Package comprises proposals for a Regulation establishing the legal framework for a possible digital euro (Proposed Digital Euro Regulation), a Regulation on the provision of digital euro services by payment services providers incorporated in Member States whose currency is not the euro and a Regulation on the legal tender of euro coins and banknotes (Proposed Legal Tender Regulation).

The European Commission has introduced the Single Currency Package to accommodate the rapidly digitalising economy and maintain the role of the euro in the digital age. The digital euro would offer a public alternative to private digital means of payment (including cryptocurrencies and stablecoins) and is intended to support financial inclusion by free access, ease of use, and wide accessibility and acceptance.

The Proposed Digital Euro Regulation sets out the legal framework for, and key features of, the digital euro. Once adopted by the European Parliament and Council, it would enable the European Central Bank (ECB) to introduce a digital euro as a complement to cash but ultimately it will be for the ECB to decide if and when to issue digital euros.

The digital euro would fit within the existing regulatory framework; for example, with payment transactions involving digital euros covered by PSD2 (or PSD3 and PSR once adopted – see further below) and AMLD5 (or AMLD6 and AMLR once adopted).

The accompanying Proposed Legal Tender Regulation is designed to ensure that citizens and businesses will be able to continue to pay with physical euro banknotes and coins across the euro area.

What is a central bank digital currency or CBDC?
A CBDC is a digital representation of fiat money issued by a central bank. The digital euro would be a direct liability of the ECB or national central banks which are members of the Eurosystem and so would not be subject to the market forces or fluctuations of value that may affect privately-issued cryptocurrencies or stablecoins.

What technology do CBDCs use?
CBDCs are often associated with underlying blockchain or DLT infrastructure, however, other technologies may instead be used with similar outcomes. The Proposed Digital Euro Regulation is technology agnostic reflecting that the European Commission has yet to make a decision on the technology that will underpin the digital euro.

Wholesale vs. retail?
CBDCs may either be wholesale (i.e. with access restricted to a limited group of commercial banks and clearing institutions) or retail (which would widen access to central bank money, perhaps to corporates and businesses or generally across the economy also to consumers). The digital euro proposed by the European Commission supports a variety of retail use cases and deliberately does not cater for wholesale uses.

Key features of the proposed digital euro

The Proposed Digital Euro Regulation would give a digital euro legal tender status in euro area Member States, i.e., mandatory acceptance at face value with the power to discharge a payment obligation. This means that payees cannot refuse payment in digital euro unless an exception applies.

Exceptions have been proposed for certain types of entities (such as microenterprises or non-profit enterprises), but this does not apply where they accept comparable digital means of payment, such as debit cards or instant payment. Exceptions also apply where the parties have expressly agreed on a different means of payment prior to payment and where a payee has refused payment based on legitimate and temporary grounds in line with the principle of proportionality. Individuals acting in the course of a purely personal or household activity are also excluded. The proposal prohibits unilateral exclusion, i.e., payees shall not use contractual terms that have not been individually negotiated (e.g., standard terms and conditions) to refuse payments in digital euro. Surcharges on digital euro debt payments are also prohibited.

The proposal clarifies that the digital euro is intended principally as a means of payment and not a store of value. Two key consequences of this are that it will not bear interest and it will be subject to a holding limit that remains to be set. These limits also help to address potential concerns around financial stability.

The proposal provides that the digital euro will be available for both online and offline payments and will not be programmable money (e.g., limited to purchase specific products or services only). This is in line with the Eurogroup statement from January 2023 which underlined that the digital euro should at all times and throughout the euro area be convertible at par with other forms of the euro, such as banknotes and commercial bank deposits (which are not programmable). Payment transactions in digital euro would be settled instantaneously, either when the transfer is recorded in approved settlement infrastructure or, for offline payments, when records are updated in local storage devices.

Role of payment service providers

The Proposed Digital Euro Regulation incorporates the definition of 'payment service provider' (PSP) from PSD2, which is a wide definition including regulated credit institutions, electronic money institutions and payment institutions, among others. Under the current proposal, PSPs may provide digital euro payment services including enabling access to and use of the digital euro, enabling digital euro payments to be made and received and managing digital euro payment accounts.

PSPs will also be responsible for funding and defunding digital euro accounts, i.e. linking each digital euro account to a non-digital euro account specified by "users" or holders of digital euros and transferring amounts between them; for example, in the event that any digital euro holding limit is exceeded on receipt of a payment.

With competition in mind, users may have one or more digital euro accounts with the same or different PSPs and linked non-euro accounts may also be held with different providers. It is also proposed that PSPs will need to allow users to switch digital euro accounts to another PSP while retaining the same identifier.

Under the proposal, a digital euro would be free of charge for basic digital euro payments by individuals and PSPs would not be paid for these services, as with cash payments. PSPs may charge for additional services and would be able to apply "proportional" merchant service charges and inter-PSP fees. The ECB will monitor the level of these charges, with a view to introducing maximum charges to be applied uniformly across the euro area.

Interaction with payments regime

The Single Currency Package proposal clarifies the interplay between a digital euro and existing regimes for payments, AML and data privacy, among others.

In parallel with the launch of the Single Currency Package and to keep pace with rapid developments in the payments sector, the European Commission also proposed a set of targeted updates to the regulatory regime for payment services and electronic money (e-money) (Proposed Payments Reform) via a new (i) Payment Services Directive (PSD3) and (ii) Payment Services Regulation (PSR). This is accompanied by a new open finance proposal in the shape of a regulation on a framework for Financial Data Access (FIDA). The primary objectives of the Proposed Payments Reform are:

- tackling fraud risk and improving customer choice and confidence;
- improving the functioning of the open banking and open finance sector;

- increasing harmonisation of the implementation and enforcement of payments and e-money regulation; and
- improving access to payment systems and bank accounts for non-bank PSPs.

In addition to changes to meet these policy objectives, the PSD3 proposal expands the definition of funds under the EU's payments framework to cover "central bank money issued for retail use" (expanded from the banknotes and coins reference under PSD2) so that it will cover any digital euro and related transactions.

While the European Commission has not yet proposed a timeline for a potential introduction of the digital euro, given the interplay between the proposal and the Proposed Payments Reform, it is likely that there will be a push for alignment on timing of adoption of the legislative packages.

For more on the PSD3, PSR and FIDA proposals, see our recent briefing.

Data privacy and AML concerns

The Proposed Digital Euro Regulation sets out when and how payment service providers, the ECB and relevant national central banks may process certain types of personal data. These organisations will be required to implement appropriate technical and organisational measures to control when, and for what purposes, users can be identified. In addition, the Proposed Digital Euro Regulation provides that each of these organisations shall be considered the controller of personal data with regard to the processing activities laid out in the Proposed Digital Euro Regulation and also describes certain scenarios in which a joint controllership shall be given.

The European Commission recognises the challenge of balancing the protection of individuals' privacy rights against concerns that a digital euro could more easily facilitate money laundering or other illicit purposes without appropriate checks and balances. The Proposed Digital Euro Regulation attempts to address this by making a distinction between data requirements for "online" digital euro payment transactions (those where settlement takes place using the digital euro settlement infrastructure) and "offline" digital euro payment transactions (where payments occur in close physical proximity (i.e. face-to-face), with settlement taking place using the parties' local devices).

Online digital euro payment transactions would be required to follow the same data protection and AML/CFT rules as other private digital means of payment, i.e. these transactions would be required to process personal data for specified limited purposes in accordance with the EU's General Data Protection Regulation, as well as adhere to the EU's AML/CFT framework and PSD2/PSD3.

For offline payment transactions, the processing of personal data by payment service providers will be limited to certain funding and defunding data to meet AML checks, with the intention that this would make such transactions more comparable to ATM withdrawals, for example. The European Commission would have the ability to set limits for offline payment transactions through delegated acts.

To help address AML concerns, it is also proposed that the ECB will establish a general fraud detection and prevention mechanism (which may be operated directly by the ECB or designated provider(s) of support services). The European Commission has proposed that the transfer of information between PSPs and the fraud detection and prevention mechanism should be subject to "appropriate technical and organisational measures including state-of-the-art security and privacy-preserving measures" to ensure that individual digital euro users are not identified by the central fraud detection and prevention mechanism.

The challenge of balancing privacy rights with AML/CFT and similar concerns is expected to be one of the areas of continued debate as the Proposed Digital Euro Regulation moves through the EU legislative process.

Territorial scope

Primarily the digital euro would be available and have legal tender status within, and for obligations to payees living or established in, the euro area. The proposal governs how distributions of the digital euro might apply outside of the euro area (both within and outside the EU), with restrictions on PSPs distributing the digital euro outside the eurozone unless the ECB and the national central bank of the relevant jurisdiction have a signed agreement in place for that central bank to implement legislation and abide by relevant ECB rules and guidelines, including in respect of individual holding limits. For jurisdictions outside the EU, there are additional criteria, including a requirement for PSPs established or operating there being subject to equivalent supervisory and regulatory requirements as within the EU, and strict AML requirements.

Next steps

The Single Currency Package will now continue through the EU legislative process. The European Commission is currently consulting on its proposal with comments due by 8 September 2023. This feedback will be presented to the European Parliament and the Council who are already considering the proposal and what their positions will be. Once the European Parliament and Council have adopted their positions on each regulation, "trilogue" discussions with the European Commission will begin with the aim of finding a compromise acceptable to all three institutions. However, it is unclear whether the European Parliament will be able to agree its position before the upcoming elections in June 2024, which may delay finalisation of the Single Currency Package.

If it is adopted, the Proposed Digital Euro Regulation would enter into force 20 days after publication in the EU's Official Journal and apply from that point. However, the Proposed Digital Euro Regulation merely sets out the framework for issuance of the digital euro and, ultimately, the ECB will determine if and when to proceed. The European Commission makes clear that "this project will require significant further technical work by the ECB". The ECB's Governing Council is scheduled to make a decision on whether to proceed with the next phase of the digital euro project following the conclusion of its investigation phase in October 2023.

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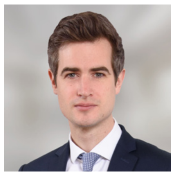

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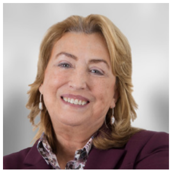

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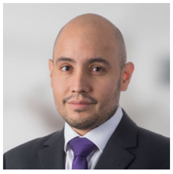

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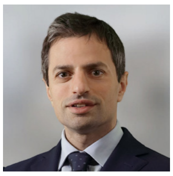

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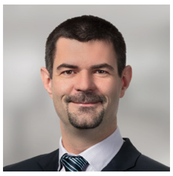

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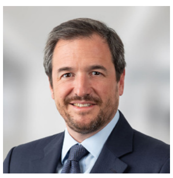

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