

# **Stablecoins—Legal, economic and geopolitical implications for Europe**

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## **The EU should embrace decentralised finance and make it safe**

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Dear Friends and Colleagues,

Thank you very much for the invitation and the opportunity to speak to you today. Decentralised finance now forms an integral part of the wider public policy discussion, including at the highest level. But I would argue often for the wrong reasons. I believe the discussion would be far more advanced if there were a greater common understanding of why and how certain elements of decentralised finance could have a major impact on the financial system.

The EU of course already embraces elements of decentralised finance through projects like Pontes and Appia by the Eurosystem and the DLT pilot regime initiated by the EU Commission. The European Investment Bank (EIB) has been an active participant in tokenised bond markets. However, I will argue much more could be and should be done.

I was given the title for the presentation. After some trepidation about how to respond I thought it offers indeed a great analytical envelope to discuss the topic. I will start with a few definitions and try to answer what is decentralised finance, why the EU should embrace it or something like it and how should the EU support it? I will end with some concluding remarks.

### **What is decentralised finance?**

The notion of decentralised finance I believe has at least three dimensions: The actors, orchestration and the financial market infrastructure.

Decentralised actors are those that do not rely on some sort of central organisation. It implies that there is no tangible entity that can be made responsible. Some decentralised arrangements may comprise Decentralised Autonomous Organisations (DAOs) as vehicles to coordinate certain aspects of financial transactions. Whether DAOs can exist in finance remains controversial and it seems incompatible with regulated financial activities.

Decentralised orchestration can be approximated in large part through technology-intermediated transactions. It may involve “smart contracts” that different parties agree to use “as is” with no recourse to the provider of the smart contract. It will likely also be in conflict with regulated financial activities but it does not mean smart contracts cannot be used in regulated finance.

Financial market infrastructures that rely on blockchain or other distributed ledger technology (DLT) platforms rest on decentralised elements. Public blockchains are databases that do not rely on tangible entities for the functioning of the platform being as replicated databases across independent parties that uses decentralised consensus to validate and record state changes to reassign control of assets—digital tokens—across addresses—digital wallets—with private keys enabling their authorisation.

Bitcoin is an example of decentralised finance. The instrument is not issued by a tangible party, does not constitute a liability of anyone (similar to gold), does not involve any contractual arrangements and rests on a public blockchain. But bitcoin is an unregulated instrument and related transactions outside regulated exchanges are mostly unregulated.<sup>1</sup>

I think the term decentralised finance is mostly wrongly understood. It may mean that regulated financial transactions are processed on public blockchains. But that does not make finance decentralised. The use of blockchain is merely an infrastructure for recording financial transactions that are similar in character to conventional transactions. However, there are many very good reasons to use blockchains in finance.

Public blockchains can function as readily globally accessible infrastructures for processing financial transactions, while permissioned blockchains can be deployed as controlled infrastructures within defined governance frameworks.

Blockchains can transform financial market infrastructures by shifting from centrally operated systems to shared, protocol-based infrastructures, potentially reducing or reconfiguring the role of intermediaries in transaction processing. Blockchain-enabled ecosystems encourage the formation of more direct financial relationships and may incentivise a shift from highly intermediated systems toward more peer-to-peer interactions.

Blockchains can accommodate different types of financial market instruments—composability—in contrast to the highly siloed and specialised conventional financial market infrastructure. Some blockchains allow embedding complex business logic—programmability—into the network to automate transaction workflows. Blockchains offer critical out-of-the-box functionalities including instant and atomic—both legs of the transaction have to succeed or none does—transactions supporting e.g. delivery versus payment.

Tokenisation can leverage blockchains. Tokenisation provides a new format—digital tokens—to represent value adjacent to dematerialisation. Tokenisation equips instruments with attributes akin to bearer instruments enabling attestation and transfer of ownership through the token transfer. Legal ownership remains a matter of law but control over the token is normally exercised through the private key, enabling transfers between wallet addresses through cryptographic authorisation.

Stablecoins represent the most tokenised financial instruments. They are similar to electronic money and other prepaid instruments. The transferability represents the principal differentiation of stablecoins compared with other monies and rests on accommodative regulation supporting non-intermediated transfers. Banknotes issued by Northern Irish and Scottish banks are the closest to stablecoins as a cash-equivalent instrument.

Stablecoins may be issued by banks or non-banks. Their regulation is often based on principles similar to those applied to electronic money, with additional considerations for non-banks for reserve backing, custody, redemption, and governance. Stablecoin use cases are particularly strong in cross-border transactions, while also extending to on-chain settlement and digital asset markets.

Tokenisation could reduce or reconfigure the role of traditional intermediaries such as custodians, central securities depositories (CSDs) and central counterparties (CCPs). A broader range of financial instruments may begin to assume liquidity and settlement functions traditionally associated with money. The adoption of increasingly instant and frictionless environments may also alter the role of money and strengthen the use of alternative settlement assets.

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<sup>1</sup> An unregulated activity must not be an illegal activity. Regulated financial activities that are processed on blockchain must not change the economic character of the financial activities.

Blockchains do not necessarily improve financial transactions. Nor are blockchains needed to perform financial transactions fast. Most frictions in financial transactions are due to compliance and regulation and blockchain does not solve for those. However, blockchains invite establishing more direct monetary and financial relationships, reducing compliance and regulation instances and thereby mitigate frictions and facilitate exchange.

### **Why should the EU support it?**

The EU should support tokenisation and blockchain amid their expected positive impact on critical public policy objectives like financial innovation, diversification and resilience of financial markets. The future financial system is expected to look more diversified by instruments, actors and will be more international, more instant and more 24/7. Tokenisation and blockchain represent critical elements to meet the demands of the future system enhancing choice, functionalities, optionality, innovation and competition in finance. The EU should support such development and play an active role in its advancement.

The EU support for tokenisation and blockchain would signal forcefully a willingness to embrace innovation. It may instil confidence that the EU is open to departure from existing financial arrangements and not particularly biased towards the status quo and preservation of existing business models and legacy infrastructures. It would encourage new entrants and their supporters.

The neutral nature of public blockchain offers the possibility to address mounting concerns about foreign actor dependencies. Blockchains may be the next best solution short of a fully owned and operated environment to mitigate any undue external interference at the network level.

The neutral character of blockchain is reminiscent to the banknote cycle. Banknotes are issued by the central bank and distributed through commercial banks, but all transactions are completely decentralised and cannot be systematically manipulated. Central banks maintain full control of issuance but for transactions rely on a neutral infrastructure they do not own nor operate while ensuring that banknotes—analogue tokens—exhibit properties sufficient to minimise fraud.

The use of tokenisation may reduce risk and enhance efficiency in financial transactions. Efficiency gains can accrue through instant and atomic transactions by reducing exposures and producing regulatory capital and liquidity savings.

Tokenised financial instruments may extend their utility. Tokenised money market funds can be used as collateral or where shares are transferred outright among subscribers to serve as settlement instruments. The use of a constant NAV money market funds—funds that invest only in government securities and equivalent assets—to acquire a security in a delivery versus delivery transaction would produce very low risk settlement conditions.

Blockchains are inherently very secure databases that will contribute to strengthening resilience in finance although security will depend on the entire tech stack. Co-existence of conventional book-entry and blockchain systems produces a more diversified environment that may provide better protection against external threats and attacks.

The efficiency gains may reduce the costs of doing business in finance. It may allow new actors to enter that had previously been prevented due to high barriers of entry. It could produce a more heterogeneous group of actors that may be better at accommodating different financial transaction demands thereby deepening financial markets.

Tokenised financial instruments may help address actual and new use cases more effectively. Business models that may not be profitable using conventional systems may be profitable using tokenisation. In foreign exchange, the use of tokenised money market funds denominated in different currencies, could produce an instant and atomic exchange of fund shares, euro-denominated for real-denominated—to enable highly efficient settlement conditions.

### **How should the EU support it?**

The EU is already engaged through various token-based financial projects including Pontes, Appia and the DLT pilot regime. However, issuance of central bank digital currencies (CBDC) is insufficient to drive tokenisation and the projects are unlikely to offer needed momentum and incentives for adoption. To effectively support tokenisation, the EU should act as coordinator.

Financial innovation often rests on coordination by the public sector. This holds for the introduction of dematerialisation, faster payment systems, open banking. It allows to overcome first mover and adverse selection problems. Tokenisation lacks this coordinator and may therefore struggle to achieve significant adoption.

The most effective way to provide coordination is through large issuance of tokenised bonds. This could be done through the EU and its institutions including the European Stability Mechanism (ESM), the EIB and in particular national governments. Government bonds represent typically the most important instruments in a given financial market and need to be held by different market actors. A sustained and large-scale tokenisation, e.g. 30 percent of national government bond issuance, would establish conditions adequate for adoption.

The issuance of government bonds could leverage the primary dealer functions in several markets and foster conditions for making markets, develop needed conditions for the development of a secondary market and thereby create incentives for other tokenised financial instruments to follow. The tokenised instruments would need to be subject to the same treatment including for eligibility as collateral in the Eurosystem's open market operations.

### **Concluding remarks**

The original idea of blockchain was the complete disintermediation of financial markets actors. The idea to use a given medium of exchange at any time irrespective of any regulatory and other constraints sounds appealing. It is similar to the use of banknotes. The universally accepted US Federal Reserve note is the one to replicate. However, while it may work for small-scale person-to-person transactions, it is highly unlikely to work for large-scale interbank and other highly regulated transactions.

Most processes do not change with the use of blockchain. Payment instructions including compliance, risk management, reporting will continue to follow existing provisions. The change consists largely in routing transactions to a blockchain for processing.

The EU is one of the leading if not the leading region for tokenisation. It offers an opportunity to shape the development of financial markets and signal a willingness to embrace innovation. The more market activity around blockchain the EU is able to mobilise the more likely it is it will play a dominant role in the next generation of financial markets.

Blockchains invite a rethink of the geographic dimension of financial relationships and transactions. Enhanced access and cross-border reach of financial instruments may contribute to a partial

denationalisation of financial activity. Blockchain offers an opportunity to rethink the boundaries of financial transactions. But it will not work if financial regulation remains national in scope.

It may not be decentralised finance the EU should embrace but to proactively support and encourage use of tokenisation and blockchain as a new financial market infrastructure to enhance performance and functionalities of financial markets would help ensure EU financial markets remain competitive.