CRYPTOASSET AND STABLECOIN REGULATION

MARTIN MOLONEY

Secretary General - International Organization of Securities Commissions (IOSCO)

Crypto: the systemic risk puzzle

The concept of systemically important institutions tends to be a size related concept and that is a reasonable proxy. But it is only a proxy.

There is a thousand-year-old English nursery rhyme, with equivalents in other cultures, which begins: 'For want of a nail…" and explains how the Kingdom was lost, for want of that nail. The point is that a failure to deal with what is ostensibly a minor issue can cause multiple compounding problems that lead to major loss in the end.

We all tend to differentiate clearly between trigger events and amplificatory processes in the causation of systemic crises and that is a good way to think about crises. It focuses our attention on the amplificatory process which can be managed, rather than the trigger events which are arguably inherent in financial markets. Markets regularly feature sudden price adjustments as markets process novel information. We do have policies to smooth sudden changes in market direction. But trying to prevent such markets events entirely would be a fool's errand and policy makers wisely focus on limiting amplification.

This is all very logical, but it doesn't exhaust the question of financial stability. Market crises are not only driven by the amplificatory effect of direct and indirect connectedness of different market participants, but also by the little understood phenomenon of 'contagion'. Contagion is a nice label for the phenomenon of market participants managing the unknown. Any market trigger event creates a risk that the consequential losses will trigger other losses and protective actions because asset prices have fallen, or counterparties have defaulted. This is interconnectedness. But it also creates a very different phenomenon: uncertainty.

Famously, most of Lehman's clients and counterparties got most of their money back once the whole insolvency process had completed, but one could not know at the time that would happen. Like hedgehogs curling into a ball in the face of threat, market participants sometimes face such uncertainty in markets that they retreat even though they actually face few risks.

The argument to leave crypto outside the regulatory net to facilitate innovation is exhausted.

If we think about the systemic risk of crypto in that context, it is evident that there is a risk. Crypto has three key features as a market subsector which make it particularly risky from a systemic risk perspective.

Firstly, the corporate structures, business models and exposures of the main crypto market participants are not transparent. It is not practical to know where their real exposures are. In the face of any trigger event in the crypto sector they all seem so intertwined that any of them could fall. This is exacerbated by evident market concentration with the three largest so-called trading platforms.

Secondly emerging DEFI protocols operate with a degree of automaticity and speed that human judgement-based protocols simply cannot compete. Risk managers have no choice but to allow automated protocols to respond in a risk minimising fashion of they have been designed to do without any assessment of what is really going on.

Thirdly, institutional investors do have a footprint in this space. Put all these three together and it is evident that any significant crypto trigger event can trigger a shudder throughout the crypto sector which only needs one possible bridge to 'tradfi' to raise the spectre of contagion into broader financial markets.

This is despite the small size of crypto. Fully applied, the G-SIFI methodology put in place in the aftermath of the GFC is meant to take not only size, but also complexity, substitutability, cross-border activities and interconnectedness into account as criteria in measuring systemic riskiness. The weighting of those other elements is important. When it comes to crypto inter-connectedness is evidently of particular importance as is cross-border footprint, but so is their lack of transparency which constitutes the same threat as complexity.

Now consider another fact about financial stability policy work and regulation: it has systematically and quite appropriately piggy-backed on regulation designed to prevent bank runs, ensure markets that operate with integrity and protect investors. That is about to happen again and it is welcome.

We have now reached the point where the argument to leave crypto outside the regulatory net to facilitate innovation has exhausted itself. Regulation to protect investors and to ensure the integrity of crypto markets is coming fast. Without a doubt, with that comes the need to improve transparency and manage inter-connectedness in crypto markets. Without that, crypto markets would remain a locus of the oblique uncertainty, which would mean that they would continue as outsized threats of contagion.

If crypto market participants are required to adopt more justifiable business models and a light is shone on the crypto sector's secret web of interconnections and dependencies in order to protect investors and support market integrity, the risk of contagion also falls.

JOSÉ MANUEL CAMPA
Chairperson - European Banking Authority (EBA)

Crypto-assets: strengthening the framework for mitigating risk transmission

Recent market developments, in particular the impact of the recent US bank failures, have served as a timely reminder of the need for the effective monitoring and mitigation of risk transmission channels within the crypto-asset sector and, indeed, across all parts of our financial system.

In the EU, the crypto-asset sector will soon be bound by the Markets in Crypto-assets Regulation (MiCA), which is expected to enter into force in early-summer 2023.

MiCA will establish a comprehensive framework for the regulation of crypto-asset issuance and service provision and will confer on the European Banking Authority (EBA) extensive new policy and supervision mandates for issuers of asset-referenced tokens (ARTs) and electronic money tokens (EMTs).

In taking forward these mandates the EBA will be paying close attention to the potential for risk transmission within the crypto-asset sector and, importantly, between the crypto and traditional finance sectors.

For example:

- in establishing the reserve requirements for ART and EMT issuers, the EBA will be paying special attention to diversification of the deposit component of the reserve;
- in defining governance requirements, the EBA will be highlighting the importance of identifying and mitigating conflicts of interest between different parts of an issuer, or an issuer's group, activities; and
- in establishing our future supervisory approach for issuers of significant ARTs and EMTs, the EBA will be taking account of interconnectedness, including in the context of the supervisory colleges to be established under MiCA which, among other themes, can be expected to monitor the business model of the issuer, and interconnectedness between the different components of crypto-asset ecosystems, such as custodians and trading platforms. These college structures will provide a useful forum for to facilitate discussion between supervisors on issues relating to potential risk transmission channels and the coordination of actions to mitigate these risks.

However, experience shows that risk transmission is typically not a one-way phenomenon and our policy response needs to be necessarily multilateral. Therefore, as well as regulating and supervising the crypto-asset sector, it is necessary for us to strengthen the framework for the regulation of other parts of the financial system, including the banking sector.

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In December 2022 the Basel Committee on Banking Supervision (BCBS) published its standard for the prudential treatment of banks' exposures to crypto-assets. This framework sets clear expectations regarding the reporting of banks' exposures to crypto-assets, thereby enabling more effective monitoring of potential interconnectedness risks, and establishes a globally consistent approach for quantifying the capital to be held against exposures. I expect this framework to be implemented faithfully in the EU and welcome the follow-up actions of the BCBS to promote convergence in the application of the framework to specific crypto-assets.

However, due to the global nature of crypto activities and the risks of regulatory arbitrage, more work is needed at the international level to promote global consistency in the regulation and supervision of crypto-assets in order to mitigate the risks of contagion across borders, whether via financial, reputational or confidence effects.

In this respect, the Financial Stability Board's (FSB) work this year on the revised high-level recommendations for the regulation and supervision of so-called global stablecoin arrangements, and for other parts of crypto-asset ecosystems, will provide an important catalyst for jurisdictions to continue to strengthen their regulatory frameworks.

In the meantime, the EBA will continue to advocate a proactive 'compliance by design' approach within the industry. The contours of MiCA are, by now, familiar and I would encourage market participants to already adjust their operations in line with the requirements to benefit from the sound risk management practices it instils.

We will also continue to actively engage with our European Commission, European Supervisory Authority, and competent authority colleagues within and beyond the EU to foster supervisory convergence in order that the opportunities offered by the underlying technologies can be leveraged whilst mitigating effectively the risks.

BENOÎT DE JUVIGNY
Secretary General - Autorité des Marchés Financiers (AMF)

The current crypto market downturn: healthy shakeout or crypto endgame?

The downturn of the crypto market since the first semester of 2022 has been a cause for concern for many crypto-assets investors and, more broadly, for the crypto ecosystem. This was accompanied by the failure of several crypto-asset service providers, including major players with a global footprint The question on many people's minds is whether this is a mere fluctuation of the market and a healthy shakeout, the bursting of a bubble, or the first stage of a possible crypto endgame.

First, it is key to note that the crypto market has always been volatile, with extreme fluctuations in price being a common occurrence. This is due to a variety of factors, including speculation, news events, current or future regulatory changes. The present downturn may simply be a healthy market correction, allowing it to stabilize in the long term as regulation builds up, as use cases in the field of finance develop or social utility for crypto holders evolves.

However, the failure of certain crypto-asset service providers and stablecoins has raised major concerns about the fragilities of existing crypto ecosystems. This has revealed weaknesses in infrastructures supporting the crypto market and has highlighted the need for greater regulation and oversight.

It is difficult to determine the exact causes of these events, as they are likely the result of a combination of factors. While some issues may be specific to the crypto market, such as crypto-assets service provider's governance problems, fraud, or issues related to the design of blockchain protocols, others may depend on broader factors such as macroeconomic conditions or economic uncertainty.

The failure of certain stablecoins, designed to maintain a stable value, has also raised concerns about the viability of such assets. This has led to calls for greater regulation and oversight of stablecoins, to ensure that they are able to fulfil their intended purpose.

The EU Markets in Crypto-Assets (MiCA) regulation, which is planned to start applying in 2024, aims to provide a harmonized framework for the regulation of crypto-assets. Ensuring better investor protection and addressing risks associated with crypto-asset markets, MiCA will also provide legal certainty to players seeking to develop their activities in the EU.

The EU is on the right path by making the choice to regulate in a comprehensive but sensible manner.

It remains unclear whether the MiCA regulation would have completely prevented the issues that have arisen in the crypto market in recent months. In the same way that traditional financial regulations could not prevent all kind of financial downturns, the regulation of crypto-assets could not be able to prevent all the possible frauds and irregularities of the crypto market.

However, it is likely that MiCA would have provided greater oversight and transparency, making it easier to identify and address issues at an earlier stage. Regarding the collapse of FTX which remains a key moment in the recent history of crypto-asset markets, a number of MICA's provisions would have at least mitigated some risks and potentially prevented this failure and the magnitude of its consequences, if the company had been established in the EU and licensed under MiCA. These provisions notably include the segregation of clients' crypto-assets and funds, measures around the management of conflicts of interest, better disclosure requirements towards clients and to some extent rules preventing the use of insider information.

This cutting-edge regulation was also designed to take into account the rapid pace of innovation in the crypto market, including emerging trends such as Decentralized Finance ("DeFi") or Non-Fungible Tokens ("NFTs") which will be the subject of ad-hoc reports by the Commission, accompanied if necessary by tailor-made legislative proposals. It remains to be seen whether EU regulation will be able to keep up with the pace of technological change and whether it will be effective in addressing future challenges, but the EU is on the right path by making the choice to regulate in a comprehensive but sensible manner.

Finally, for this regulation to be truly effective in a crypto environment that is cross-border in nature, cooperation with other international authorities will also be an important factor for success and a decisive element for adequate investor protection.

Europe has chosen tailor-made regulation for crypto-assets, designed to enable innovation while protecting against risk. The crypto asset market has seen several upheavals, but these events can help clean up a bubbling ecosystem that is constantly evolving. The MiCA regulation is a major step in the right direction, but it remains to be seen whether it will be effective in addressing the challenges faced by the crypto market in the years ahead.

MARCO SANTORI
Chief Legal Officer - Kraken Digital Asset Exchange

Executing the next phase of the EU's leadership in crypto assets

The EU has taken an important step in developing a bespoke regulatory framework for crypto assets. The design and agreement of the Markets in Crypto Assets regulation (MiCAR), is the foundation of a functional and efficient market for cryptoassets. Likewise, the regulation's forward-looking technical implementation will be critical to member states maximizing the economic opportunity of digital assets.

MiCAR, which once seemed a lofty legislative ideal, has come into its own as a comprehensive blueprint for other jurisdictions to consider as they develop their own frameworks. While jurisdictions across the globe are playing catch-up following the fallout of FTX, the EU had foresight to recognise both the digital asset sector's economic opportunity and the investor protections required to mature the sector. Dedication to understanding traditional finance's challenges, as well as the viable alternative of decentralized finance, empowered the EU to develop clear expectations, definitions and scope to regulate digital assets.

While the industry scrutinises individual aspects of MiCAR, it's important to recognise the laudable achievement of having secured a political agreement on such a fast-moving sector. This agreement now bears the potential to translate into practical regulation that allows cryptoassets to innovate. Crypto asset-focused businesses, aspiring innovators and entrepreneurs, venture capitalists and retail investors all stand to gain from the legal clarity it offers. The framework opens the door to a pragmatic and proportionate regime which can evolve over time as the digital asset industry develops within a sensible regulatory perimeter.

To capitalize on the economic opportunities of crypto assets, the EU should continue its efforts. Improved accessibility of financial services, efficiencies in payment settlements, job creation, and boosted growth are only a few of the rewards waiting at the finish line if the EU can get the final technical implementation right. The European Supervisory Authorities, including the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA), alongside the competent national authorities, will have key roles to play in promoting orderly financial markets and in how this new framework is implemented.

MiCAR opens the door to a pragmatic and proportionate regime which can evolve over time as the digital asset industry develops within a sensible regulatory perimeter. As we approach this final stretch, there are three key components of MICAR's implementation that both policymakers and regulators must keep in the forefront of their minds.

MiCAR opens the door to a pragmatic regime which can evolve along with the digital asset industry.

- **Deliver workable transitional arrangements** - the transition from national crypto regulatory regimes (so-called "VASP regimes") to a pan-European regime should be orderly and structured if it is to be successful. Crypto businesses should be able to avoid operational disruption while adapting to the new pan-EU framework. This adjustment period will require a predictable and universally agreed upon grandfathering process. This is currently at the discretion of each EU member state. We recommend instead a coordinated approach in the pan-EU spirit of MiCAR.
- **Ensure a level playing field across the Member States** - obtaining a CASP license should be a clear sign that the business is mature, has invested in appropriate functions and controls, and is willing to cooperate with the regulators in a constructive manner, regardless of in which Member State the licensing takes place.
- **Collaborate with global stakeholders to ensure harmonized international markets** - Crypto asset markets are inherently fungible and global. Thus they will require a globally-coordinated oversight. For this reason, the implementation of MiCAR, while setting a high bar for others to follow, should also be compatible with international financial standards from across the world. An efficient customer experience requires efficient interplay between the laws of jurisdictions across the globe.

The world's eyes are trained on the progression of MiCAR. Europe has the opportunity to set a critical global standard for customer protection and business efficiency. We stand ready to support policymakers and regulators through this important next phase.

RICHARD TENG
Regional Head of Europe and MENA - Binance

Transitioning towards MiCA

In a few weeks, the EU's long awaited crypto regulatory framework is set to enter into force. The clock will start ticking for European issuers of stablecoins and crypto asset service providers (CASPs), who will have 12 months and 18 months, respectively, to prepare for implementing the Markets in Crypto Assets (MiCA) requirements.

MiCA is an example of the EU's determination to leverage its regulatory heft to advance the agenda of strategic autonomy. It seeks to reconcile the impulse to tame markets and to harmonize rules across the block, with the objective of taking a leap towards global leadership in Web 3.0.

EU policymakers have accepted that crypto assets can be different from financial instruments and offered a bespoke regulatory framework for them. But whether MiCA will meet its objectives hinges on how the regulation is translated into detailed rules, so-called level 2, and how it is implemented.

The work on regulatory standards and guidelines will unfold as the industry strives to rebuild and regain trust from the negative events of the past year and against the backdrop of a volatile monetary and financial environment. Throughout this work, EU regulators should not lose sight of the ethos of MiCA - to provide clarity around the rules for the sector to thrive - and the industry must engage more constructively than before to help them find pragmatic solutions to implementation.

This must be achieved notwithstanding the tight timelines. In some instances, there is a risk that MiCA will apply before the technical standards are finalized. This will be a challenge for CASPs. Clear communication on the key requirements, supervisory expectations and enforcement actions will be paramount for the industry to overcome it.

MiCA aims to protect consumers and investors, and increase financial stability within the market, while at the same time not hampering innovation within the crypto and Web3 space. Binance is committed to play its part. As the largest crypto trading venue, by volume, we have a responsibility to lead by example. We are registered in seven Member States under the AML Directive, including France, Italy, Poland and Spain, and are accelerating our transition towards MiCA.

We are building on the existing strong processes and infrastructure to offer further confidence to European users that their crypto assets are segregated, that heightened protections are enforced, and that trading happens in a fair environment. This is our way to contribute to the development of the Web 3.0 economy in Europe.

Binance is committed to play its part in making stablecoins in Euro available to users.

Euro stablecoins

The range of issues to be covered in the Level 2 work is wide, from the criteria to identify crypto assets that are financial instruments, to the rules on conflicts of interest for CASPs and the requirements for stablecoins. The latter will be especially important because they straddle the worlds of traditional finance and crypto.

Stablecoins have been an early concern of policymakers. MiCA, which was negotiated under the shadow of Libra, Facebook's failed digital currency project, strictly regulates the issuance of stablecoins and introduces negative incentives to move the market away from USD and towards Euro stablecoins.

We are looking at a huge shift. The top 5 USD coins have $130bn (€120bn) in reserves, according to Coinmarketcap. The top 5 EURO coins have less than €150m. Any transition and rebalancing, no matter how desirable, should be done gradually to avoid market dislocations that will ultimately hurt consumers.

While we are opposed to measures that reduce consumer choice and fragment liquidity in a global market such as crypto, Binance is committed to play its part in making stablecoins in Euro available to users.

We believe blockchain is, in many ways, a superior technology and appropriately designed stablecoins, fully backed, are, therefore, a superior form of money. Not only do they play a critical role in supporting crypto markets and DeFi, they can support faster, more efficient and inclusive payments.

Research by the Digital Euro Association, supported by Binance, shows how Euro stablecoins hold the promise of propelling Europe to leadership in machine-to-machine payments. Furthermore, Euro stablecoins can become the settlement asset in tokenised financial markets, as envisaged in the DLT Pilot Project.

Regulation should not stand in the way but play an enabling role. In the context of MiCA, this will require sensible rules on stablecoin reserves and capital, as well as a pragmatic definition of the scope of the prohibition of interest payments by CASPs. But this issue goes beyond the crypto regulation and will permeate discussions on a range of policy files, from payments to the digital euro.

Ultimately, the question that needs answering is where do stablecoins fit in the financial system, alongside bank deposits, backed by fractional reserves, and central bank money. Europe must create a level playing field, to foster competition and, with it, innovation.