Cryptoasset and stablecoin regulation

Introduction

The Chair introduced the session by mentioning that while some people had thought that crypto was a fad and would not last very long because it does not serve any useful economic function, it is not gone, still attracts investors and is probably due to last. There are however some concerning aspects to crypto that need considering such as a high degree of anonymity that has led crypto to be used for illegal activities and a recent downturn in the market, as well as the failure of several cryptoassets and service providers in 2022. Ensuring sufficient resilience of crypto is a starting point for further development of the market. The panellists were invited to discuss the added value of crypto and its future prospects, the lessons that can be learned from the recent market turmoil and whether the issues facing crypto can be handled with the policy initiatives that are being led in various jurisdictions including the EU.

1. Added value of crypto and future prospects

An industry representative stated that the value proposition of crypto is quite simple to understand. Crypto is the ability to transmit value electronically. The internet has evolved from a medium where people could simply read information into a medium where people can also participate and contribute to providing information online for others to read or use, such as social media. Crypto is part of the third generation of the internet (Web 3), which adds the ability to transmit value via tokens, which can be used to store that value or as a payment mechanism. Tokens can also be used to safeguard personal information or affinity, which has enormous value, since it can facilitate online participation without handing over the data for others to monetise.

A second industry representative believed that the future for digital assets and blockchain technology is bright. There are significant value drivers that will support their development. Blockchain and cryptocurrencies were indeed invented to solve a problem, which was a lack of trust in the existing financial system and traditional currencies. Those who dismissed Bitcoin initially were sceptical about the value of such assets and about the benefit of self-custody, with the common belief that banks could be trusted with holding assets. Then some banks in the US started failing, which reinforced the value of self-custody, which ensures that an asset cannot be taken away from its owner and that an intermediary such as a bank cannot use it inappropriately. Self-custody is an ongoing value driver for digital assets and there has been repeated proof of that over the last few months. A similar effect is taking place with decentralised finance (DeFi), which is proving to be a powerful force of growth in the market. Over the last year, there have been many weeks in which the volume of DeFi has exceeded the volume of transactions on centralised exchanges. A key value driver of digital assets and crypto going forward is their capacity to solve real-world problems of value transmission in the financial sector and also everyday questions such as functional non-fungible tokens NFTs that can be used by their holders to e.g. prove club membership.

A regulator emphasised the need when speaking of crypto to distinguish between the underlying technology, and the products and assets that are issued and used with the technology. The difficulty is understanding the value of each component of the crypto ecosystem and addressing it in an appropriate way. Some regulators are concerned about consumers and banks buying or storing cryptoassets because of the difficulty of understanding the precise nature and value of these assets. There is no doubt about the value of Distributed Ledger Technology (DLT) which is being used in many processes within financial institutions in a profitable way and there are many further opportunities to exploit. NFTs are easy to understand, they are a product, not a financial asset, but their value is difficult to evaluate. Stablecoins are more challenging to categorise. They look like a financial product but can also be considered as a payment device, in which case they need to be regulated as such.

2. Lessons learned from the recent market turmoil

An industry representative stated that the recent downturn was the fourth in crypto. As with many early stage asset classes or early technologies, there is an up and a down cycle until greater maturity is reached. The fact that there has been so much public coverage of the latest downturn is a credit to or a product of the increasing adoption of crypto over the last couple of years and also of the rising interest of policymakers in the implications of this. What has been learned over the last few weeks is that crypto is like many other asset classes. People brought the asset into their portfolios when the value was going up and then, when de-risking occurred in the wider financial market because of macro conditions in particular, people de-risked and sold crypto as part of this.

The core elements of crypto have nevertheless remained strong over the recent period, the industry speaker stressed. The technology has proven to be hugely resilient under enormous stress. The networks and the tokens have worked efficiently and with no interruption. DeFi protocols such as borrowing and lending protocols have continued to be able to provide credit through smart contracts. Stablecoins backed by short-dated assets have done very well also. What have not done well are the more fragile or badly managed components of the ecosystem: either highly experimental models like algorithmic stablecoins, or activities that were poorly risk managed or did not operate a viable business model. In terms of adoption, retail trading activity has been down but holding steady. What has picked up and stayed high throughout the market downturn is institutional interest, which is expected to continue to develop with an increasing number of hedge funds or pension funds accessing the crypto markets.

A regulator stated that the root causes of the recent turmoil and failures in the crypto system are a combination of five main factors. First, the high inherent volatility of crypto markets. Second, IT security and hacking issues experienced by some platforms. Third, issues related to the design of certain protocols, for instance algorithmic stablecoins. Fourth, governance problems, including conflicts of interest and the lack of segregation of client assets and also the difficulty for domestic regulators of monitoring risks in large and complex international crypto groups with a wide range of activities. Finally, there have been domino effects within the crypto sector due to a high level of interconnectedness among crypto players. No major spill-over effects have been observed at this stage between crypto activities and the traditional finance world however. For all these reasons, there needs to be a regulation of crypto activities in place at the EU level and possibly at the international level.

A second regulator observed that the recent market turmoil revealed the truths about unregulated stablecoins and exposed the illusion of some unsustainable crypto business models. For example, algorithmic stablecoins are not unlike Ponzi schemes, sustainable only with continuous inflow of new money. The various risks and vulnerabilities to which the crypto ecosystem is exposed are similar to those facing traditional financial systems, but the problem is that they are not regulated adequately in most jurisdictions. For example, stablecoins backed by assets may suffer liquidity and maturity mismatch, and run risks. Cryptoasset lending and derivative transactions involve the risk of excessive leverage. When entities manage clients' assets, there are risks of misuse of these assets and of conflicts of interest.

An official summarized that the crypto market has been exposed both to the same adverse macroeconomic conditions as the rest of the financial sector and also to more specific issues of poor risk management and governance failures, which led to a stream of crypto companies filing for bankruptcy protection in the second half of 2022. Many of the measures that were put in place to increase the resilience of the traditional financial system post-financial crisis, including a reinforcement of risk management and corporate governance requirements, industry-driven best practices and a strengthening of supervisory oversight, are missing in the crypto market. There are some instances of crypto entities, however, where a regulatory framework does apply - for example, LedgerX, a derivatives exchange and clearing organization purchased by FTX in 2021, which is registered with and regulated and supervised by the U.S. Commodity Futures Trading Commission (CFTC)[1]. As a result of that regulation and supervision, LedgerX remained solvent following FTX's bankruptcy, and was successfully sold in April 2023 and remains a going concern.

The official emphasized that individual investors are particularly exposed to the risks of crypto markets. Regulators should ensure that the right guardrails are in place to ensure that markets are fair and transparent, with appropriate customer protections and that regulators have sufficient visibility on how the different activities of firms are handled. During summer 2022, when prices were at their highest, retail investors were still buying in cryptoassets, while sophisticated investors were exiting the market, engaging in a sell-off as the melt-down began. That left regulators deeply concerned. A study by a Bank of International Settlements (BIS) economist recently noted that not only did retail investors pay the highest price, but they likely lost the most in comparison with other larger and more sophisticated investors.

3. Progress made with the regulatory framework of crypto

3.1 Main objectives and scope of crypto regulation

A regulator noted that in order to correct the shortcomings exposed by the recent turmoil in the crypto market in terms of operational resilience, corporate governance, segregation of funds, etc., an authorisation process is needed, as well as regulatory requirements addressing governance and conflict of interest and potentially also liquidity and leverage issues. The interactions with the traditional financial sector and with the investor world also need considering, e.g. whether investors are appropriately protected when investing in crypto products, whether the role played by banks in the crypto value chain is creating new vulnerabilities, spill-over or interconnectedness risks. Finally, it is important to understand whether crypto technology is being used for providing a financial product or asset. If this is the case, particularly if there are interactions with the banking sector, these activities need to be regulated and supervised e.g. as payment activities.

1. On the day of FTX's bankruptcy, LedgerX was solvent, could account for customer funds and was able to present financial resources to ensure that the firm could participate in an orderly wind down. Pursuant to the CFTC's regulatory framework, there was a segregation of customer accounts and customer funds. There were conflict of interest policies, cybersecurity policies and direct oversight of management in place to ensure that a qualified, capable board of directors was engaged in ensuring the risk management of the firm.

An industry representative stated that the regulatory momentum around crypto in the EU and in many other jurisdictions including the UK, Brazil, APAC region, UAE and more recently the US is a healthy development and shows that crypto is becoming a more mainstream activity that should be subject to appropriate regulation. It is essential that these initiatives do not regulate crypto as a technology, but consider the underlying activities that are performed with the technology (e.g. providing a payment mechanism, a financial asset, an affinity coin) and that the need for regulatory oversight is determined depending on the significance of activities for the wider public and the potential risks posed.

The industry speaker suggested that the primary area where regulation and oversight are needed is for activities led by cryptoasset service providers (CASPs) serving as centralised intermediaries, taking client funds and safekeeping client assets. The regulators should ensure that these activities are performed in a safe way and that funds and assets can be returned to the customer if needed. The second category of players that should be regulated are stablecoin issuers. Regulators should ensure that stablecoins are appropriately backed by a particular fiat currency, that the assets are stored safely, that there is transparency in audits with regard to the reserves, that the rules around redemption are clear, and that customers understand what their rights are and the terms under which they can get their money back.

3.2 The EU Market in Cryptoassets (MiCA) regulation

A regulator explained that MiCA will provide significant improvement but will not solve all the issues posed by crypto. MiCA will come into application between 2024 and 2026, so will take up to three years to be completely applied. It will complete existing requirements and registration processes put in place in certain member states e.g. France and contribute to investor protection. In terms of legal clarity there are still problems of definitions and of consistency between jurisdictions for instance between the US and Europe on what is a financial instrument and what is a virtual asset. MiCA provides many new and welcome requirements concerning segregation of assets, governance, management of conflicts of interest, internal controls, IT security requirements, better disclosure requirements towards clients and anti-money laundering (AML). The question is whether this is enough to tackle the main risks from crypto and what may be missing.

The lessons from the failure of FTX should also be taken into account, the regulator suggested. Even in a more regulated world, large frauds are difficult to avoid. Therefore, supervisors need to remain very vigilant. One of the possible difficulties with MiCA is having a fully consolidated view on large diversified crypto groups. The European Supervisory Authorities (ESAs) and the National Competent Authorities (NCAs) have to find a way to cooperate in a forum where they are able to discuss real cases, with colleagues from other sectors. Another possible issue regarding MiCA is the way market abuse is handled, because existing surveillance tools used in the traditional financial market are not adapted to crypto markets. The thinking on this topic is still at an early stage and will need to be pursued.

An industry representative considered that MiCA is a ground-breaking initiative and a model for ensuring that assets are being held safely, that CASPs have appropriate prudential controls in place, and that there is sufficient surveillance of potential market manipulation. An important step will be the production of the Level 2 rules, which should be an opportunity to clarify a certain number of aspects of the regulation. The policy intentions of MiCA with regard to stablecoins need clarifying in particular. Reserve capital requirements and hard caps on the number of stablecoins issued seem excessive in the present rules. That may reduce the opportunities for the euro to be tokenised and to be widely used in digital environments that are due to develop. Europe should be part of those evolutions, which is why the euro stablecoin needs to be widely accessible.

A regulator stated that significant progress is being made with MiCA. The regulation will enter into force in two years' time and regulators and supervisors are preparing for this. In this perspective, supervisors need to enhance their capabilities and regulators need to provide more clarity in terms of definitions, distinguishing technology, products and financial assets.

3.3 Policy initiatives in other jurisdictions

A regulator stated that in Japan the JFSA introduced a regulatory framework for cryptoassets in 2016, followed by a revision three years later, which has been working successfully. For example, CASPs are required to use highly reliable methods to manage and protect customers' cryptoassets. They have to undergo external audits over the status of their segregation management. CASPs are also required to have their financial statements audited and disclosed publicly. Even after the bankruptcy of FTX, FTX Japan was able to protect client assets and the clients have had access to their funds since February 2023. The Japanese regulation and supervision of cryptoassets address issues like conflicts of interest, onboarding procedures and fairness. As a result, complex and opaque trading platforms have not developed in Japan in the same way as in some other jurisdictions. The Japanese framework is effective but not yet perfect. While the existing regulation of virtual asset providers has been effective, some cryptoasset activities are not yet regulated. For example, crypto lending activities which were one of the causes of recent problems are not regulated.

An industry representative suggested that although there are still some hard questions about conflicts of interest and transparency, the path to a sensible regulatory framework for cryptoassets and stablecoins is quite straight forward. Jurisdictions around the world are making significant progress and are generally adopting the same type of framework. The UK, which is in the midst of its own consultation process, is expected to adopt something similar to MiCA. Brazil and Australia will start consultations by Q2 or Q3 2023. Dubai has a regime in place. Hong Kong is in the midst of consultations. The US is however still an outlier on crypto regulation, because the US regulatory system is fragmented across several different regulators at federal and state level. There is in particular a jurisdictional issue around whether cryptoassets can be considered as securities.

An official suggested that one benefit of the US regulatory framework is that it is flexible and there is hope that a solution will be found to address the divisions in Congress about the way to address cryptoassets.

3.4 International coordination

The panellists were generally in favour of consistency and coordination among jurisdictions in the policy approach to crypto assets and activities at the international level.

A regulator stated that, given the cross-border nature of cryptoassets, there is a need to strongly promote consistent and effective regulation and supervision across jurisdictions. The FSB's high level recommendations on cryptoassets and stablecoins are being finalised. IOSCO is working on these issues as well. International cooperation among supervisors is also necessary, even though there may be some differences across frameworks.

An industry representative concurred that global consistency is critical. In the US, the legislative process is chaotic, so there is a risk of inconsistency in regulation across jurisdictions. The real risk is that innovators and entrepreneurs start building for the US markets and that the products distributed in Europe end up being inferior because of this. If regulation is not sufficiently consistent, siloing will occur.

The Chair wrapped up the discussion mentioning that IOSCO will produce its own proposals for global standards for the regulation of crypto before summer 2023, which should contribute to achieving a consistent framework for cryptoassets at the international level.