CRYPTOASSET AND STABLECOIN REGULATION

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Crypto-Assets: delivering investor protection and market integrity outcomes

As I wrote back in April, the argument to leave crypto outside the regulatory net to facilitate innovation is exhausted. Since then, regulators globally have made impressive progress to capture crypto-asset activities within our net.

At IOSCO, in late May, we consulted on policy recommendations to address the proximate investor protection and market integrity risks in crypto-asset markets. Application of existing IOSCO Standards, bolstered by these recommendations, will facilitate effective supervision, enforcement and international cooperation in respect of entities who engage in activities relating to crypto-assets ("Crypto-Asset Service Providers / CASPs") with the goal of promoting regulatory compliance.

While the full suite of Recommendations are essential to the delivery of effective regulatory outcomes in crypto-asset markets, let me pinpoint two elements, conflicts of interest and custody.

CASPs engage in multiple activities under one roof through a single legal entity or a closely affiliated group of legal entities in a wider group structure, often structured in an intentionally non-transparent way to obfuscate the legal entity that the investor is transacting with.

The significant conflicts of interest must be identified and mitigated, and may necessitate separate licenses as seen in traditional financial markets. In some cases, the conflicts may be unmanageable and therefore legal and functional disaggregation may be necessary.

Safeguarding client assets is at the heart of investor protection. Key custody risks relate to asset segregation, re-use of assets, liability and ownership considerations. CASPs have evidenced a clear inability to effectively safekeep client assets, starting with Mt. Gox in 2014 through to the multiple instances of misappropriation and loss of client assets in recent years.

Regulators around the world need to work in a coordinated manner to stamp out regulatory arbitrage.

Tackling custody-related risks in crypto-asset markets is informed by traditional financial markets. Risk mitigation measures including recordkeeping and reconciliation requirements; separation of client assets from proprietary assets and fundamental disclosures to help investors understand the risks they are exposed to by allowing CASPs to safekeep their assets.

Turning to financial stability risks, thankfully interconnectedness and transmission channels from crypto-asset markets into the real economy are limited at present.

The FSB published their two sets of High-Level Recommendations in July. Given the high-level nature of the FSB Recommendations and the prevalence of non-FSB member jurisdictions with material crypto-asset activities, policy measures from IOSCO are critical in ensuring the regulatory net captures bad actors across the globe, while setting out more granular regulatory expectations for regulatory authorities and market participants alike.

The IOSCO measures acknowledge that jurisdictions are at different stages in tackling crypto-assets. Some jurisdictions have existing regimes which capture crypto-assets and the corresponding activities. Other jurisdictions have sought to develop new, bespoke frameworks to remove any supposed lack of regulatory clarity.

Look no further than MiCA in the EU. The co-legislators' measures are aligned with the IOSCO Recommendations as they seek to introduce guardrails for CASPs to bring much-needed investor protection and market integrity.

One of the greatest challenges we have as regulators is to achieve the right level of global cooperation to ensure that borders are not abused, particularly with inherently cross-border crypto-assets. Given the global nature of crypto-assets, regulators around the world need to work in a coordinated manner to stamp out regulatory arbitrage. Unfortunately, an EU framework alone will not solve the crypto-asset conundrum.

IOSCO's wide membership, over 130 countries who together regulate more than 95% of securities markets, uniquely positions us to deliver regulatory outcomes in the coordinated, global manner needed.

The IOSCO Recommendations on Crypto-Assets and on DeFi will be finalised by the end of this year. Attention then turns to adoption and implementation. IOSCO has a long standing record of implementation monitoring but jurisdictions must first be given time to adopt the Recommendations and build them into their regulatory frameworks.
For some jurisdictions it will be a challenge to meet these standards and it is reasonable for them to take some time to put all the elements in place. Having said that, I am very confident that we will get full take-up across our global membership in the next couple of years which will fundamentally change the way crypto-assets are regulated with consistent outcomes achieved across jurisdictions.

The development of an effective regulatory framework is not solely the task of regulators but rather a joint effort with all crypto-asset market participants. This provides CASPs and other participants with the opportunity to restore some credibility by bringing activities into compliance with accepted global standards.

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Regulating crypto-assets: advancing sound practices

In the year to-date, the crypto-asset market has been characterised by pockets of market turmoil, yet sustained retail and institutional interest in tokenisation, and use-case proliferation. This year can be seen as a tipping point in terms of regulation, with significant progress towards consistent and effective standards at the EU and international level to regulate not only so-called stablecoin issuance, but also the wider crypto-asset ecosystem.

In the EU, the Markets in Crypto-assets Regulation (MiCAR) entered into force on 29 June, starting the clock on an intensive phase of work as industry and supervisors prepare for application (in the case of asset-referenced token (ART) and electronic money token (EMT) issuance, from 30 June 2024, and for crypto-asset service provision, 6 months thereafter).

To facilitate convergence in the transition to the application of MiCAR to ARTs and EMTs, the European Banking Authority (EBA) has published a statement addressed to issuers, and to national supervisory authorities, with the objectives of reducing the risks of potentially disruptive and sharp business model adjustments at a later stage, fostering supervisory convergence, and facilitating the protection of consumers. The statement includes 'guiding principles' to which issuers are encouraged to have regard until the application date, encompassing topics such as disclosures to, and fair treatment of, potential acquirers and holders of ARTs and EMTs, and sound governance, including effective risk management.

Under the MiCAR, the EBA is responsible for ART and EMT 'level 2' and 'level 3' work (i.e. technical standards and guidelines) and has published a first set of consultation papers covering the information to be included in applications for authorisation to issue ARTs, qualifying holdings, and complaints handling. The majority of the EBA's consultation papers will be published in autumn 2023, including on important mandates relating to governance, own funds, and reserve assets. The EBA strongly encourages industry feedback.

2023: a tipping point with major strides towards unified, effective standards in the EU and globally.

Additionally, the EBA is accelerating its own preparatory steps for the supervision of significant ARTs and EMTs under MiCAR, as well as promoting dialogue between supervisors on market developments and supervisory experience to-date. Focus areas include consumer protection and money laundering risks - another area in which consultations can be expected before year-end on mandates under the Funds Transfer Regulation as extended to crypto-assets.

Looking beyond Europe, the EBA continues to engage actively in the crucial work at the international level to promote regulatory convergence and mitigate risks of forum shopping – both necessary elements if we are to see truly global robust and resilient crypto-asset markets.

The Financial Stability Board (FSB) published last July recommendations to promote the comprehensiveness of regulatory approaches to crypto-assets.4 These recommendations take account of the lessons learned from recent crypto-asset market developments, and include enhancements regarding the regulation and supervision of 'global stablecoin' arrangements, and new recommendations for crypto-asset activities and markets. These additional measures to mitigate risks of conflicts of interest within the sector and, importantly, to strengthen cross-border supervision are much welcomed. The EBA will be paying close attention to these recommendations as we further develop the framework for supervisory colleges for all significant ARTs and EMTs under MiCAR.

Additionally, the Basel Committee on Banking Supervision (BCBS) continues to assess bank-related developments in crypto-asset markets, including the role of banks as stablecoin issuers and custodians of crypto-assets, and broader potential channels of interconnections within the crypto-asset ecosystem. It will also monitor the implementation of its December 2022 prudential treatment of banks' crypto-asset exposures, carrying out reviews as appropriate. This is crucial work to ensure that we have not only aligned regulatory standards, but also aligned implementation, on the classification of crypto-assets for prudential purposes.

In light of the ongoing developments at international level and acknowledging the importance of fully implementing the Basel standards on banks' exposures to crypto-assets in the EU, the recently agreed CRR/CRD package will include a transitional prudential treatment for crypto-assets taking into account the strict legal requirements introduced in MiCAR and specifying amongst others the capital treatment of EMTs and ARTs.

Overall, regulatory progress is strong, but much work lies ahead as industry and supervisors work to embed the new frameworks – work that depends on continued sound collaboration and coordination between industry and supervisors and among supervisors and I look forward to our discussions at EUROFI.

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MiCA and next steps: the way forward for addressing crypto risks in the EU

Introduction

Recent events such as the fall of FTX have highlighted the need to address the risks of crypto-asset activities aimed at retail consumers and have developed in a global cross-border manner.

From its entry into application in 2025, the EU's MiCA regulation will regulate the issuance and offering of crypto-assets to the public across EU jurisdictions and the admission for such crypto-assets to trading on crypto-asset platforms operating within the EU, and will seek to address the risks that this new asset class poses to consumers.

The entry into force of MICA will address the main risks stemming from crypto

MiCA intends to provide one of the first comprehensive frameworks for crypto-asset activities across the EU. It places a number of obligations across different types of crypto-asset service providers (CASPs), including crypto asset trading platforms, custodians, and on offerors or issuers of crypto-assets, including stablecoins.

Concerning AML-CFT risks, MiCA points to the requirements of the EU's AML Directive, which CASPs and stablecoins issuers will have to comply with. In particular, the text addresses the risks through the angle of governance and fitness and propriety of individuals and shareholders.

Alongside these obligations, MiCA sets forth prudential, organisational, and conduct of business requirements. MiCA also implements rules for the safekeeping of client asset and the prevention of market abuse. In particular, CASPs will be required to hold regulatory capital, make a certain number of disclosures, and address conflict of interests, including in the context of the wider group they belong to.

With these requirements, MiCA intends to address the risks and issues posed by the lack of information that users of crypto-assets might face, the risks related to governance and overall robustness of service providers, and the specific risks of market abuse linked to the trading of crypto assets.

MiCA will also specifically address the risks pertaining to the issuance and use of stablecoins, subjecting their issuers to stricter requirements, including around the maintenance and funding of reserves, redemption obligations, and specific governance requirements.

Level 2 requirements will need to clarify a few topics

Following the publication of the level 1 text in June 2023, a number of areas remain to be clarified via the upcoming level 2 publications, with ESMA and the EBA intending to publish several consultation packages in several stages up until Q1 2024[1].

These areas in particular include the form and content of notifications and applications by regulated firms intending to provide crypto services and by CASPs and the governance requirements applicable to them, transparency obligations especially applicable to platforms, requirements applying to issuers of stablecoins (including own funds and liquidity management), and market integrity requirements.

The key priority for the coming months and years should be supporting a smooth and fast implementation of MICA

MiCA excludes certain areas from its scope such as non-fungible tokens (NFTs) or DeFi activities, where these are entirely decentralised or disintermediated. Some issues are also left unaddressed by MICA: for instance, there exists a number of issues with large global crypto players that would certainly deserve further thoughts.

However, the top priority for regulators should be to support a swift implementation of MICA provisions. Relatedly, supervisory cooperation both within the EU and with third countries is needed to give supervision its full force over global players.

What are the potential impacts in terms of risks and financial stability of the greater role that institutional investors are expected to play in cryptoasset activities and are these appropriately addressed by existing regulations?

Despite the recent uncertainty and volatility in crypto-asset markets, there has been an increased interest from participants in these[2]. Participation from institutional players could make the impact of a problem in the crypto world much larger as interconnection with the global financial system will grow.

MiCA intends to provide the first comprehensive frameworks for crypto-asset activities within the EU.

Institutional investors also need other forms of crypto assets that support different use cases such as stablecoins, which tend to be among some of the most used assets on crypto-asset platforms.

For regulators this comes with greater responsibility, but this is also an opportunity as traditional financial players will only add to the pressure in the crypto industry to move towards a fully regulated world.

1. *https://www.esma.europa.eu/esmas-activities/digital-finance-and-innovation/markets-crypto-assets-regulation-mica*
2. *https://www.amf-france.org/sites/institutionnel/files/private/2023-07/CARTOGRAPHIE%202023_EN.pdf.pdf*

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Crypto after the hype: regulatory hurdles and the role of banks

Following the spectacular demise of some well-known crypto names over the past 1.5 years, the public's interest in crypto has waned. But this may have a silver lining. Now that the attention has shifted away from the hype and "number go up", there is renewed focus on applications that foster useful innovation. And while some jurisdictions are still contemplating how to fit crypto assets in their regulatory edifice following FSB and IOSCO guidelines, the EU has most of the building blocks in place for a regulatory framework:

- Crypto was already subject to anti-money laundering and counter financing of terrorism (AML/CFT) requirements since 2020 (AML Directive 5), topped up with an extension of the "Transfer of Funds" Regulation earlier this year.
- Basic investor protection measu-res are included in the incoming Markets in Crypto Assets Regulation (MiCAR). These include suitability assessments for investors and responsible publicity and transparent information about product risks and costs.
- Financial market integrity is also covered in MiCAR, including e.g. trade execution obligations and trade monitoring to prevent market manipulation.

From a financial stability perspective, the EU's CRR3 will implement the relevant global Basel standard for exposures to crypto-assets by 2025, and includes a transitional regime until then. While the EU regulatory framework is taking shape, some issues remain:

- As EBA and ESMA are still consulting and developing Level 2 and 3 measures, regulatory and supervisory requirements have not crystallised fully yet;
- Significant parts of the crypto universe are not subject to MiCAR, most notably decentralised finance, meaning lack of regulatory clarity may slow down any explorations there;
- The prudential treatment of crypto assets as included in CRR3, applicable from January 2025, takes a welcome differentiated approach to crypto, distinguishing e.g. stablecoins and tokenised "traditional" assets. The EU transitional regime however is much more restrictive, hampering bank explorations in the coming 1.5 years;
- MiCAR requires the development of sustainability indicators, on which ESMA will soon issue a consultation. The energy intensity of some blockchains (like bitcoin) has been a hotly debated issue. Less energy hungry alternatives are available, but they come with trade-offs, in terms of increased software code complexity and potentially more vulnerable network governance. The right balance has yet to be found.

So while the EU regulatory road towards crypto use cases has been paved, it is certainly not free from potholes. But what exactly are those use cases, beyond hype and speculation? At this point, ING mainly sees applications in areas where efficiency gains can be made. This includes cross-border and micro (machine-to-machine) payments, but also securities trading and settlement. Obvious initial roles for banks include wallet, identity and custody services. Further roles can be envisaged in transaction and treasury services, advisory and portfolio management.

But to facilitate further innovation, the crypto universe is first in need of a virtually risk-free means of payment. Recent experience has made clear that unregulated, unbacked stablecoins cannot play that role. Global stablecoins are politically unpalatable, as they compromise monetary sovereignty. Banks are obvious candidates to issue payment tokens, as they already provide the vast majority of money in the traditional financial system. Banks could issue "tokenised deposits" using their existing balance sheet and banking license.

Alternatively, banks could issue stablecoins, covered by MiCAR. There are subtle but important differences between the two, and we think at this stage they could co-exist in a well-diversified monetary-financial system, serving different use cases. Key characteristics of both tokenised deposits and stablecoins include their well-regulated nature and there issuance by well-known (groups of) banks. This inspires confidence, and sets both tokenised deposits and bank-issued stablecoins apart from unregulated stablecoins that have earned such a notorious reputation.

To facilitate further innovation, crypto is in need of a virtually risk-free means of payment.

Having a trusted and euro-denominated means of payment available on a blockchain infrastructure is a necessary condition to enable much-anticipated use cases. The bank-issued means of payment could serve as the payment leg of instantly-finalised securities and foreign currency transactions. Other areas of interest include on-chain working capital and supply chain financing.

Stablecoins and tokenised deposits could also stimulate development and adoption of peer-to-peer investment, funding and insurance products, where intermediaries may play an advisory role.

Beyond the hype, crypto is now back to earth, and that's good news. Potential use cases of crypto don't eliminate the role of intermediaries like banks, but do change them considerably. Banks and regulators are well-advised to keep an open mind as to what crypto can bring, and to be prepared.