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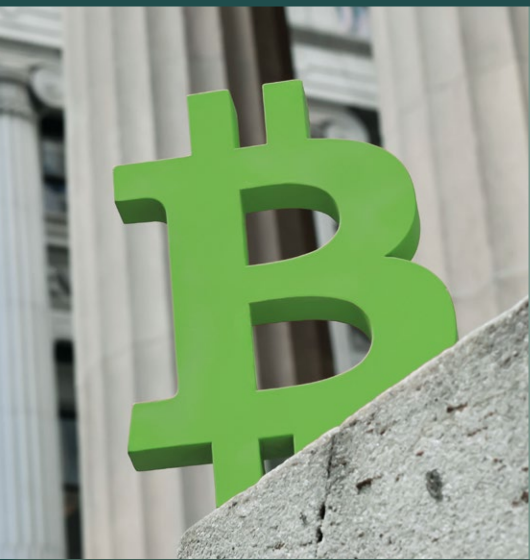

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Promotion of sustainable ‘cryptoization’ by global standard setters

The Digital Regulator

Redefining Finance for the New Economy

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Executive summary

October 2021 witnessed several fundamental policy pronouncements on cryptofinance by global standard setters. These aimed to set the policy direction for cryptocurrencies (or 'crypto') in the foreseeable future. The emerging global policy message from standard setters such as the International Monetary Fund (IMF), Financial Stability Board (FSB), Bank for International Settlements (BIS), International Organization of Securities Commissions (IOSCO) and the Financial Action Task Force (FATF) is supportive. Risk-based regulations should support the buoyant 'cryptoization' (a term introduced by the IMF in its latest Global Financial Stability Report (GFSR)) of economies, and the potential role of stablecoins in enhancing cross-border payments should be recognised. Furthermore, developers of decentralised finance (DeFi) applications should be assured of a pragmatic and selectively permissive regulatory stance. On balance, global standard setters intend to introduce supportive regulation for cryptoization to ensure the societal sustainability of distributed ledger technology (DLT)-based innovation.

In a significant development in cryptofinance, the United States (US) Securities and Exchange Commission (SEC) authorised a bitcoin futures exchange-traded fund (ETF) for the first time on 18 October 2021. Other notable regulatory developments include progress in the central bank digital currency (CBDC) space in Hong Kong, France, Georgia, Ghana, and Nigeria, and material regulatory/governmental cryptofinance developments in jurisdictions such as Australia, Malta, Guernsey, Sri Lanka, and Russia.

In October 2021, global standard setters issued several policy recommendations to handle the buoyancy in cryptocurrency adoption, the use of stablecoins, and the risks posed by thriving decentralised finance (DeFi) applications. Nearly all these recommendations have been supportive of 'cryptoization' (a term introduced by the IMF in its latest Financial Stability Report) and convey a positive outlook for cryptofinance.

1. Focus on cryptoization, stablecoins, and DeFi: An assessment

The IMF, for the first time in October, addressed the potential threat of increased crypto adoption to systemic stability and stated the conditions and policies appropriate to handle such threat. The FSB, BIS, and IOSCO focused on stablecoins. While the FSB examined how stablecoins could address cross-border payment challenges without introducing new sources of risk, BIS/IOSCO undertook consulting to improve the principles of financial market infrastructure and accommodate systemically important stablecoin arrangements. The FATF issued long-awaited and updated guidance notes for a risk-based approach to virtual assets (VA) and virtual asset service providers (VASP), proposing ways to address the money laundering and terrorist financing (ML/TF) risks posed by DeFi.

Cryptoization

In its GFSR, the IMF highlighted the challenges posed by the buoyant crypto ecosystem. Among the key risks identified are operational risks (such as failures and disruptions that prevent the use of the services and cause losses to users), cyber risks (hacks and frauds), and governance risks (such as investor losses due to a lack of transparency). The IMF concluded that till date, these losses have not had a significant impact on global or domestic financial stability. It singled out an important variable that will require careful monitoring, namely the degree of crypto adoption. It also listed a series of factors that enhance crypto adoption, such as unsound domestic macro policies, foreign exchange restrictions, vulnerabilities of the banking sector, and the degree of inclusion in the financial sector. According to the IMF, crypto policies should aim to 'balance enabling financial innovation and reinforcing competition and the commitment to open, free, and contestable markets, on one hand, against challenges to financial integrity, consumer protection, and financial stability'[1]. Implementation of global standards that enable the proper monitoring of the growth of and risks associated with cryptoization should be prioritised. Moreover, efforts should be made to enhance the credibility of monetary policy and promote sound fiscal positions.

Stablecoins

The FSB recognised the inefficiencies of cross-border payments due to high costs, low speed, limited access, and insufficient transparency for end-users. It also highlighted that the challenges are particularly pronounced for individuals and small companies in the retail payment space, and are acute in emerging market and developing economies. The FSB, therefore, included in its roadmap, an examination of the scope for global stablecoin arrangements to address the challenges that cross-border payments face without compromising the minimum supervisory and regulatory standards required to control risks to monetary and financial stability. It will analyse ways to foster robust global stablecoin arrangements for cross-border payments and factor an international dimension into the CBDC design. In response to a call by the Group of Seven (G7), Group of 20 (G20), and FSB, BIS and IOSCO have opened consultations (on the application of the principles) for financial market infrastructures to adopt systemically important stablecoin arrangements. The guidance covers governance principles (asking for clear responsibilities and accountabilities), risk management principles (requesting the implementation of a comprehensive framework), settlement principles (that should align technical and legal irrevocability of transactions), and money settlement principles (that should minimise or eliminate credit and liquidity risks).

[1] https://www.imf.org/en/Publications/GFSR/Issues/2021/10/12/global-financial-stability-report-october-2021, page 53

DeFi

The FATF issued an updated guidance for a risk-based approach to VA and VASP. The revisions focused, inter alia, on definitional issues (ensuring that all relevant financial assets in the fintech industry are and will be covered by the FATF Standards), stablecoins, and peer-to-peer (P2P) transactions. The focus on P2P transactions is of particular importance because it directly concerns DeFi applications. The FATF believes that DeFi applications may pose ML/TF risks, which may become significant as DeFi grows. It defined P2P transactions as 'VA transfers conducted without the use or involvement of a VASP or other obliged entity (e.g., VA transfers between two unhosted wallets whose users are acting on their own behalf)'[2]. Such transactions have so far not been explicitly subject to Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) controls under the FATF Standards. This is because the FATF Standards are currently in terms of obligations placed to (centralised) intermediaries, rather than on individuals. While the FATF clarified that a DeFi application is not a VASP under the FATF Standards, it noted that 'creators, owners and operators or some other persons who maintain control or sufficient influence in the DeFi arrangements, even if those arrangements seem decentralized, may fall under the FATF definition of a VASP where they are providing or actively facilitating VASP services'[3]. The FATF Guidance has global standing. National authorities are delegated the responsibility of evaluating individual situations and determining the presence of an identifiable person, (whether legal or natural) providing a covered service. The FATF suggested that national regulators liaise and cooperate with the private sector to execute this task.

These policy pronouncements and recommendations paint a positive picture for cryptofinance. The IMF encourages policies that enable cryptoization, including those that ensure financial integrity, consumer protection, and financial stability. The FSB, BIS, and IOSCO welcome stablecoins, provided they do not weaken the current financial market infrastructures, and address cross-border payment challenges. In its final draft guidance, the FATF presented a risk-based approach to VA and VASP by incorporating the gist of industry feedback from an earlier draft[4]. Furthermore, it refined the original draft, allowing for case-by-case judgment regarding the maintenance of control and influence of DeFi applications, and called for enhanced cooperation between the officials and private sector.

[2] https://www.fatf-gafi.org/media/fatf/documents/recommendations/Updated-Guidance-VA-VASP.pdf, page 18

[3] https://www.fatf-gafi.org/media/fatf/documents/recommendations/Updated-Guidance-VA-VASP.pdf, page 27

[4] SEBA Bank commented in May 2021: https://www.seba.swiss/research/fatf-and-defi-further-thinking-is-required/

2. Other Noteworthy Developments

The US SEC approved the first bitcoin futures ETF and an ETF based on bitcoin active companies.

- On 5 October 2021, the US SEC approved the trading of ETF tracking entities holding a majority of their net assets in bitcoin or deriving a majority of their earnings from bitcoin-related activities.
- On 18 October 2021, the US SEC approved the trading of bitcoin futures ETF applications submitted by ProShares and Invesco Ltd., and trading commenced on 19 October 2021.

News regarding progress in the CBDC space included developments from Hong Kong, France, Georgia, Ghana, and Nigeria.

- The Hong Kong Monetary Authority (HKMA) provided a technical view on the issuance of a CBDC with a wholesale and retail approach. The wholesale layer would be open only to banks and payment service providers, while the retail layer would be an open system accessible to the public.
- In a project led by Euroclear that involved a few commercial banks, the Bank of France (Banque de France) explored how a CBDC would operate with government bonds. The CBDC was tested on activities including paying coupons and redeeming deals.
- Georgia intends to launch a pilot program for a CBDC in 2022. It has called for fintech companies to cooperate with the country on the project.
- Ghana is entering a new phase in its CBDC project, where it will develop offline capabilities aiming to promote the use of its CBDC across all segments of the society.
- Nigeria has reiterated its commitment to launching CBDC, announcing the official rollout on 29 October 2021. The central bank has been working on the CBDC for a few years, aiming to ensure speed and the presence of merchant wallets.

Material regulatory or governmental developments concerning cryptofinance were presented in several jurisdictions including Australia, Malta, Guernsey, Sri Lanka, and Russia.

- The Australian Senate proposed 12 recommendations for the regulation of digital assets. The proposals include new licenses for crypto exchanges, new laws to govern decentralized autonomous organizations (DAOs), provisions to mend the capital gains tax in DeFi, and a tax discount for crypto miners who use renewable energy.
- The Australian Securities Exchange (ASX) is poised to allow Australian ETF provider BetaShares to launch the BetaShares Crypto Innovators ETF (CRYP). This fund will invest in global companies working in the digital asset space, and not take outright cryptocurrency exposure.
- Malta's financial regulator has approved the listing of a crypto index fund by Iconic Funds. The fund will be the first in Europe listed on a regulated market, featuring direct exposure to crypto assets.
- The Guernsey Financial Services Commission (GFSC) granted approval to Jacobi Asset Management to launch a bitcoin ETF.
- The government of Sri Lanka approved a policy proposal on blockchain technology and its applications, aiming to promote the digitisation of the economy (including digital banking and crypto-mining).
- In the aftermath of the Chinese crypto ban and news that the US authorities will not ban crypto, Russian authorities clarified that they have no plans to prohibit crypto trading by Russian citizens.

3. Conclusion

The last few weeks presented several positive regulatory and policy developments for the cryptofinance industry. These range from approval for trading the first bitcoin futures ETF in the US, to presenting constructive policy recommendations to accompany cryptoization with regulations that aim to ensure the sustainability of DLT-based innovations from a societal point of view. The underlying message for cryptofinance is positive and consistent. We expect that this will further consolidate the prevalent buoyant momentum.

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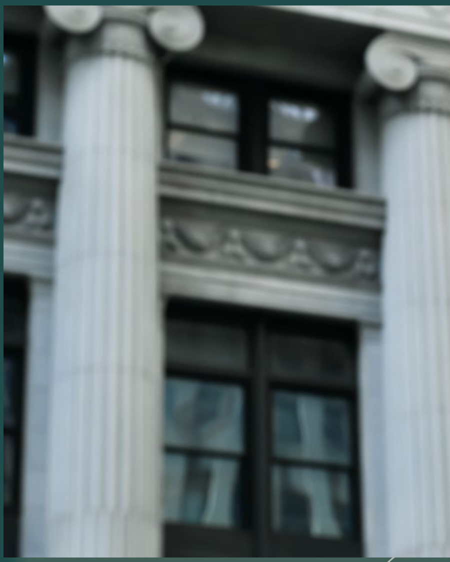

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