

Cryptoasset and stablecoin regulation

1. Value added of crypto, market trends and opportunities

1.1 Cryptoasset and stablecoin trends

An industry representative observed that, so far, crypto has developed as an early-stage technology with fast adoption and boom-and-bust cycles. With unabated interest in the market, there is little doubt about the trajectory of growing adoption. This will however depend on whether regulations focus on the right areas, while leaving room for innovation. In established crypto companies, despite the significant March 2022 downturn, there has been no reduction in developer activity or open-source code engineering work. Institutional investors are increasingly interested in entering the cryptoasset space. Coinbase was recently onboarded to BlackRock's Aladdin platform to provide Aladdin institutional clients with access to crypto trading and custody. Applications of crypto are also developing in other areas such as cross-border payments. Visa recently announced the integration of a stablecoin-based settlement mechanism for their payment system. Observations have also been made by the Bank for International Settlements (BIS) that a tokenised store of value could be a solution for dealing with the complexities and limitations of the current cross-border payment system.

A regulator noted that the first wave of crypto development was mainly in the retail market. In France, 8% to 10% of households have invested in crypto. The key priority for supervisors at present is to ensure that these customers are protected by implementing the Markets in Cryptoassets Regulation (MiCAR) as soon as possible.

An industry representative stated that banks have been exploring use cases in crypto for many years. Stablecoin issuance that will be covered by the upcoming MiCAR regulation is one of these areas. Stablecoins are not viewed by banks as a goal in itself e.g. to provide an additional retail payment solution, but rather as an enabler to allow corporate clients to develop their business-to-business use cases on a blockchain infrastructure. In this sense, stablecoin is an infrastructure-focused project. Blockchain has long been used for recording transactions, but adding a technology for payments in the blockchain environment would open up new applications. A stable currency issued by a regulated and reputable institution could for example be used as a means of payment in trade finance, allowing automated payments to be triggered conditionally to the arrival of freight in a port and recording this on a blockchain. The Chair agreed that it could be transformative if banks develop a viable business case for the use of stablecoins in trade finance and other business-to-business transactions.

A regulator stated that technological innovation normally leads to use cases in the form of products or services, which are then brought to market by firms. Eventually, those firms may capitalise the products into assets and sell them as financial assets with future expectations of returns. The crypto process, however, has gone from the technology directly to the assets by-passing products and firms. With discussions around the use of distributed ledger technology (DLT) within banks and other financial institutions, questions around the products that may be brought to the market are now being addressed. Trade finance is an example of a product that can be supported by DLT and stablecoins.

It is necessary to first define the products that can be developed with DLT and cryptoassets, the firms that can bring these products to the market, and also the risk management capabilities and governance needed around them, the regulator emphasised. There is now a good understanding of the different use cases of DLT both for financial and non-financial purposes, the potential of the technology and the related risks. MiCAR clearly defines some financial products based on crypto technology, including asset-referenced tokens, e-money and stablecoins, which will be able to be safely developed in the market under the MiCAR requirements. There are other applications of DLT within financial institutions that have nothing to do with selling financial products and that could be taken advantage of, such as trade finance, facilitating intermediation, and transaction recording. As these use cases develop, specific regulation within the prudential framework of banks, albeit of a different nature, will probably be needed.

1.2 Opportunities from the underlying crypto technology and tokenisation

An industry representative stated that the value of crypto is simple but profound. Currently, it is easy to send information via the internet. However, without crypto technology, it is not possible to transmit ownership or value. Crypto is therefore a significant technology with financial and broader societal applications. In the US, there is a concern around privacy in relation to large tech intermediaries. Tokenised identity can be a solution to that. NFT-based crypto solutions can also be a solution in terms of enforcing rules around supply chain controls and making sure that ESG or human rights rules are protected. There are also applications with AI. The ability to tell the difference between a legitimate AI outcome and a deepfake can be achieved with a tokenised paper trail of digital information that goes into the algorithm. These are non-financial applications of crypto that regulations should not inhibit.

A second industry representative agreed that tokenisation is a key use case of crypto technology and has many different applications. Tokenisation can

facilitate the trading of traditional assets, such as securities. There are also markets for digital assets, such as game characters, and digital assets can also be useful in areas such as intellectual property, music rights and sports club memberships. What is missing, however, is a well-regulated and trusted payment solution to support these use cases. Unregulated and unbacked stablecoins cannot play that role, and global stablecoins are politically unpalatable following the Libra experience, as they may compromise monetary sovereignty. Banks could issue payment tokens, either in the form of 'tokenised deposits' falling under the banking prudential regulatory framework or stablecoins covered by MiCAR. This could allow the provision of trusted and euro-denominated means of payment available on a blockchain infrastructure. The recent guidance published at the international level by the BIS indicates a preference for tokenised deposits over stablecoins. However, both can co-exist if they are well regulated.

A regulator agreed that the tokenisation of traditional financial assets is a promising route because significant productivity gains are difficult to achieve in the current post-trading space which is structured around legacy infrastructures. There is significant interest in evolutions around DLT and digital assets among market participants in France, which is why the French regulator has supported the EU DLT pilot regime initiative. At present, however, some key enablers are missing, most notably a settlement means of payment available directly on the blockchain to support transactions between market participants. The challenge in this respect for the public authorities is to provide as much certainty as possible to market participants, because the technology is somewhat ahead of the legal basis. This requires engaging proactively with market participants to help them implement projects and develop their ideas in the safest way possible.

2. Risks from crypto and policy challenges

The Chair stated that the regulation of crypto activities faces several challenges. Some are specific to crypto, such as the difficulty of identifying responsible persons¹. This issue is more significant for DeFi activities but can also be encountered in more centralised cryptoasset activities and even TradFi (traditional finance). It is addressed in both IOSCO's recently published DeFi recommendations and the CPMI-IOSCO stablecoin recommendations. Other challenges are more common and relate to innovation in the sector. One issue is appropriately balancing investor protection and financial stability objectives with facilitating innovation. A potential weakness in the policy approach is also the slow pace of policymaking given the speed of innovation. The full implementation of MiCAR is scheduled for 2024, with a review currently scheduled for 2027.

Although MiCAR is a decisive step forward, there is a risk that it may be outflanked by further innovation.

A Central Bank official stated that the 2022 turmoil showed that the crypto sector has fundamental problems relating to basic risk management, internal controls, weak governance and a lack of segregation of client accounts. Following these events, there was a strong regulatory and supervisory response, with recommendations around implementing controls, appropriate regulatory tools and proper supervisory cooperation at the international level. It is hoped that these recommendations will be implemented by jurisdictions globally. Although MiCAR is a positive development, it will not solve all these problems. Once MiCAR is in place, there might even be a false perception that the crypto sector now functions in a sound way, but the crypto sector still needs to evolve towards a more mature base of quality and safety. This should be worked on in parallel with the implementation of MiCAR.

The traditional financial sector's interest in moving into the area of crypto may also be a double-edged sword. On the one hand, its involvement will contribute to improving the safety and quality of activities in the sector. However, it may also increase interconnectedness risks. So far, the impacts of the failure of certain cryptoassets and cryptoasset service providers (CASPs) have been limited in terms of financial stability. This might no longer be the case with greater interconnectedness. Addressing these matters will require additional work on the regulatory framework. While the difficulty of identifying responsibilities in the crypto space is often put forward, it should be recognised that there is a reasonable level of centralisation in crypto activities, which should make it possible to enforce regulatory requirements. Authorities need to prepare to act forcefully when requirements are not followed.

Another policy objective that has been widely discussed at the Financial Stability Board (FSB), the Central Bank official added, is to ensure that all major jurisdictions adopt recommendations so that crypto activities and stablecoins are properly regulated around the globe. However, there may be some opportunistic behaviour by smaller jurisdictions seeking to attract business. Policymakers need to ensure that all jurisdictions implement the recommendations and that small jurisdictions do not try to service the rest of the world from a lightly regulated area, in order to achieve a sufficient level playing field. A further issue is that the legal situation regarding these activities varies across jurisdictions. In some jurisdictions, they are already captured by existing legislation, whereas in other jurisdictions new legislation needs to be implemented to ensure proper regulation of stablecoins and cryptoassets.

An industry representative acknowledged that there have been governance issues in the crypto sector, but many bad actors have been washed out by the market downturn and the advent of regulation should also help to address this issue. The area where regulation is most

1. One particularly striking case is that of Tornado Cash, in which the company argued that it was just a collector or an aggregator in code. The government's argument, and the ruling of the federal district court, was that Tornado Cash was an association and could therefore be sanctioned.

urgently needed is intermediaries such as cryptoasset and virtual asset service providers (CASPs and VASPs) that hold client assets and therefore need to be subjected to proper rules and supervision. Policymakers in some jurisdictions, including the EU, are taking action in this area but others, such as the United States, still need to move faster.

3. Implementation timeframe of MiCAR and issues to further consider at Level 2

A regulator noted that MiCAR came into effect as of June 2023, with a period of application until the end of 2024 in two phases: rules concerning asset-referenced tokens will start to apply at the end of June 2024, while the remaining rules concerning CASPs and other cryptoassets will start to apply at the end of December 2024. The development of the Level 2 regulations has started, with some Level 2 documents already put forward for consultation on issues relating to how to bring cryptoassets to market including authorisation, complaint handling and qualifying holdings. There will be further consultations on issues relating to the reliability of these products such as governance, composition of reserve assets and liquidity requirements. Many of the issues are similar to those covered for other financial products. Another point being worked on is the coordination of the authorities within the European Union so that the process of authorisations runs smoothly. The EBA is responsible for issuers of asset-referenced tokens, but other ESAs are responsible for CASPs. The ESAs are working closely together and it is hoped that this provides a framework in which firms can operate efficiently and safely in providing services to customers.

Until MiCAR Level 2 requirements apply, it is important that firms developing cryptoassets and applying for authorisations consider how these developments will fit with the MiCAR framework, the regulator emphasised. The European Banking Authority (EBA) issued a statement on this point in July.

An industry representative stated that MiCAR is a major step forward and provides a good template for other jurisdictions to emulate. It provides regulatory clarity and a passported rulebook that allows operation across the EU market without needing to build a multiplicity of legal entities. The industry must adapt to the standards that regulators expect. However, as Level 2 requirements are developed, the goal of policymakers should not be to simply import the business model of the traditional markets into crypto rules. The specificities of crypto need to be considered. The traditional finance model, unlike crypto, is quite fragmented with many intermediaries and infrastructures involved in the life cycle of transactions, causing lags between trades and final settlements. These are not strengths of the current system, but legacies of how the architecture was developed. There is an opportunity to take advantage of atomistic settlement and tokenisation, which are more efficient and safer than current processes and eliminate

lags, but this may require adjusting the current regulatory approach and focusing more on achieving similar outcomes than reproducing identical rules.

An industry representative noted that the timelines for the implementation of MiCAR and particularly those for stablecoins are very ambitious, since they will enter into force midway through next year. Supervisors, banks and institutions normally take at least six months to prepare for a new authorisation or regime once the regulatory standards are available.

A Central Bank official added that, as market developments in this sector are difficult to predict, a further challenge for supervisors is to prepare for these requirements in terms of resources and capabilities.

4. MiCAR implementation challenges

4.1 Issues raised by the transition to the new MiCAR requirements

A regulator stated that MiCAR is a key priority for the French regulator. CASPs cannot remain unregulated, either due to a lack of applicable regulation or to non-compliance. In France, the PACTE law, passed in 2019, introduced a national registration requirement for CASPs with a licensing regime that remains optional. The first full licensing was granted a few weeks ago. A degree of uncertainty while new regulatory requirements are implemented is normal, but this issue is magnified in the case of MiCAR by the provision for a transitional period of up to 18 months, starting from December 2024 for CASPs already registered at the national level, during which they will be able to continue to operate under the domestic regime.

The regulator stressed that there is a risk of regulatory arbitrage and of forum shopping during this transition period. Industry players have an incentive to register domestically to postpone the implementation of the MiCAR requirements and some entities are trying to obtain registrations in multiple EU member states, as a proxy to a passport. This is a major loophole in the regulation. It is hoped that the implementation of the MiCAR regulatory technical standards (RTS) will allow these loopholes to be closed. However until then a coordinated approach is needed at EU level to accelerate the inclusion of crypto market participants in a common regulated framework, for example with the introduction of stricter requirements in current domestic registration requirements aligned with MiCAR requirements.

4.2 Level playing field and consistency issues at the EU and international levels

A regulator emphasised that beyond the risks of regulatory arbitrage and forum shopping during the transition period, there is also a risk of continued non-compliance, particularly in the context of reverse solicitation. Some crypto market participants operate platforms that market - under reverse solicitation - crypto derivatives considered as financial instruments under EU law. This issue is amplified by the fact that

there may be a different interpretation of what reverse solicitation is across EU member states. This reinforces the need for a coordinated approach to the implementation of MiCAR across the EU. A further issue is that many market participants are global and operate in models implying intragroup transactions that may rely on market participants located abroad. This potentially exposes the EU market to weak points in the global system and may affect the capacity of regulators to enact their mission. For example, a CASP might be fully licensed in the EU and fall under all MiCAR requirements, but if it imports prices from a global platform located in a third country, European regulators have no authority to ensure that there is appropriate price formation. To address these issues, it is essential that there is a coordinated approach at the global level to the implementation of the principles being developed by IOSCO and FSB in the area of crypto.

An industry representative noted that, in terms of implementation of MiCAR, there is also a need to ensure a level playing field across the EU. Supervision will occur at the national level, which means that there is the risk of inconsistent application of rules across different member states and potential for gaming the rules, which is a key concern for large CASPs in particular.

A second industry representative felt that the preferred solution would have been centralised EU supervision in this area in the same way as the Single Supervisory Mechanism (SSM) for banks. For political reasons, that was not feasible. Unfortunately, the RTS sometimes leave room for national interpretations and a lack of harmonisation.

A Central Bank official agreed that there are concerns relating to the level playing field, forum shopping and regulatory competition because providers will be able to enter at the national level and then move to the European level under MiCAR. As these are new issues, it will be necessary to monitor the implementation of requirements, but what the EBA, ESMA and the involved national competent authorities (NCAs) have delivered so far in terms of Level 2 is moving in the right direction.

4.3 Additional challenges related to distribution and prudential rules

An industry representative stated that there is also room for improvement at the distribution level in the EU. Retail investors must have the support they need to make choices and engage properly in the financial markets. Distribution models in Europe mainly rely on non-independent advisors recommending inducement paying products. MiFID rules have not shifted that pattern so far. Disclosures are not sufficient for consumers to fully understand the products they are investing in and just mandating additional disclosures will not solve the issue. There need to be more radical proposals for the longer term, which might entail significant changes to distribution structures.

An industry representative noted that the prudential treatment of cryptoassets on banks' balance sheets is currently being negotiated in Brussels. The signals are that political agreement is close. The differentiated treatment of different cryptoassets which is envisaged, with a 'look through' treatment of tokenised assets and stablecoins is positive, but the proposed prudential treatment of cryptoassets that are very liquid (group 2A in the BIS terminology) will make it difficult for banks to keep them on the balance sheet. It remains to be seen what the Commission will propose as a final treatment in this area.