



REGULATING CRYPTO

The right rules could provide a safe space for innovation

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Crypto assets have been around for more than a decade, but it's only now that efforts to regulate them have moved to the top of the policy agenda. This is partly because it's only in the past few years that crypto assets have moved from being niche products in search of a purpose to having a more mainstream presence as speculative investments, hedges against weak currencies, and potential payment instruments.

The spectacular, if volatile, growth in the market capitalization of crypto assets and their creep into the regulated financial system have led to increased efforts to regulate them. So too has the expansion of crypto's many different products and offerings and the evolving innovations that have facilitated issuance and transactions. The failures of crypto issuers, exchanges, and hedge funds—as well as a recent slide in crypto valuations—have added impetus to the push to regulate.

Applying existing regulatory frameworks to crypto assets, or developing new ones, is challenging for several reasons. For a start, the crypto world is evolving rapidly. Regulators are struggling to acquire the talent and learn the skills to keep pace given stretched resources and many other priorities. Monitoring crypto markets is difficult because data are patchy, and regulators find it tricky to keep tabs on thousands of actors who may not be subject to typical disclosure or reporting requirements.

Playing catch-up

To complicate matters, the terminology used to describe the many different activities, products,

and stakeholders is not globally harmonized. The term “crypto asset” itself refers to a wide spectrum of digital products that are privately issued using similar technology (cryptography and often distributed ledgers) and that can be stored and traded using primarily digital wallets and exchanges.

The actual or intended use of crypto assets can attract at once the attention of multiple domestic regulators—for banks, commodities, securities, payments, among others—with fundamentally different frameworks and objectives. Some regulators may prioritize consumer protection, others safety and soundness or financial integrity. And there is a range of crypto actors—miners, validators, protocol developers—that are not easily covered by traditional financial regulation.

Entities operating in financial markets are typically authorized to undertake specified activities under specified conditions and defined scope. But the associated governance, prudence, and fiduciary responsibilities do not easily carry over to participants, who may be hard to identify because of the underlying technology or who may sometimes play a casual or voluntary role in the system. Regulation may also have to reckon with the unwinding of conflicting roles that have become concentrated in some centralized entities, such as crypto exchanges.

Finally, in addition to developing a framework that can regulate both actors and activities in the crypto ecosystem, national authorities may also have to take a position on how the underlying technology used to create crypto assets stacks up against

other public policy objectives—as is the case with the enormous energy intensity of “mining” certain types of crypto assets.

In essence, crypto assets are merely codes that are stored and accessed electronically. They may or may not be backed by physical or financial collateral. Their value may or may not be stabilized by being pegged to the value of fiat currencies or other prices or items of value. In particular, the electronic life cycle of crypto assets amplifies the full range of technology-related risks that regulators are still working hard to incorporate into mainstream regulations. These include predominantly cyber and operational risks, which have already come to the fore through several high-profile losses from hacking or accidental loss of control, access, or records.

Some of these might have been lesser concerns if the crypto asset system had remained closed. But this is no longer the case. Many functions in the financial system, such as providing leverage and liquidity, lending, and storing value, are now emulated in the crypto world. Mainstream players are competing for funding and clamoring for a piece of the action. This is all leading to greater calls for the “same activity, same risk, same rule” principle to be applied, with the necessary changes, to the crypto world—piling pressure on regulators to act. It is posing another conundrum for public policy, too. How closely can the two systems be integrated before there is a call for the same central bank facilities and safety nets in the crypto world?

Contrasting national approaches

It’s not that national authorities or international regulatory bodies have been inactive—in fact, a lot has been done. Some countries (such as Japan and Switzerland) have amended or introduced new legislation covering crypto assets and their service providers, while others (including the European Union, United Arab Emirates, United Kingdom, and United States) are at the drafting stage. But national authorities have, on the whole, taken very different approaches to regulatory policy for crypto assets.

At one extreme, authorities have prohibited the issuance or holding of crypto assets by residents or the ability to transact in them or use them for certain purposes, such as payments. At the other extreme, some countries have been much more welcoming and even sought to woo companies to develop markets in these assets. The resulting

fragmented global response neither assures a level playing field nor guards against a race to the bottom as crypto actors migrate to the friendliest jurisdictions with the least regulatory rigor—while remaining accessible to anyone with internet access.

The international regulatory community has not been sitting idle either. In the early years, the major concern was preserving financial integrity by minimizing the use of crypto assets to facilitate money laundering and other illegal transactions. The Financial Action Task Force moved quickly to provide a global framework for all virtual asset service providers. The International Organization of Securities Commissions (IOSCO) also issued regulatory guidance on crypto exchanges. But it was the announcement of Libra, touted as a “global stablecoin,” that grabbed the world’s attention and added a greater impetus to these efforts.

The Financial Stability Board began monitoring crypto asset markets; released a set of principles to guide the regulatory treatment of global stablecoins; and is now developing guidance for the broader range of crypto assets, including unbacked crypto assets. Other standard-setters are following suit, with work on the application of principles for financial market infrastructures to systemically important stablecoin arrangements (Committee on Payments and Market Infrastructures and IOSCO) and on the prudential treatment of banks’ exposures to crypto assets (Basel Committee on Banking Supervision).

The regulatory fabric is being woven, and a pattern is expected to emerge. But the worry is that the longer this takes, the more national authorities will get locked into differing regulatory frameworks. This is why the IMF is calling for a global response that is (1) coordinated, so it can fill the regulatory gaps that arise from inherently cross-sector and cross-border issuance and ensure a level playing field; (2) consistent, so it aligns with mainstream regulatory approaches across the activity and risk spectrum; and (3) comprehensive, so it covers all actors and all aspects of the crypto ecosystem.

A global regulatory framework will bring order to the markets, help instill consumer confidence, lay out the limits of what is permissible, and provide a safe space for useful innovation to continue. **FD**

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