TC Podcast:
Regulatory and Supervisory Aspects of Crypto-Assets

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Opening automation: You're listening to a Toronto Centre podcast. Welcome. The goal of TC podcasts is to spread the knowledge and accumulated experience of global leaders, experts, and world-renowned specialists in financial supervision and regulation. In each episode, we'll delve into some of today's most pressing issues as it relates to financial supervision and regulation, the financial crisis, climate change, financial inclusion, FinTech, and much more. Enjoy this episode.

Demet Çanakçı: Hello everyone. I am Demet Çanakçı, program director at Toronto Center. Welcome to Toronto Center Podcast Series. My guest today is Eva Hüpkes. Eva is head of regulatory and supervisory policies at the Financial Stability Board. Since she joined the FSB in 2009, she has contributed substantially to the development of the FSBG20 post crisis policy reforms. In particular, the framework for addressing threats to financial stability posed by systemically important financial institutions.

Prior to joining the FSB, she served as head of regulation at Swiss Financial Market Supervisor Authority, where she for over a decade helped design and draft a broad range of legislative and regulatory reforms. During 1997 and 1999, she worked at the International Monetary Fund, supporting the fund's response to the Asian financial crisis. Eva holds a PhD in law from University of Bern. Welcome Eva. Thank you for taking the time to talk with us today.

Eva Hüpkes:

Thank you so much, Demet, for inviting me. Just upfront and as is customary, I'd like to note that the views expressed here on this podcast are my own and that I'm not speaking on behalf of the Financial Stability Board or any of its members.

Demet Çanakçı: Okay, well noted. Let me kick off by asking what are crypto assets and why does the FSB think crypto assets present a risk and they need to be regulated?

Eva Hüpkes: Sure. Well, digitalization in the financial sector started already decades ago with the dematerialization of existing financial instruments, the creation of electronic records, of securities, of company shares, for instance. However, new forms of digital assets have emerged in the past decade and most of these require the holder to have a cryptographic key to access and transfer them, and they are therefore referred to as crypto assets. They can be transferred, stored, or traded electronically without intermediaries and often utilize distributed ledger technology.

The FSB distinguishes two types of crypto assets, so called unbacked crypto assets and so-called stable coins. What initially emerged were so called unbacked crypto assets, so assets where actually nobody is liable, where there is no intrinsic value and no backing by any collateral. This makes them speculative in nature and rather volatile, like for instance Bitcoin. The price of unbacked crypto is essentially determined by what the market participants are prepared to pay for them at any given moment.

Stable coins emerged to address the risk of volatility of these unbacked crypto assets. They're designed to have a stable price, typically through being backed or pecked to an underlying asset, such as a commodity or fiat currency, or algorithmic mechanism. However, as regards to the later, and as we have seen by recent events with TERA USD, where an algorithmic server coin couldn't maintain its peck and then essentially plunged, some stable coins are stable in name only.

But now to your second question, why do crypto assets present a risk and why is there a need for regulation. Earlier this year, in February, the FSB issued a report on the assessment of risk to financial stability from crypto assets and the report notes that there has been a tremendous growth and evolution of crypto asset markets in recent years. The FSB found that they could reach a point where they would present a threat to global financial stability. For instance, dress and crypto asset markets could spill over to players in the wider financial system through direct asset holdings or ownership of service providers, or a fall in the value of crypto assets might have an impact on the wealth of investors, with knock on effects on the broader financial system.

And more generally, a loss in faith in the value of crypto assets, for instance, because of operational failures, uncertainty about the underling stabilization

mechanism in the case of a stable coin, fraud, price manipulation or cybercrime. All this could lead to a loss in confidence, runs and fire sales, and then could spill over to broader financial markets. And many of these risks and vulnerabilities are actually quite similar to those from traditional finance, loss of investor confidence, negative wealth effects, losses from exposure to crypto assets. However, there are also wider public policy concerns related to the use of crypto assets in the context of money laundering, cybercrime, ransomware. More recently also concerns about use of crypto assets to circumvent international sanction. And also, concern about the environmental footprint, for instance, of mining activities. So, Demet, all these risk factors point clearly to a growing need for regulatory action.

Demet Çanakçı: Thank you very much, Eva. This is very detailed. Thank you for that. A follow up question perhaps on the same issue. What is the FSB doing to promote regulatory action?

Eva Hüpkes: Well, if we go back to October 2020, then the FSB issued a set of high-level recommendations on the regulation and supervision of so called global stable coins. So, this work on global stable coins, that's very much prompted by the announcement earlier of meta, then stable coin to issue global private money, a libra that then became DM, but never materialized. So stable coins at present are being mainly used as a bridge between traditional fiat currencies and digital assets, not for mainstream payments, at least not at a significant stay yet.

However, the FSB is quite concerned that in the absence of effective regulation and oversight, an increased use for retail payments, for instance, could give rise to broader financial stability issues. For instance, confidence in a stable coin arrangement could be undermined by a lack of clarity regarding the redemption rights of users. So, the FSB found that the composition and amount of reserve assets backing the stable coin varies significantly from one stable coin to the other. And in some cases, for instance, stable coin users may not have a direct right against the issuer or the reserve to redeem the coin.

Redemption rights may be mismatched with the liquidity of the underlying assets that are held in the reserve. And these assets may fall in price or then just become illiquid. So, if that happens, and if users lose confidence in the backing of the stable coin, there could be a disruptive run. And to address things, we are currently working with standard setting bodies to see whether gaps in existing policy and standards applicable to stable coins, as well as to other crypto assets.

And the presumption here is for the regulation and supervision of crypto assets and stable coins, that the sectoral standards apply based on the principle, same activity, same risk, same rules. So, we're not in a regulatory back room here. We have standards and policies that are applicable. And this means that crypto assets should be subject to the same standards that apply to any other entity performing the same set of economic functions.

The issue is that sectoral standards were not designed with crypto assets in mind. Some adaptation may be necessary to capture the specific features and risk profiles of crypto assets. So, should crypto assets be treated according to the same standard as deposit securities, money market funds or something else? So, these are the challenging questions regulators are facing today. Not least given the diversity and constantly evolving nature of crypto assets.

So, Demet, to come back to your original question about the challenges in regulating and supervising crypto assets, I think the principle challenge is the need for an international coherent approach. Crypto assets may be structured in a way that implicates multiple regulatory frameworks, and it seems likely that without coordination, they will be subject to different regulatory regimes or combination of regulatory regimes across jurisdictions.

It is therefore critical to address risks in crypto markets wholistically and avoid fragmented approaches that could give rise to regulatory gaps. Crypto also demonstrated an ability to change structure very quickly in order to move and possibly opportunistically from one regulatory regime or jurisdiction to another. So, this introduces potential for arbitrage and fragmentation. And both of which undermine the ability of regulation to deliver effective risk management.

So, what we need is a global coordinated regulatory approach. In particular also to address the use of crypto as it's illicit cross border activities, as well as their environmental footprint. So, regulation needs to balance the risks and benefits so as not to stifle innovation that could improve efficiency and payments and the broader application of these technologies.

Demet Çanakçı: Many thanks Eva. So how should you regulate and supervise crypto assets? What measures should regulatory authorities be taking?

Eva Hüpkes: The FSB high level recommendation provides that regulators should take a functional approach. This means they should apply the principle, same activity, same risk, same rules. And this means that crypto should be subject to standards that align with those imposed on any other entities performing the same set of economic functions. For example, crypto assets that involve tying the value to a basket of underlying assets that are used as a store of value on crypto platform may replicate activities that are subject to oversight by market regulators such as, for instance, money market funds.

Crypto assets intended to provide a settlement asset for payments that are directly linked to a sovereign currency may replicate functions that require oversight from central banks and payment system regulators, given that these have mandates around monetary and financial stability and safe and efficient payment systems. The issuance and distribution of crypto assets or stable coins by institutions in a manner that mirrors traditional bank like functions may require the attention of bank regulators. And finally, banks that play a role in or have exposures to crypto assets are already subject to banking supervision. And currently the BASA committee is evaluating the capital treatment for banks' crypto related exposures, including crypto assets, crypto derivatives.

So, the challenge for regulators is, however, that crypto assets operate under a wide range of structures which do not align neatly with the way in which functions and structures are defined and addressed in existing sectoral standards and the way they operate in the traditional financial system. For instance, certain crypto assets may perform or seek to perform functions currently executed by banks or financial market infrastructures, but they may actually be structured in a way that more closely aligns to investment funds. So therefore, we need to adapt existing standards and policy to make sure that these are applicable to crypto assets and achieve the same regulatory objectives. And this process of adaptation or review of international standards should be provided by the risks associated with the activities, not the underlying technology. So, where if a possible regulation should be tech neutral, so there is no reason to treat the crypto market differently just because of the technology, we should be technology neutral where assets are stored on a balance sheet or distributed ledger shouldn't matter for the purposes of regulation.

A challenge, however, is that many crypto related activities just fall short of regulatory remit or even lack an identifiable entity that could serve as anchor point for regulation. So, one approach here that authorities are exploring is to focus on the interface between the traditional financial system and the regulated world, and to identify so called gatekeepers that are then subjected to a regulation. One such gatekeeper is, for instance, the VAS, the virtual asset providers, the wallet providers, and these are currently captured by the vat of rules, the so-called travel rule.

Demet Çanakçı: Thank you Eva. How about financial inclusion? Do you think crypto assets or global stable coins can enable financial inclusion? If so, how?

Eva Hüpkes: Sure. We are very conscious that crypto asset use is quite prevalent in some emerging markets. And actually could, in principle, assist with financial inclusion. However, it is somewhat less clear whether the current users of crypto assets are in practice those who were previously financially excluded. A wide use of crypto assets may present a particular financial stability risk in emerging markets. For instance, it may serve as an additional channel for capital outflows or lead to currency substitution. So, it is very important that crypto assets be properly regulated, in particular also in emerging markets, so that they can actually support stable and sustainable financial inclusion.

Demet Çanakçı: Thank you Eva. Is there a way to engage with the FSB on the topic of crypto assets?

Eva Hüpkes: The FSB is working on a consultative document that addresses many of the issues I just mentioned about the regulation and supervision of stable coins and other crypto assets. And this will be put out later this year, probably around October. And we will be seeking input from stakeholders, academia, and the interested public on this consultative document. We'll also hold virtual outreach meetings and therefore very much look forward to comments from the public on these forthcoming important reports.

Demet Çanakçı: Excellent. Thanks very much Eva. It has been a fascinating conversation. Do you have any final comments?

Eva Hüpkes: Yes, thank you Demet. I too enjoyed this conversation. I think what is important is that we all make a coordinated effort at the global level to bring crypto assets into the regulatory purview. We need to make sure that they're subject to standards that are in line with those applied in the traditional financial system. And in developing regulation and bringing crypto within the regulatory perimeter, we need to balance the goals of promoting innovation, promoting financial inclusion, preserving financial stability, and ensuring consumer protection. And we do need to make progress fast with our regulatory efforts, given the very significant or continuous growth of the sector. We want to avoid irresponsible risk-taking that triggers the next financial turmoil.

Demet Çanakçı: Thank you Eva. Many thanks for your time. Very much appreciate it. I hope to see you in person, either in Basel or Toronto or anywhere else in the world. I am here today with Eva Hüpkes, and you have been listening to Toronto Center's podcast on crypto assets. Thank you for joining us today and stay tuned for the next episodes.