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The role of crypto-assets in the digitisation of financial services

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On the 3rd of April 2020 the European Commission published its 'Digital Finance Strategy', which set out an ambitious vision for the transformation of financial services through increased digitisation. Technologies such as Cloud, Artificial Intelligence, Distributed Ledger Technology (DLT), and a growing focus on the value of data-sharing, will play a central role in transforming financial services.

The global response to the recent COVID19 pandemic has illustrated the importance of technology to increase the resilience of financial infrastructures. Technology has played a key role in enabling remote working and allowing financial markets to continue to function during the crisis.

The role of crypto-assets, types of digital financial assets, is consequently expected to accelerate in importance as financial services become increasingly digital. It is therefore essential to recognise the various use-cases, features, benefits and risks of different types of crypto-assets in order to clarify their regulatory treatment. By bringing crypto-assets within the regulatory perimeter, regulators can further support innovation in this area.

What are crypto-assets and how are they different from traditional financial assets?

Crypto-assets are financial assets that are represented digitally using Distributed Ledger Technology (DLT) and cryptography. It is the use of these technologies that differentiates them from traditional financial assets:

- Distributed Ledger Technology (DLT), such as blockchain, is used to create a decentralised network for recording and storing information in multiple locations, without the need for a central administrator (such as a financial intermediary).
- Cryptography is a method of encryption that is used to create 'digital keys' to manage ownership or control of a crypto-asset, providing security for the recorded information to prevent tampering or theft.

Crypto-assets have a wide range of current and potential use-cases in financial services, such as securities trading (as shares or bonds) or improving post trade processes (such as settlement and recording ownership).

Crypto-assets also have a wide range of features. For example, some crypto-assets, often referred to as 'stablecoins', have built-in price stabilisation mechanisms that link them to other financial assets or algorithms (a programmed sequence of executable instructions). Other crypto-assets are programmed to automate key functions like dividend pay-outs, or contain smart contracts that automatically execute all or part of a legal agreement when programmed to.

Association for Financial Markets in Europe
London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700
Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971
Frankfurt Office: Bürohaus an der Alten Oper, Neue Mainzer Straße 75, 60311 Frankfurt am Main, Germany
T: +49 (0)69 153 258 967
www.afme.eu

It is important to understand the various use-cases and features of different crypto-assets because they are associated with different levels of risk. For instance, some crypto-assets (e.g. tokenised securities) are issued by regulated financial institutions and are essentially digital, cryptographically secured versions, of traditional financial assets and subject to existing regulations. However, other crypto-assets (e.g. cryptocurrencies) currently fall outside of existing regulations and may contain features (such as anonymity and unrestricted access) that may make it difficult, or even impossible, to conduct the controls necessary to protect investors, consumers and financial markets.

There are multiple benefits that crypto-assets can provide compared to traditional financial assets, such as:

- Allowing for increased efficiency and cost-savings by reducing the need for financial intermediaries;
- Increasing investor access to asset classes through fractional ownership (where an asset is split into smaller investments);
- Providing a more secure and accurate store of information (by creating tamper-resistant records);
- Distributing information between multiple participants in real or near-real time (to mitigate risks such as single points of failure); and
- Increasing the speed and efficiency at which capital can be provided (for instance by allowing for faster post trade settlement).

The potential benefits of crypto-assets can be understood in the context of the recent COVID19 pandemic, where European capital markets have played a vital role in supporting the economic response, and recovery, required. The benefits of crypto-assets (such as increased efficiencies and improved resilience of financial services) will become more pronounced as their adoption continues to increase and where other disruptive events, such as the current crisis, occur.

Even so, increased adoption and further innovation for crypto-assets remains hampered by a lack of clarity on their exact regulatory treatment. This lack of clarity stems from two main factors:

1. *Crypto-assets have a variety of features and use cases:* There are many different types of crypto-assets that are used to conduct a wide range of activities, with varying features and risks; and
2. *There is no commonly used global taxonomy:* There is no globally accepted taxonomy for classifying crypto-assets, to take account of these variations and to help identify the appropriate regulatory treatment.

It is therefore essential to establish a global taxonomy, that distinguishes these different activities and features, to encourage innovation, realise the potential benefits and appropriately manage any associated risks.

Why are crypto-assets so difficult to define and classify?

Crypto-assets, whilst evolving at pace, remain at an early stage in their development and use within financial markets. Therefore, identifying the appropriate regulatory treatment has proven difficult as current regulations were not developed with crypto-assets in mind.

For example, existing regulations are generally built on the basis of 'bilateral relationships' (a linear relationship between the seller, intermediaries, and buyer respectively), whereas crypto-assets are able to facilitate multiple interactions between decentralised parties.

This has resulted in a fragmented approach to crypto-assets regulation across EU Member States (and globally). This creates uncertainty for market participants as to which rules will apply to the issuers of crypto-assets and related service providers (such as those providing exchange or custody services). Clarity on what rules will apply is necessary for encouraging crypto-asset adoption and innovation.

The need for a global taxonomy to classify crypto-assets

In December 2019 the European Commission issued a public consultation for the development of a comprehensive regulatory framework for crypto-asset markets in Europe. This framework will be an important step towards harmonising crypto-asset regulation in Europe and creating a common baseline of understanding for market participants.

However, a global crypto-asset taxonomy is still required due to the global nature of financial markets; and particularly for those market participants engaging in cross-border activity. This global taxonomy must be high level in order to remain flexible as crypto-assets continue to develop, but detailed enough to provide the regulatory clarity required to encourage innovation.

Industry collaboration across the EU, and globally, will be essential in achieving this taxonomy and in realising the benefits of crypto-assets, whilst mitigating any risks.

AFME initiatives

In support of a European, and global, crypto-assets taxonomy, AFME (as part of the Global Financial Markets Association, GFMA), has developed an initial approach for the classification of crypto-assets. We believe this approach provides an important basis for a future global taxonomy and that it can support the collaboration required between financial market participants and regulators to achieve this aim.

The approach we developed is based on the principle that the regulatory treatment of crypto-assets should be underpinned by a clear understanding of the existing features of crypto-assets and their associated risks. We believe this approach will support the development of an appropriate framework for crypto-assets regulation in Europe, and globally, as crypto-assets continue to evolve and new offerings are created.

You can find our approach here, in Annex A (p 10-12) of our response to the BCBS Discussion Paper on *Designing a Prudential Treatment for Crypto-assets.*

You can find our response to the European Commission public consultation on *An EU Framework for Markets in Crypto-assets* here.