20 June 2022

Last week's agreement by the European Parliament and the European Council on a final draft of the Markets in Crypto Assets (MiCA) regulation six months ahead of the expected timeline was a major milestone. First proposed by the European Commission in September 2020[1], MiCA is expected to come into force towards the end of 2023.

Through MiCA, the EU will join Japan at the forefront of crypto regulation among the world's major jurisdictions. To avoid regulatory overlap, MiCA refers only to crypto assets not already covered by existing EU financial legislation. It aims to establish rules for crypto asset service providers (CASP) at EU level, thus superseding any existing national frameworks.

MiCA covers three main areas:

1. Issuers of crypto assets (other than stablecoins, referred to as asset-referenced tokens and e-money tokens) can only offer or trade them if they have been authorised by their respective national competent authorities (NCAs). To be authorised, they have to submit a detailed crypto asset white paper with the details of the planned offering. The NCA has the power to suspend or prohibit the offering, or demand that additional details are included in the white paper.
2. On stablecoins, a difference is being made between asset-referenced tokens (ARTs) and e-money tokens. Issuance and trading conditions for ARTs are similar to those for crypto assets other than stablecoins (see above). To qualify as an ART, the issuer has to invest the reserve assets in secure, low-risk assets. Holders of ARTs need to have clarity on their rights or claims on the reserve assets directly. Importantly, MiCA prevents ART issuers from granting any interest to ART holders.
Issuance of e-money tokens can be only authorised for credit institutions (such as banks) or electronic money institutions (EMIs). EMIs are legal entities licenced to disburse electronic money for online payments. In addition to banks, there are over 540 EMIs in Europe (many in the UK). Electronic payments are made via debit or credit cards or bank deposits, but alternatives such as e-wallets or cryptocurrency transfers are also growing.

[1] https://bit.ly/3ureAFU

Unlike ARTs, e-money tokens are considered electronic money. Any funds received by an issuer in exchange for e-money tokens must be reinvested in assets denominated in the same currency as the one referenced by the e-money tokens. Holders of e-money tokens have a direct claim on the issuer. At their request, the issuer must redeem them at any moment and at par value.

The EBA will determine, based on a set of pre-determined criteria, which issuers of ARTs or e-money tokens are significant. Those considered as such will be directly supervised by the EBA. Alternatively, the EBA can delegate specific supervisory tasks to the issuer's respective NCA when necessary.

3. Across the EU, crypto assets of all categories can only be issued or managed by authorised legal entities called crypto asset service providers (CASPs). To counter money-laundering risks, ESMA has been mandated to establish a register of all CASPs, which will include information on their white papers.

   This information will have to be communicated by the home NCA to host NCAs within the EU. Significant CASPs will also have to disclose their energy consumption. ESMA will prepare technical standards to provide the market with proper guidance on such disclosures.

   Non-fungible assets (NFTs) offered publicly at a fixed price – art, collectibles etc. – are exempt from MiCA. However, NFTs which can be traded on a fractionalised basis are included in regulated crypto assets.

The speedier-than-expected conclusion of an agreement may have been influenced on its last leg by the French presidency of the EU. France has been a more vocal proponent of crypto regulation with teeth across the EU and globally. The deal between the Parliament and Council was announced on 30 June, the last day of the French mandate.

Within Europe, the country with the most stringent national crypto regulation is Germany. Under its Banking Act, all companies engaging in cryptocurrency trading or custody require a banking licence and are subject to regulatory requirements like investment firms. In fact, MiCA superseding Germany's existing rules will mean a relative regulatory easing for the crypto market in Germany as crypto asset service providers would not necessarily need to be regulated as financial institutions.

Agreement on travel rule

In parallel with agreeing to finalise MiCA, EU authorities have reached an understanding on updating the rules on information accompanying the transfer of funds ("travel rule") to include the transfer of crypto assets. This is very relevant in the context of the global fight against money laundering and terrorist financing and is based on the recommendations of the Financial Action Task Force (FATF).

Specifically, CASPs will have to collect and make accessible information about the originator and beneficiary of crypto asset transfers, ensuring their traceability. Importantly, this obligation is regardless of the amount being transferred (criminals are known to transfer large amounts in small separate packs).

Positive effect for European banks

The implementation of MiCA should be a positive for the European banking sector. First, by regulating the crypto market, it provides more clarity to crypto-related activities of some larger banks, such as custody, investments via subsidiaries, or even trading.

Second, if the CASP is a credit institution already authorised in the EU, it will not require a separate CASP licence. This will be an advantage especially for banks with a cross-border presence, which can carry out crypto-related activities through passporting.

Third, unlike the situation in the US, the obligation that CASPs be legal entities should be a major hurdle for the European growth of decentralised finance (DeFi) – in which issuance is through decentralised autonomous organisations (DAOs) with no identifiable issuer. That said, if DeFi grows in relevance worldwide, it is possible that, at a future point, EU regulations will be adjusted to accommodate it.

As with other developments in the digital arena, the winners in the new ecosystem will be banks with state-of-the-art technology and resources to compete. However protective the current regulatory architecture in Europe is for banks now, it should not be construed as a get-out-of-jail free card for the long haul. As we are seeing with MiCA, intelligent regulators can in time catch up with change and innovation, not to stop it just to help slow-adapting incumbents.

Right regulatory balance

In my view, MiCA is the type of balanced regulatory framework that the crypto market needs. Rather than being restrictive and hindering innovation and growth, it calls for a high degree of disclosure and transparency for both crypto assets and their service providers – including for stablecoins. It is certainly not trying to stifle innovation. On the contrary, by establishing common rules for all 27 Member States, it aims to create a single crypto market which offers participating institutions depth and breadth for their digital footprints, as well as cross-border regulatory reliability.

MiCA clearly aims to mirror existing regulations for traditional financial products and institutions, so that the evolution of the crypto market does not disrupt and affect the much larger financial markets.

Critics point to the announced potential limits in stablecoin issuance as an unnecessary hurdle, but policymakers' concern is to preserve monetary sovereignty and consumer protection.

Following the Terra/Luna fiasco, there is increased interest also in the US to somehow regulate the stablecoin market. However, the focus there seems to be somewhat different from Europe's. While the EU does not seem inclined to accept all private stablecoins as part of the official financial and banking system (see above the difference between asset-referenced tokens and e-money tokens), the US Stablecoin TRUST Act of 2022, if adopted, would allow precisely that if the issuer adheres to certain rules and conditions.

This could, according to some observers, question the need to establish a digital dollar. By contrast, the ECB and the EC seem to be increasingly committed to a digital euro – a fiat digital currency not usurped by private stablecoins.

The latter is also the view coming from the BIS. In its recently published Annual Economic Report, a section on the future monetary system[2] highlights its belief that it will remain grounded in central bank money, principally through central-bank digital currencies (CBDCs). The report cautions that "structural flaws make the crypto universe unsuitable as the basis for a monetary system: it lacks a stable nominal anchor, while limits to its scalability result in fragmentation."

To try to preserve the privileged reserve-currency status of the dollar, the US will have to move faster and more decisively into the CBDC world,

[2] https://www.bis.org/publ/arpdf/ar2022e3.pdf

especially as China is several laps ahead. This may cloud the outlook for stablecoins as one day being more than just a marginal payment channel, even in the US.

Collapsing crypto market

Finalising MiCA was very timely, given the massive turmoil the crypto markets are suffering, underpinned by collapsing cryptocurrency valuations. Crypto market cap has dropped 70%, from last November's peak of USD 3trn to around USD 900bn at present, mirroring the drop in Bitcoin valuation from USD 69k to USD 19k (the low was USD 13k last month).

While the number of Bitcoin millionaires globally came down from roughly 109k to 26k (and the number of 'whales'[3] from 10.6k to 4.3k), low crypto valuations have attracted newcomers: 13k wholecoiners (investors in at least one full unit) and over 250k targeting a fraction of a coin; mostly retail investors eager to dip their toes.

Many of these investors lack proper understanding of the risks involved. And far too many crypto specialists and enthusiasts, through the social media and other channels, continue to cheer the glass half-full, asserting that the meltdown will clean up the crypto market of excessive leverage and make it more investable. While admitting that regulations are needed, many of them call for a very light touch, "not to stifle technology innovations".

Meanwhile, the bad news in the crypto sphere keeps coming, from the collapse of 'stablecoins' TerraUSD and Luna (a 93% meltdown of the USD peg) to the default of British Virgin Islands-based crypto hedge fund Three Arrows Capital and the severe problems experienced by crypto lenders Celsius and Voyager Digital (the latter being the creditor of Three Arrows).

A recent Capgemini survey of the crypto world[4] revealed that the main concerns of actual or potential crypto investors are lack of security, price volatility, lack of education, tax complexities, as well as, importantly, lack of suitable regulation. Viewed from this angle, MiCA will alleviate some of these concerns, which is clearly a positive step for crypto issuers, servicers, traders and investors in the EU. And not only in the EU, as Europe's regulatory blueprint may and in fact should inspire crypto regulations elsewhere.

Debate on crypto regulation rumbles on in US

In the US, the world's largest crypto market by far, there is still debate about the optimal way to regulate crypto amid concerns that regulation will hurt innovation.

A contemplated bipartisan Senate bill would require the SEC to consider setting up a self-regulatory organisation (SRO), giving crypto industry participants considerable leeway. Debate also dwells on the conundrum of which regulator should take the lead – the SEC or the Commodities Futures Trading Commission (CFTC). Crypto participants reportedly prefer the latter, as the SEC has been known for more aggressive enforcement actions.

[3] In crypto parlance, a 'whale' is a wallet holding a large percentage of one cryptocurrency (often over 10%) or a large mix of different cryptocurrencies. A 'whale' moving in or out can make a difference to liquidity of a specific coin.

[4] https://worldwealthreport.com/pdf/Capgemini_WWR_2022_VFinal_Digital.pdf

This report is published by Scope Group. The content is an independent view not related to Scope's credit ratings.

Scope SE & Co. KGaA

Lennéstraße 5
10785 Berlin
info@scopegroup.com

Scope Ratings GmbH

Lennéstraße 5
D-10785 Berlin

info@scoperatings.com

Scope Ratings UK Limited

52 Grosvenor Gardens
London SW1W 0AU

info@scoperatings.com

Scope ESG Analysis GmbH

Lennéstraße 5
D-10785 Berlin

esg@scopegroup.eu

Scope Analysis GmbH

Lennéstraße 5
D-10785 Berlin

info@scopeanalysis.com

Scope Investor Services GmbH

Lennéstraße 5
D-10785 Berlin

info@scopeinvestors.com

Scope Hamburg GmbH

Stadthausbrücke 5

D-20355 Hamburg

info@scopehamburg.com

www.scopegroup.com

www.scoperatings.com

www.scopeanalysis.com

www.scopeinvestors.com

www.scopehamburg.com

Disclaimer