SCOPE

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Interconnectedness between banks and cryptocurrencies is modest but crypto regulation is sub-standard. The unbridled growth and extreme price gyrations seen in cyber markets have not impacted the performance of the much larger traditional financial markets or the banking industry. Though it has rapidly risen in volume – from USD 16bn five years ago to ca. USD 2.6trn – the crypto market accounts for a small share of the USD 250trn global financial system and has a far narrower investor base. But banks will not be immune to crypto risks if clients and counterparties require services in this area.

A *Wide Angle* report back in April 2021[1] pointed out that the growing presence of crypto assets – cryptocurrency trading, smart contracts, decentralised finance (DeFi) – should not threaten European banks' core activities of lending, deposit taking, trading, and investing. My view has not changed.

Very limited interaction between banks and crypto means that systemic risk brought about by interconnectedness remains low. This is significant, given that the Global Financial Crisis was triggered to a large extent by dangerous interconnectedness in the global financial system, in FX, securities and derivatives trading books and notably the USD 1.2trn of US subprime residential mortgage exposure spilling over into financial markets to institutions worldwide through securitisation run amok.

When it comes to crypto, the fear is that insufficiently regulated and unsupervised crypto assets can gradually flow into traditional financial markets, polluting them with massive new risks. Indeed, more categories of market participants are joining the bandwagon of Bitcoin and Ether, which account for 40% and 20%, respectively, of aggregate crypto market capitalisation.

Crypto markets continue to be fuelled mainly by retail investors engaging in trades that are predominantly speculative or of a hedging ("digital gold") nature. The growing role of crypto exchanges, like Coinbase, Binance, FTX, and many others, makes access easier for new segments of retail investors hoping for quick and massive gains, beyond the early echelon of technology geeks and crypto enthusiasts. Many of these more recent investors barely understand

[1] Growth of crypto assets does not threaten EU banking sector

or even care about cryptocurrency fundamentals or underlying risks. This is not reassuring.

Institutional investors, mostly hedge funds and investment funds such as crypto-focused ETFs, are increasingly active. This inherently jeopardises financial stability. Not only because funds invest other people's money but also because of the vigorous use of leverage on a much larger scale. Not surprisingly and not a moment too soon, financial regulators are paying increasing attention to the threat posed by the growing interconnectedness of crypto markets with traditional financial markets.

The crypto markets are currently in a sustained downslide, with Bitcoin having lost almost 60% of its peak value and Terra, a supposedly "stable" stablecoin, having totally melted down. Back in March[2], and not for the first time, the three European supervisory authorities (ESAs) warned consumers about the real risks of crypto assets, noting that they are not suited for most retail consumers as an investment or as a means of payment or exchange. In a recent TV interview, ECB president Christine Lagarde, referring to crypto, said that "it is worth nothing, it is based on nothing, there is no underlying asset to act as an anchor of safety". This characterisation is hard to argue against.

And yet crypto fever seems far from abating. It is estimated that around 10% of the adult population in Europe has some form of crypto investment and 16% in the US. Sadly, there are no estimates of how many of these investors understand crypto and the risks they are exposing themselves to.

The risk is there

Against this unsettling backdrop, banks have generally remained on the sidelines. A BIS study published last month[3] noted that major banks' crypto exposures remain immaterial. This conclusion is based on a Q4 2020 Basel Committee survey of 178 banks in 26 countries.

Only seven banks in the survey – in Canada, France, South Korea, the UK, and the US – reported any crypto exposure and in all cases, it was driven by client needs (although no data exists on crypto custody services). The average crypto exposure was 0.02% of risk-weighted assets, with the highest level at 0.05%. The aggregate amount of crypto exposure for the surveyed banks was just USD 188m.

In contrast to the benign showing of the banks, the BIS report highlighted that exchanges play a dominant role in crypto markets, being defined as key nodes of the crypto ecosystem. Most crypto exchanges are lightly regulated and many are headquartered in offshore financial centres. Unlike banks and other properly regulated financial intermediaries, crypto exchanges also provide limited and often inconsistent disclosure.

For example, open ledger blockchains provide a complete history of all transactions and the crypto amount held by each individual wallet address, but ownership of wallets is typically undisclosed.

Not surprisingly, the BIS report points to the heightened risk of crypto exchanges, noting the need for a proper credit risk assessment of these institutions – including their liquidity and loss-absorption capacity.

The report highlights three challenges for policymakers:

1. Ongoing digitalisation of finance and interest in DeFi could spur the growth of the crypto shadow financial system so this segment demands proactive and forward-looking regulation and supervision.

[2] EU financial regulators warn consumers on the risks of crypto-assets

[3] BIS Working Papers No 1013 Banking in the shadow of Bitcoin? The institutional adoption of cryptocurrencies

2. Cryptocurrencies originate from outside the traditional financial system but crypto risks could easily transfer to banks and other financial intermediaries. Which again would require more regulatory clarity around the process.
3. Important data gaps, which can undermine the ability to regulate and oversee cryptocurrencies holistically, need to be addressed. One possible route is “embedded supervision”, which harnesses information in distributed ledger-based finance.

Crypto regulations building up

Public authorities are calling for crypto markets to be regulated to match existing frameworks for traditional banking and financial markets. But while putting forward new regulatory initiatives is of course important, bringing the approval process to completion speedily through all the political, procedural and legal hurdles is critical. Because, spurred by the fast-advancing underlying technology and innovative approaches, the crypto markets are moving forward in leaps and bounds. Bringing with them massive volatility, risk-management uncertainties, and not least the potential for crypto criminals and rogue States to take advantage of the situation.

On this latter point, governments and regulators are rightly warning that Russia, in revanchist mode and free of any compunction, is likely to look for ways to bypass tight financial and economic sanctions via the crypto markets.

The EU is at the forefront of crypto regulation efforts. In September 2020, the European Commission launched its proposal for a Markets in Crypto Assets (MiCA) regulation, expected to be adopted by the European Parliament later this year or early next year and applied from early 2024. The excessively lengthy approval process is suboptimal in my view, but positive finalisation will be real progress.

In a nutshell, MiCA regulation will require cryptocurrencies to meet the same transparency, disclosure, licensing, compliance, authorisation, and oversight conditions as other financial products, while at the same time harmonising the crypto legal framework across the EU’s 27 Member States. Better regulation and supervision should help investor confidence in this market. Importantly, MiCA will also introduce an EU passport that will allow non-EU crypto platforms and other service providers to apply for licences across all 27 countries.

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