SLAUGHTER AND MAY/

CLIENT BRIEFING

FEBRUARY 2022

CRYPTOASSETS AND BANKING

2022 OUTLOOK

1. New Horizons

1.1 The UK regulatory framework underpinning cryptoassets is in a period of gestation, leaving the future relationship between cryptoassets and banking open to question.

1.2 Despite the Kalifa review's promise in February 2021 of a new UK regime for the regulation of cryptoassets in general, and stablecoins in particular, the UK is yet to articulate tangible legislative proposals like those presented in the US and the EU. The UK government and regulators have, however, signalled the direction of travel, producing a slew of consultation papers, discussion papers and commentary across 2021.

1.3 In this briefing we attempt to decipher these broad strokes, asking what might be on the horizon for banks seeking to engage with cryptoasset opportunities in 2022. More specifically, we consider what might be in store for stablecoins, the emerging ecosystem that will support the use of cryptoassets in banking, and noises that the regulators have been making about crypto.

2. Stablecoins: Standing on the Brink of Change

2.1 While FCA guidance published in 2019 has generated relative confidence in the regulatory treatment of those cryptoassets which resemble securities and e-money, the approach to stablecoins—a type of cryptoasset that aims to maintain a stable value relative to a specified asset, or a pool or basket of assets—is on the brink of change.

2.2 Currently, a stablecoin might, depending on its structure, be treated as e-money, or it could be unregulated altogether. Upending this status quo, in January 2021 HM Treasury consulted on the introduction of a regulatory regime for stablecoins in recognition of the significant role that they could play in retail and cross-border payments (and the attendant risks they could introduce).

2.3 While proposals remain at a high level and no detailed firm requirements have been specified, it is likely that banks will be in scope of the new regime if they execute transactions in stablecoins, manage stablecoins on behalf of owners, or issue, create or destroy stablecoins.

2.4 Beyond this, many questions remain. For instance, what requirements will apply to reserves held for stablecoins (particularly where they operate at systemic scale)? How might this stablecoin regime interact with the existing e-money regime? And, crucially, will the proposals take account of the significant shifts that have occurred in the crypto landscape since January 2021 (including the growth of decentralised finance or 'DeFi')? We expect to hear more on this in 2022.

3. An Emerging Ecosystem

3.1 While the development of a coherent regulatory framework for stablecoins remains nascent, an ecosystem supportive of the circulation of cryptoassets within the banking system is being constructed.

3.2 On a practical level, in April 2021 the Bank of England (the Bank) launched a new omnibus account as part of its Real-Time Gross Settlement service, enabling it to support a wider range of innovative payment systems including those using distributed ledger technology.

3.3 Legislative support is similarly coalescing. Anti-money laundering and counter-terrorist financing legislation targeting virtual currency exchange platforms and custodian wallet providers has been in place since the entry into force of the Fifth Money Laundering Directive in January 2020, promoting safer interaction with cryptoassets. This was bolstered by robust JMLSG and FATF guidance published across 2020-2021. Further regulation may soon appear in this space given that, in September 2021, the FCA called for

legislators to make it harder for cryptoassets to be used for financial crime.

3.4 At an international level, in October 2021 the Committee on Payments and Market Infrastructures and IOSCO published a consultation addressing how their 'Principles for Financial Market Infrastructures' should apply to systemically important stablecoin arrangements. This was hailed by Sir Jon Cunliffe, Deputy Governor for Financial Stability at the Bank, as a major step towards the consistent application of international standards to crypto-based financial services.

3.5 Moreover, in November 2021 the Basel Committee on Banking Supervision (BCBS) confirmed that it intends to specify a proposed prudential treatment of banks' cryptoasset exposures, and will consult on this further by mid-2022. This announcement sits against a backdrop where the UK is expected, following comments made by the Bank's Deputy Governor Sam Woods in September 2021, to "take a very conservative view on capital treatment" and will, if necessary, "front run" global capital rules on cryptoassets. While BCBS progress in this area is welcome—further certainty on the question of capital requirements is crucial to banks' entry into the cryptoasset space—stringent capital requirements could lead to some interesting structuring questions in the years to come. They could also tip the balance of power away from banks towards other cryptoasset market actors if it becomes too costly for banks to participate.

3.6 These developments complement industrious Law Commission work conducted throughout 2021, the outcome of which suggests that English and Welsh law is sufficiently flexible to accommodate both smart legal contracts and (subject to reform in certain areas) the proprietary nature of cryptoassets. And yet, as we have already alluded to in the context of capital requirements, this budding environment must be placed in a context where the regulatory attitude to cryptoassets is characterised by caution.

4. Regulatory Attitude

4.1 The potential for innovation presented by cryptoassets has been recognised by UK regulators. For instance, during 2021 the Bank has expended significant resources assessing the case for a UK central bank digital currency, or 'CBDC', launching a dedicated CBDC taskforce in April 2021. We expect a consultation on this subject to be opened this year.

4.2 The possible threats posed by cryptoassets are, however, front and centre of the regulatory mindset. In January 2022 HM Treasury rang in the new year by announcing that, in a bid to enhance consumer protection, it will bring a wider range of cryptoassets (in particular, those which are currently unregulated and used as a means of investment, like Bitcoin) within scope of the UK's financial promotions regime – an announcement which was swiftly followed by muscular (proposed) FCA rules.

4.3 In September 2021 Charles Randell, outgoing chair of the FCA, emphasised the consumer risk posed by speculative cryptoassets and warned that boards of FCA authorised firms, including banks, must be able to show how they have addressed the risks that cryptoassets can pose in the context of unregulated activities (both to the conduct of firms and their prudential soundness).

4.4 The PRA has exhibited similar caution, writing to banks in 2018 to emphasise the risks associated with cryptoassets and subsequently taking a strong interest in new cryptoasset business launched by banks. More recently, in December 2021 the Financial Policy Committee (FPC) of the Bank stated that financial institutions should take an especially cautious and prudent approach to any adoption of cryptoassets until a regulatory regime is in place.

4.5 Looking to the long term, the Bank has suggested that stablecoins and the advent of a retail CBDC could upset the very model of banking itself. In a paper on new forms of digital money published in June 2021, the Bank suggested that if customers migrated their deposits away from the banking system to CBDCs and stablecoins (in a process known as 'disintermediation'), banks might restore their liquidity positions—and their ability to continue lending—by issuing long-term wholesale debt. The Bank argued that this could affect the cost and availability of borrowing from banks, a conclusion which will no doubt influence the prudential approach to stablecoins and CBDCs in the future. The same concerns were echoed by the Economic Affairs Committee of the House of Lords in a report published in January 2022.

5. Conclusion

5.1 2022 promises greater clarity for banks on how they might engage with cryptoassets. In

particular, we expect further, crucial, detail to be fleshed out on a regulatory regime for stablecoins, and to know more about how cryptoasset exposures might be treated for prudential purposes.

5.2 Whether and how any regulation may disadvantage banks at the expense of other market actors in the cryptoasset space remains to be seen. To a large extent, this question also hinges on the future regulatory approach to payment services firms as compared to the treatment of firms with a banking licence.

5.3 Amidst this uncertainty, one thing is clear. Given significant and fast-paced growth in the cryptoasset market in 2021—a year that saw a reported $15.8tn worth of cryptocurrencies traded—cryptoassets will remain high on the regulatory agenda, and regulatory solutions to the risks introduced by cryptoassets will be a legislative priority.

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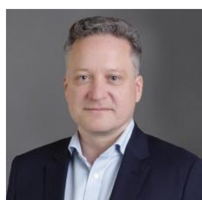

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