Opinion **Cryptofinance**

Crypto poses serious challenges for regulators

There are important questions to answer on systemic risk, market integrity and consumer protection

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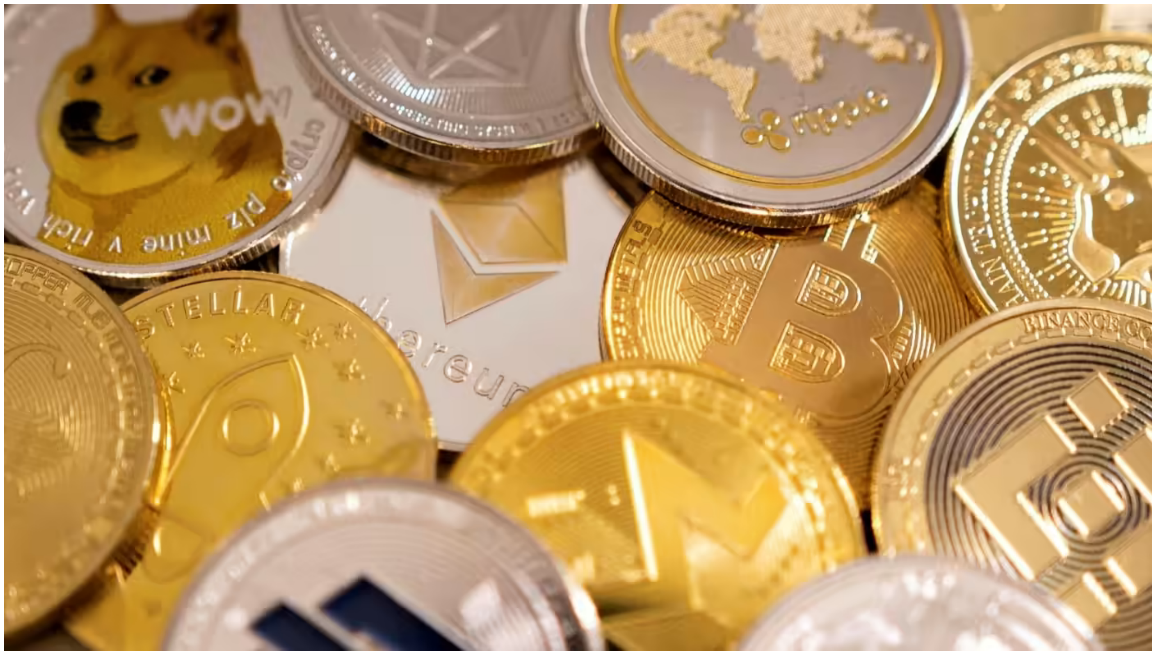

The crypto industry has an interest in muddying the waters © Dado Ruvic/Reuters

Eswar Prasad 56 MINUTES AGO

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Whatever the fate of decentralised cryptocurrencies like Bitcoin, other forms of cryptocurrencies and blockchain technology are here to stay. Decentralised finance can create innovative ways of delivering and broadening access to financial products and services, while the added competition forces traditional institutions to improve their efficiency.

This creates challenges for regulators who recognise the potential benefits. How to facilitate innovation while keeping risks contained?

Answering a few basic questions would help to harness the technology and improve the inevitable benefit-risk trade-offs.

First, is blockchain technology the best answer to extant deficiencies? Digital payments in the US, for instance, remain beset by high costs due to regulatory and other barriers. International payments everywhere are still costly, slow and difficult to track.

Blockchain technology is hardly the only or asset industry. Explore the FT's coverage here.

optimal solution. Mobile phone-based and other technologies are enabling broad and easy access to low-cost digital payments. Regulators should favour simpler technologies that best address the real needs of consumers and businesses, rather than those that promise speed and efficiency but make it harder to trace payments and facilitate illicit commerce.

Second, how to protect investors and consumers? Regulators cannot always constrain how much risk an investor should take on. But they must protect unsophisticated investors. Public blockchains are transparent and accessible, but that is no substitute for disclosure that renders downside risks comprehensible, backed up by steps to bolster financial literacy.

Third, how to prevent any one product or protocol from infecting the broader financial system? Stablecoins collateralised by government bonds and high-quality securities might not face panic-driven runs. Still, a wave of redemption requests could trigger large-scale liquidations of collateral, disrupt underlying securities markets and have a cascading effect across the financial system. Regulation should account for systemic risk that rises as the sector expands.

Fourth, how to avoid regulation that simply entrenches established players and intensifies market concentration by raising the cost of entry? Simpler, more transparent rules would enable newer and smaller firms to compete on a level playing field. Some degree of churn among financial institutions is not necessarily harmful, so long as it doesn't damage confidence in the system.

And finally, how to maintain market integrity? Decentralised architectures and governance, while appealing and secure in principle, open up vulnerabilities such as front-running of certain protocols. Technology hardly eliminates the need for effective oversight.

Definitional issues are also important. Is a stablecoin issuer a narrow bank or a money market mutual fund? Is Ethereum a commodity or a security?

The answers to such questions are crucial for determining what, whom and how to regulate. The crypto industry has an interest in muddying the waters. This heightens the need for expeditious action, recognising that some innovative technologies are merely improving the packaging and delivery of existing products. Definitions also matter for emergencies. Classification as a bank would give a stablecoin issuer access to central bank liquidity facilities, for instance, but this should trigger capital requirements.

When an industry clamours for regulation, it typically craves the legitimacy that comes with it, while trying to minimise oversight. That is the biggest risk regulators must guard against — giving the crypto industry an official imprimatur while subjecting it to light-touch regulation.