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# Are cryptoassets systemically relevant?

 The Digital Regulator



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## Authors

**Mattia Rattaggi**  
External Regulatory Analyst  
METI Advisory AG

**Yves Longchamp**  
Head of Research  
SEBA Bank AG

## Contact

research@seba.swiss



## Executive summary

The issue of whether cryptoassets pose a risk to the financial system has been firstly raised after their all-time high capitalisation level reached in January 2018. It has been raised again more recently, following the all-time highs scored in April and November 2021. Systemic risk is not about investor protection and anti-money laundering aspects. It is about the stability of the broad financial system, the solidity of its infrastructure, and the effectiveness of monetary policy. Governmental and regulatory bodies such as the G20, the Financial Stability Board (FSB), the International Monetary Fund (IMF), the European Central Bank, the Bank of England, and the US Federal Reserve have concluded that cryptoassets do not pose a systemic risk. Over time, however, the growing size of the crypto market, enhanced confidence and adoption by investors, and increased interconnection with traditional financial markets have made it more challenging than before to assess the point where financial stability risks could rapidly escalate. Moreover, several emerging economies are more exposed to this risk because the relevance of cryptoassets in their economies is higher than in mature economies. Following the latest analysis by the FSB (February 2022), the authorities intend to improve data collection to better monitor the risk and have called for improved cross-border cooperation. As cryptoassets become more integrated with traditional markets and more sizeable in terms of market capitalisation, it is reasonable to expect enhanced supervision of cryptoasset exposures by the regulated sector, a finalisation of the Basel Committee on Banking Supervision's prudential treatment of banks' cryptoasset exposure, and the acceleration of the work to broaden the regulatory perimeter to cryptomarket actors. Those actors that have been regulated by design benefit from a first-mover advantage.

During the last few weeks, the development of Central Banks Digital Currencies (CBDC) has continued unaltered, with initiatives in several jurisdictions and a new study from the IMF, which believes a one fits all approach is not possible. With regard to authorising a bitcoin spot Exchange-traded Fund (ETF) in the US, the Securities and Exchange Commission (SEC) has started a consultation on how to avoid frauds and manipulations with such ETF. It has also delayed the responses of a few pending submissions. Hong Kong and Ireland decided to prevent the retail sector from investing in crypto spot ETF and crypto investment funds. Recently, the Swiss government has taken steps to promote digital finance in Switzerland.

The steady adoption of cryptoassets, and their recent all-time high capitalisation level, has raised again the issue of whether cryptoassets pose a systemic risk to the financial system. International regulators believe that this risk is now more real than in the past and will take action.

## 1. The evolving assessment of the systemic relevance of cryptoassets

The issue of whether and under which conditions cryptoassets carry systemic risk is a lingering one. The definition of systemic risk focuses on the stability of the entire financial system – as opposed to the stability of an individual market participant, the solidity of the financial markets infrastructure, and the effectiveness of the monetary policy. It excludes money laundering/terrorism financing and consumer/investor protection aspects. The issue was first discussed and assessed in 2018 after bitcoin and cryptoassets reached an all-time high capitalisation. It was not an issue of concern during 2019 and 2020. However, the discussion intensified again during the second half of 2021, following another all-time high capitalisation of cryptoassets in April and November 2021. We review below the arguments made in the discussion of the systemic relevance of cryptoassets, and the conclusions achieved. We summarise in some detail the most recent assessment and conclusion published by the Financial Stability Board (FSB) on 16 February 2022 and offer an outlook.

### FSB's initial analysis

On 13 March 2018, following the all-time high capitalisation level achieved by cryptoassets in January 2018, the [FSB](#) advised the G20 that cryptoassets do not pose a risk to the overall stability of the much larger traditional financial system. The conclusion is based on the size of the cryptomarket - small relative to the size of traditional financial markets – and on the very limited use of cryptoassets for the real economy and related financial transactions. However, the FSB warned that the assessment would be different if the use of cryptoassets increased significantly along with enhanced investor confidence and bigger interconnection with the regulated financial system.

### 2019: BoE, ECB, US Fed, and G20

During the 'crypto winter', the Bank of England ([BoE](#)) confirmed on 1 May 2019 that cryptoassets do not pose a risk to the overall stability of the much larger traditional financial system. The conclusion rested on the market capitalization of the crypto market - too small compared to the multi-trillion-dollar global financial market. The European Central Bank ([ECB](#)) reached a similar conclusion on 14 May 2019, warning that the dynamics displayed by cryptomarkets meant that more significant threats to the EU financial stability could not be ruled out, and careful monitoring was needed. On 28 February 2019, however, the United States Federal Reserve ([US Fed](#)) included the collapse of the bitcoin market amongst the stressed events conducted to measure risk to the US financial market. On 1 July 2019, the [G20](#) confirmed that crypto-assets do not pose a threat to global financial stability but acknowledged the need to monitor their developments closely.

### 2021: BoE and IMF

On 13 October 2021, after cryptoassets grew from a capitalisation of USD 191 billion on 1 January 2020 to USD 2.3 trillion in October 2021, the [BoE](#) concluded that while the financial stability risks remain limited, the current developments of cryptomarkets raise financial stability concerns because of the increasing interconnectedness with the traditional banking and financial system, the emergence of leveraged players in the unregulated sector, and the rise of Decentralised Finance (DeFi) and stablecoins. In October 2021, the International Monetary Fund ([IMF](#)) highlighted that in several emerging economies the macro-relevance of cryptoassets is higher than in mature economies because they feature a more extensive adoption and penetration of crypto compared to the levels characterising mature economies.

### FSB's latest analysis

On 16 February 2022, the [FSB](#) recognised that the market for cryptoassets has been evolving fast and is getting nearer to representing a threat to global financial stability. It concluded that it has become more challenging than before to assess the point where financial stability risks could rapidly escalate. The market capitalisation of cryptoassets remains small compared to all assets making up the financial system, and the degree of interconnectedness is still limited. However, nonbanks and banks have been increasingly undertaking cryptoasset

activities and gaining exposure to the cryptoasset class through dedicated and sometimes leveraged financial products; investors and consumers continue to display low levels of understanding of crypto-assets; there is uncertainty around the degree of operational resilience of some crypto-asset-focused actors.

- Regarding potential vulnerabilities emerging from unbacked cryptoassets (such as bitcoin), the FSB notes that the connections between cryptoassets and systemically important financial institutions are currently limited and follows the IMF in assessing such connections as more important in emerging economies than in mature economies. It also notes the growing institutional adoption of cryptoassets through nonbanks (such as hedge funds) and related products such as Exchange-traded Products (ETPs) and funds offering leveraged trading strategies; the provision of crypto custodial, trading and other services by financial institutions and banks; the wealth and confidence effects that sudden market shocks could trigger; and the degree with which these cryptoassets are used in payments and settlement (which remains limited).
- Concerning exposures associated with stablecoins, the FSB flags that the nature and composition of the reserve assets of the companies issuing and managing stablecoins may represent market exposures; governance, risk management, and operational weaknesses may impact investor confidence level. The FSB also flags that critical payment systems on which the real economy depends could be impaired if stablecoins were used more extensively for payments. This particularly applies to global stablecoins.
- In relation to DeFi, the FSB highlights that risks to financial stability may emerge in connection with the growing size of DeFi and the insufficient regulation and oversight.
- The FSB concludes that financial stability risks originating from cryptomarkets have become more real than before. The increasing adoption of cryptoassets by the traditional financial sectors and actors enhances the interconnectedness between traditional and cryptomarkets, which facilitates the transmission to traditional financial markets of shocks originating in the cryptomarkets.
- The authorities face gaps in identifying and quantifying financial stability risks originating from cryptomarkets. The FSB will continue to monitor crypto-asset market risks and explore potential regulatory and supervisory actions to address financial stability threats, including improving data collection and enhancing cross-border and cross-sectoral cooperation/information sharing.

The assessment of whether cryptoassets and related markets carry a systemic risk for the financial system has been considered by regulatory bodies such as the FSB, IMF, ECB, US Fed, and BoE regularly since 2018. The conclusion has always been that, currently, cryptoassets do not pose a systemic risk. The assessment is based on the relative size of the cryptoasset markets and the degree of interconnectedness with traditional financial markets. The conclusion has been nuanced over time. The introduction of bankable investment products and other institutional-grade investment vehicles, the initiatives by the banking sector to develop cryptoasset services, the advent of DeFi solutions and stablecoin offerings, and the growing general popularity of cryptoassets, have increased the interconnectedness between cryptomarkets and traditional financial markets. This development exposes traditional financial markets to shocks destabilising cryptomarkets in a more significant way than had been the case in the past. Regulatory authorities respond through increased data collection and monitoring and enhanced cross-border cooperation. As cryptoassets become more integrated with traditional markets and more sizeable in terms of market capitalisation, it is reasonable to expect a strengthening of the supervision of cryptoasset exposures by the regulated sector, a finalisation of the Basel Committee on Banking Supervision (BCBS) prudential treatment of banks' cryptoasset exposure, and the acceleration of the work to broaden the regulatory perimeter to include cryptomarket actors.

## 2. Other noteworthy developments

### The development of CBDCs continues intact with a new study by the IMF and initiatives in several jurisdictions.

- The [IMF](#) believes that each country should follow its own route because one type of a CBDC will not work in every nation due to stability and privacy features that must be tailored to each specific case. The IMF recalls that approximately 100 countries are currently working on launching their own version of digital fiat currency, while in six nations, digital money is already up and running or at an advanced stage.
- The [Federal Reserve Bank of Boston](#) informed about the CBDC research being carried out with the Massachusetts Institute of Technology. The collaboration has created a scalable CBDC model capable of handling 1.7 million transactions per second. The research aims to analyse key issues of any CBDC system, such as privacy and resiliency.
- The Central Bank of [Jordan](#) is exploring the launching of a CBDC, while the Central Bank of [Kenya](#) is requesting public feedback on the applicability of a CBDC. The Central Bank of [Zambia](#) is researching on CBDC and expects results by the fourth quarter of 2022. The Central Bank of [Bahrain](#) announced the successful transfer of funds cross-border using JPMorgan's JPM Coin.
- The [EU](#) said that a bill for a digital euro (EU's version of a CBDC) will be proposed in early 2023. The [BoE](#) informed that it plans to publish a consultation paper setting out its assessment of the merits of a 'Bitcoin' later this year.

### In relation to the approval process of the first bitcoin spot ETF in the US, the SEC is consulting on how to avoid frauds and manipulations and has again delayed responses on pending submissions. Hong Kong and Ireland decided to prevent the retail sector from investing in crypto spot ETF and crypto investment funds

- The US [SEC](#) is consulting publicly on whether the bitcoin spot ETF would be susceptible to fraud and manipulation. At the same time, the SEC has delayed its decision on the [Grayscale](#) bitcoin ETF and the [Bitwise](#) bitcoin ETF.
- In [Hong Kong](#), the financial regulators have decided to limit the sale of crypto spot ETFs to professional investors only. The Central Bank of [Ireland](#) intends to prohibit retail investors from investing in crypto funds. In both cases, the agencies want to protect retail investors from risks they are not equipped to bear.

### The activism of financial and banking regulators in the US continues amidst the Treasury-led effort to finalise a federal framework.

- The [SEC](#) reiterated being working with the Commodity Futures Trading Commission (CFTC) on crypto regulation and stressed its ongoing effort to work with the private sector - crypto platforms, exchanges, and lending platforms in particular.
- The [CFTC](#) requested to be granted with greater oversight on the emerging cryptocurrency market while the Federal Deposit Insurance Corporation ([FDIC](#)) fears that the rapid integration of digital assets with the current financial system could pose significant risks to its safety and soundness. Accordingly, it has included the assessment of crypto-asset risks on its list of priorities for 2022.
- The Department of Justice ([DoJ](#)) appointed its first Director of the National Cryptocurrency Enforcement Team (NCET), established to ensure the agency can rise to the challenge posed by the criminal misuse of cryptocurrencies. The Team will focus on virtual currency exchanges, mixing and tumbling services, infrastructure providers, and other entities that may be potentially involved in facilitating illicit activities.

**The Swiss government has taken steps to promote digital finance in Switzerland, and several other jurisdictions progressed with the implementation of cryptoregulations.**

- The Swiss Federal Council adopted a report on digital finance that proposes twelve areas of action with specific measures to strengthen Switzerland as a leader in digital finance, with a goal to implement the measures in the following years. The measures include promoting active dialogue with stakeholders (financial institutions, consumers, suppliers, innovative startups and global tech firms, academia, and operators of decentralised networks) and focusing on risks with respect to the use of data, clouds, and distributed ledger technology, cybersecurity, and artificial intelligence.
- The Central Bank of Spain has decided to intensify the monitoring, regulation, and supervision of the cryptocurrency market and urged more collaboration at the national and international levels and across institutions to achieve the goal. Brazil approved a bill regulating crypto markets. The regulation should grow and allow the day-to-day usage of bitcoin in financial transactions over time. The new law also exempts from taxes imports of hardware and software related to the processing, mining, or preservation of bitcoin and cryptocurrencies, provided the business only uses renewable energy sources.

### 3. Conclusion

Cryptoassets are inexorably establishing themselves as a standalone new asset class. Governmental and regulatory authorities continue to assess the risk this asset class pose for the stability of the financial system, the solidity of the financial markets infrastructure, and the effectiveness of the monetary policy. The growth of cryptoassets and the interconnectedness of their markets with traditional finance and financial markets is increasing the systemic relevance of this new asset class over time. Over time, we expect the authorities to extend their supervisory action and regulatory perimeter to cryptomarket actors. Crypto actors regulated by design have a first-mover advantage in this circumstance.

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