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The Digital Regulator

CBDCs and asset tokenisation kick off digital regulation in 2020

Abstract

After much conceptual debate in late 2019, wholesale CBDCs are poised to become reality during 2020. This will concern monetary flows between commercial banks and the central bank (CB). The degree of centralisation or decentralisation of the underlying distributed ledger technology (DLT) will depend on each specific case. The introduction of CBDCs at retail payment level, on the other hand, is less likely, owing to the number of structural issues raised that hinder the governance of the monetary system.

Discussions about asset tokenisation have traditionally focused on the benefits and consequences for the financial markets. The Organisation for Economic Co-operation and Development (OECD) has put forward a systematic analysis of the regulatory issues connected with widespread asset tokenisation. Allowing, supporting and accompanying asset tokenisation will require substantial regulatory upgrading work. First-mover jurisdictions that follow a principle-based approach to regulation, such as Switzerland, enjoy a material advantage over other countries.

Other noteworthy developments in the digital space at the beginning of 2020 further legitimate DLT on a global scale and underline the leading position of Singapore as a cryptofinance hub.

Wholesale CBDCs to materialise in 2020

CBDC initiatives are poised to move from concepts to reality in 2020. The applications will however be limited to the wholesale segment.

During the fourth quarter of 2019, international regulators focused on analysing CBDCs and their integration into DLT infrastructures, and concluded on the inevitability of CBDCs as a consequence of the demand for continuously available payment services and the emergence of electronic payment instruments and systems. A series of regulatory pronouncements in early 2020 indicates that wholesale CBDCs are poised to move from conceptual work and experimental tests to actual implementation in the course of this

year. The centralised or decentralised nature of the underlying DLT will vary from case to case.

- ✓ The Bank for International Settlements (BIS) released a survey^{link1} showing that CBs are undertaking extensive work on CBDCs and moving from conceptual research to intensive practical development. According to the survey, CBs representing a fifth of the world's population are likely to issue the first CBDCs in the next few years.
- ✓ The BIS also brought together the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Sveriges Riksbank and the Swiss National Bank to form an official group^{link1} for the purpose of sharing experiences when analysing and developing CBDCs. The focus is on assessing economical and functional use cases for CBDCs – as well as options for their technical design.
- ✓ The World Economic Forum released the results of its survey^{link1} on CBDCs carried out across the globe over the past few months. It launched a CBDC policymaker toolkit to facilitate the analysis of CBDCs and to lay common groundwork for central banks.^{link1}
- ✓ European Central Bank^{link1} (ECB) reported that it will continue to pursue the issuance of a CBDC during 2020, believing that this is needed on the back of a secular decline in the use of cash and the need to respond to the urgent demand for quicker and cheaper payments.
- ✓ The People's Bank of China^{link1} announced that it will continue developing a CBDC in 2020. While it has not set a deadline, the work will involve substantial top-level design, formulation, functional research and testing of the CBDC created in 2019.
- ✓ The Federal Reserve^{link1} confirmed it is conducting research and experimentation related to DLTs and their potential use in connection with CBDCs.
- ✓ The former governor^{link1} of the Banque de France forecasted that digital payments between commercial banks will happen fairly soon.

The introduction of retail CBDCs, on the other hand, is far from complete and will require further analysis. As emphasised by the ECB in a research paper^{link1}, retail CBDCs could lead to risks such as the structural disintermediation of commercial banks, centralisation of credit allocation, facilitation of systemic runs on banks in crisis situations and blurring of responsibilities for the enforcement of know your customer (KYC) and anti-money laundering (AML) regulations. In an extreme scenario, the dual banking system would come under pressure and, concurrently, influence the way monetary policy is currently conducted.

Tokenisation: long regulatory updating work needed

The OECD highlights the daunting regulatory tasks related to widespread asset tokenisation. This provides first-mover jurisdictions such as Switzerland with an advantage.

There is little dispute about the benefits that widespread asset tokenisation would bring to financial markets in terms of efficiency gains, transparency, improved liquidity, inclusivity and easier access to financing by smaller businesses. There is also a common understanding of the challenges faced by asset tokenisation, which come in different forms, be it technological (scalability, interoperability, network stability, cyber-risk) or governance-related (AML/CFT compliance, data protection and privacy issues, legal status of smart contracts).

In a report^{link1} issued in January, the OECD recognises the consequences of widespread asset tokenisation (disruption of the market-making model, repo and securities lending activities, potential bifurcation of liquidity between on-chain and off-chain markets for the same asset) and focuses on the substantial regulatory upgrading work needed to allow, accompany and support widespread asset tokenisation.

The report:

- ✓ Makes it clear that tokenised markets would have to grant financial stability, investor protection and market integrity while promoting competition. This requires proper handling of financial, consumer and investor protection as well as of market conduct aspects in order to safeguard investors' interests and ensure a fair and orderly market for tokenised assets.
- ✓ Highlights that the nature of new business models and processes involved in the tokenisation process would require regulators to establish, mostly on a case-by-case basis, whether or not activities fall within the regulatory perimeter, and to resolve any regulatory gaps to counter arbitrage opportunities.
- ✓ Emphasises new risks (mainly operational in nature) which would need to be added to prudential supervision activities. These include recourse and redress in the event of damage arising from a technical issue, theft or a non-existent real asset backing the tokenisation, market integrity issues stemming from the immaturity of the market, the potential lack of monitoring and controlling mechanisms, and insufficient information concerning tokenisation.
- ✓ Stresses other regulatory challenges such as those related to the need to communicate the new or adapted rules to participants in the tokenised markets and to explain the related compliance duties, and those connected to cross-border transactions of tokenised assets. These would require international cooperation to limit regulatory arbitrage and ensure smooth operations.

The OECD argues that jurisdictions that adopt a technology-neutral approach to regulation have an advantage over other countries when it comes to adapting the regulatory framework. Switzerland has been a first mover by making its legal set-up compatible with DLTs, and has followed a technology-neutral approach in the context of a principle-based method to regulation. The Swiss jurisdiction is therefore clearly attractive to asset tokenisation projects and is prepared to take the lead in widespread asset tokenisation.

Other noteworthy developments

The announcement of national blockchain strategies further legitimates DLT technology

- ✓ Australia is developing a National Blockchain Roadmap^{link1} to assess blockchain opportunities in various sectors of the economy and to investigate standards related to blockchain through the International Standards Organisation.
- ✓ India has published for comment its National Strategy^{link1} on Blockchain. The document suggests that regulations should be based on the functions performed by the technology and not on the technology itself.

Turkey is initiating regulatory work in support of the widespread use of cryptocurrencies

- ✓ The Capital Markets Board of Turkey^{link1} has taken note of the fact that one in five Turkish residents has used or currently owns cryptocurrencies, and is planning guidelines to address common concerns regarding cryptocurrencies, including taxation, malicious actors, market manipulation and cryptocurrency exchanges.

Germany is promoting cryptofinance by extending the regulatory perimeter^{link1} to include digital asset custody services

- ✓ A new law attributes the status of financial institutions to many market participants in digital assets that currently fall outside the perimeter. Thus, for instance, all exchanges that actively address the German market must have a licence. A grandfathering rule will assist the transition of existing exchanges.

Singapore has adapted the regulatory perimeter to include crypto, thereby generating a record number of digital banking licence applications

- ✓ The Monetary Authority of Singapore (MAS) is introducing the Payment Services Act^{link1}, which adopts an activity-based licensing framework for payment services, and is expanding the remit of the MAS to cover digital payment token services.
- ✓ The MAS has confirmed a record number of digital banking licence applicants^{link1}, including Grab and Singtel, Razer Youth Bank, Ant Financial, iFast Corporation, Hande and Yillion, ByteDance, ShengYe Capital, Phillip Capital and Advance.AI, AMTD, Xiaomi, SP Group and Funding Societies.

Conclusion

The ineluctability of wholesale DLT-based CBDCs is the most prominent regulatory development this year. Everything points to the first wholesale CBDCs coming into being this year.

The list of regulatory issues to be tackled by the authorities in order to support and accompany the widespread adoption of asset tokenisation confirms that regulatory issues are indeed a major obstacle preventing such adoption. Similarly, this situation grants a material advantage to jurisdictions like Switzerland – an early mover in adapting regulations within a technology-neutral and principle-based context.

The announcement of national blockchain strategies (Australia and India) further legitimates DLT technology, while a number of countries such as Germany and Singapore are adapting their regulatory perimeter to include and support digital asset activities.

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