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FINANCIAL SERVICES
SPECIAL REPORT
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New risks, new rules

The regulatory challenges for financial services in an era of climate change, green finance, cryptoassets and Big Tech disruption.

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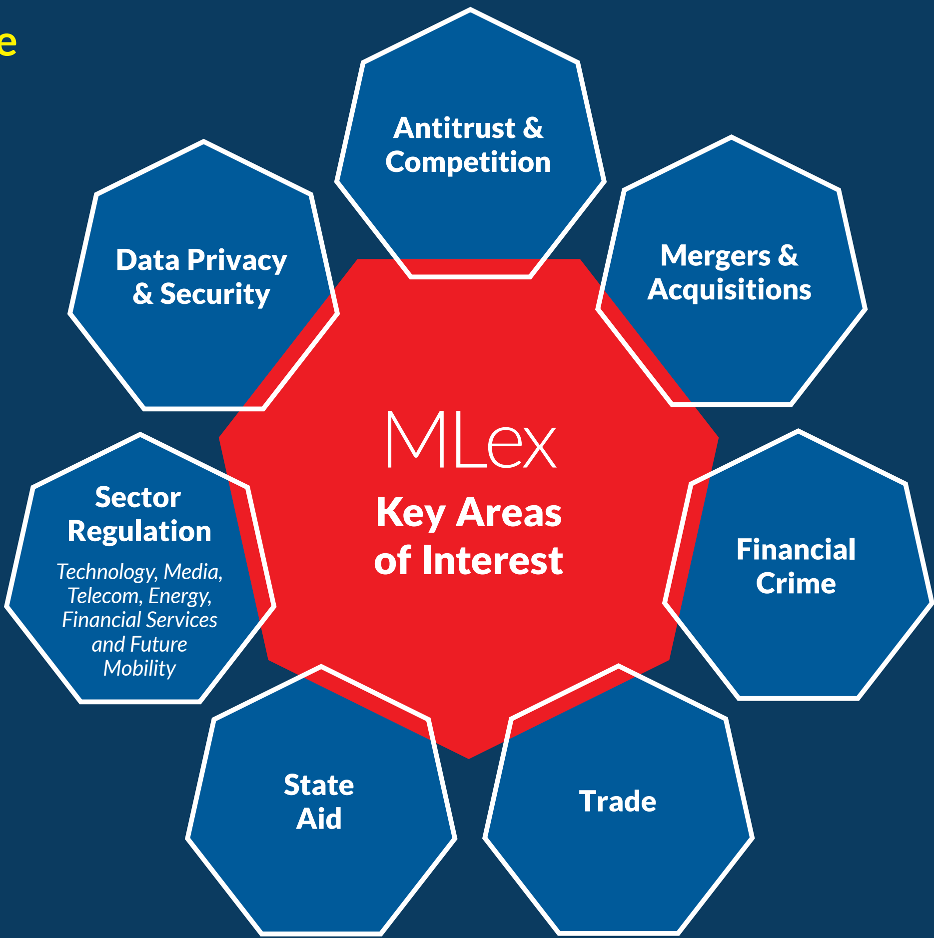

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Editor's Letter

Fiona Maxwell
Chief Correspondent for
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There's no obvious fit between cryptoassets and sustainable finance. In fact, one of the most controversial aspects of Bitcoin and other digital currencies is the massive energy spend needed to mint them, undermining the global push to reach a net-zero economy in the coming decades. There's nothing green about a cryptocurrency.

But they do have a couple of things that unite them. First, they're often described as the "future" of financial services — relatively niche topics just a few years ago, now the most talked about issues in financial centers around the world. Second, the world's biggest financial institutions and their regulators are puzzling over how these new pieces of the financial jigsaw should fit into the capital framework, in what boils down to an urgent question of how to maintain financial stability.

In 2022, there was no shortage of news on both topics, most notably the collapse of FTX, the cryptocurrency exchange hitherto valued at tens of billions of dollars. That was a shock for the sector's boosters, while for many traditional financial services representatives and regulators, it represented further proof that virtual tokens have no intrinsic value and, worse, are a front for fraudulent activity.

In the bank capital world, long-awaited final policy was published by the Basel Committee on Banking Supervision in the final weeks of the year. EU lawmakers, concerned about recent events in crypto, want to front-run the international policy and make it tougher.

Progress on sustainable finance policies varied across jurisdictions, while global weather events and limited progress at the latest UN climate-change conference vindicated activists who believe action has stalled and that the world is running out of time to fight global warming.

Bank and insurance regulators know they can't fight the effects of climate change, but they can limit the impact on financial services. There is a long way to go, however: In its inaugural climate-change stress test last year, the Bank of England found that lenders would face 110 billion pounds ($135 billion) in additional losses under »» a scenario where the UK government was slow to act on global warming. The European Central Bank has said the glass is "not even half full" when it comes to eurozone banks incorporating climate risks into their risk-management frameworks.

While the EU continues to explore whether banks and insurers should be offered lighter capital requirements for green-friendly investments, the UK is at the beginning of its thinking in how to link the prudential framework with sustainable finance. And discussions continue on what investors can officially view as green, with Austria announcing legal action against the European Commission for controversially classifying nuclear and natural gas power as environmentally friendly investments.

One more uniting factor: This year will inevitably see more regulatory developments aimed at shielding individuals, investors and financial-services institutions from the impact of crypto-gone-wrong and the risks of climate change. In this special report, MLex journalists explore what the months and years ahead are likely to bring as financial regulators grapple with the two forces profoundly changing the financial landscape.

Financial services are emerging as a major front in legislation and enforcement worldwide, and MLex is at the forefront of providing forensic insight, commentary and analysis on this developing area of regulatory risk. We trust you enjoy reading this report and find it a useful guide to a complex, evolving issue. The reporting here is a brief example of the analysis that MLex brings subscribers every day.

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What do cryptoassets and climate finance have in common? The prudential headaches they are giving regulators

Cryptoassets and green finance are linked by their status as new topics needing to be included in the bank-capital framework. International standard-setters have finalized their approach on the prudential treatment of crypto, but there is still some thinking to be done on what sustainable finance means for the capital framework.

By Fiona Maxwell

From a bank capital perspective, cryptoassets and climate-change risks are new frontiers only just starting to be mapped.

Regulators are still considering how prudential frameworks for banks can be used to ensure safe risk management in these still-emerging topics, and they'll have to decide whether they want to use capital requirements as a method of encouraging or discouraging certain investments.

Although digital assets and green finance are entirely different topics, bank capital is one of the key strands that links them.

Since financial institutions started showing interest in cryptoassets, via trading, custody arrangements or even clearing, regulators have rushed to put in place a new framework with conservative prudential requirements for banks. For sustainable finance, the approach is a little slower, but regulatory discussions continue over whether a dedicated prudential framework for green finance is needed.

Neither has yet entered the regulatory rulebook, and it remains to be seen whether the new approaches will have the effects regulators hope for.

CRYPTO CAPITAL

Regulation of cryptoassets is envisaged from different angles: regulating the technology providers directly, preventing unsophisticated investors from betting too much of their own money on a cryptoasset, and going via the banks.

For the first two, it's tough for regulators to directly impose rules on crypto businesses — the collapsed cryptocurrency exchange FTX was based in the Bahamas for a reason — and it's also not necessarily for market regulators to tell individuals where their money should go.

But banks are heavily regulated to ensure financial stability, and supervisors don't want to see a rerun of the 2008 financial crisis. Regulators, including the Bank of England governor and deputy governors, have warned that allowing lenders to expose their funds to digital currencies could lead to significant losses, resulting in financial stability issues including potential knock-on effects to the real economy.

The Basel Committee on Banking Supervision, a global standard setter, in June 2021 began developing prudential standards for crypto-exposed banks. The Basel Committee and other global regulators argue »» that tough rules are necessary as they fear that extreme volatility in the crypto industry could ricochet into the banking sector, resulting in losses or financial instability that could ultimately hit the real economy.

With almost every month that passes, regulators appear to be vindicated in their warnings. The value of Bitcoin, the best-known cryptoasset, has plummeted over the past year. TerraUSD crashed despite supposedly being a stablecoin pegged to the US dollar. And, most recently, FTX, once valued at $32 billion, collapsed. The crypto exchange's founder is facing decades in jail on allegations of fraud.

Despite the calls for tougher regulation, the Basel Committee's final standards were slightly less conservative than first proposed. That final policy was published at the end of 2022, providing some long-awaited clarity on whether banks will be able to offer digital currency services to their customers, or whether capital hikes would be so punitive that they would have to abandon the market.

In December, the final standards were revealed to be less restrictive than the two previous proposals, but nonetheless they remain conservative. They set out a two-tiered approach to the capital treatment of cryptoassets, with the very riskiest coins attracting a 1,250 percent risk weight, effectively a full capital tax for banks on any exposures.

The final standard also includes an overall exposure limit, preventing overall exposures breaching a portion of capital, but this is more lenient than previous proposals had envisaged. And a previously proposed capital add-on for infrastructure-related risks was also removed, making it easier for lenders to utilize distributed ledger technology.

The final standards are likely to be welcomed by banks, which pushed back against the Basel Committee's previous two consultations. They argued that these were overly conservative, blocking them entirely from the crypto sector. Regulators shouldn't want that, lenders argued, as crypto isn't going anywhere, and preventing banks from participating in the market would just mean it happens in an entirely unregulated sphere.

But although a final policy has been agreed among the Basel Committee's 45 members from 28 jurisdictions, it doesn't mean eventual national laws will be the same. In reality, once the standards are transcribed into each jurisdiction's laws, national

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interests and politics can get in the way, meaning some countries may opt to be crypto havens for traditional banks — or, conversely, hike capital requirements even more to prevent bank participation.

There's already some indication of divergence. EU lawmakers are pushing for the Basel standards to be applied six months earlier in the bloc, and in the meantime impose a 1,250 percent risk weight for bank exposures to any cryptoassets. The controversial proposal needs to be discussed with member countries and the European Commission, and there is no guarantee it will become law, but it is reflective of the tougher approach the EU wants to take.

GREEN CAPITAL

The future is less certain on bank capital requirements for sustainable finance. Regulators globally continue to consider how the existing prudential framework could incorporate the financial-related risks from climate change, with different views emerging.

In linking sustainable finance with the prudential framework, several questions arise, the first of which is whether existing capital rules are sufficient to cover the impact of global warming on banks and insurers.

In December, the Basel Committee issued guidance on how its rules should be interpreted for such risks. The standard-setter generally advised banks to consider the effects of the physical and transition risks stemming from climate change in all aspects of their prudential safety. Its advice is designed to ensure consistent interpretation of existing rules, but no regulators can yet rule out new policy to answer the open questions about whether current rules are sufficient.

For example, do capital frameworks already sufficiently capture the kinds of risks that climate change poses, particularly given the long time horizon over which they may emerge? Can existing regulatory tools be used, or is a new approach needed?

The BOE attempted to answer those questions in a two-day conference in October, inviting experts from all over the financial services industry to discuss 11 research papers. The central bank's prudential chief, Sam Woods, said the regulator has a "completely open mind" and that he doesn't yet have the answer to these important issues.

One of the bigger open questions is whether banks can be incentivized to go green. For example, a bank could get a capital cut if it provided a mortgage on an energy-efficient home, or it lent to an electric-vehicle company.

This is something under consideration in the EU, as the European Commission has asked the European Banking Authority to assess by this year whether lenders should get preferential capital treatment for climate-friendly lending. It's the only jurisdiction actively considering such a move, as financial supervisors and even financial institutions have voiced their unease that the framework used to keep banks safe effectively replaces wider government policy to reach net-zero emissions.

While the EU continues to investigate the issue, regulators in different jurisdictions struggle to work out how to incorporate climate-change risks into the capital framework. The headline message from financial supervisors is that green doesn't mean prudentially safe, but nothing has been ruled out.

In all scenarios, data is a real problem, and it would require a clear idea of what counts as sustainable. Again, the EU provides a test case for this: After much controversy, the commission decided to classify power from nuclear and fossil gas as environmentally friendly investments in its green finance taxonomy. The law passed despite intense opposition from lawmakers, and it has led to Austria announcing legal action against the EU executive.

An answer may be required soon. The BOE's inaugural climate stress test revealed that banks face an estimated 110 billion pounds ($135 billion) in losses if there is slow government action on climate change. That first exploratory test did not result in additional targeted capital for banks, nor individual results, leading to criticism from climate-change campaigners.

For now, most regulators are in investigation mode. But climate change isn't going away, and it won't be long before their thinking will need to turn into firm action. ■

Climate risk questions loom for large US banks awaiting guidance on developing scenario analyses

US regulators are preparing recommendations to possibly dozens of big banks in developing climate-scenario risk analyses ahead of a federal pilot program this year. The US has been studying scenario frameworks created by the Bank of England and European Central Bank. The pilot is designed to improve regulators' and banks' ability to "measure and manage" climate-related financial risks.

By Neil Roland

US regulators are preparing to give non-binding recommendations to possibly dozens of large banks in developing climate-scenario risk analyses, as six of these institutions gear up to participate in a federal pilot program this year.

The US, which lags years behind a number of other countries, has been studying scenario frameworks created by the Bank of England and European Central Bank. Authorities in China, Hong Kong, Japan, France, Germany, Switzerland and Canada have also all completed scenario exercises.

The Federal Reserve and the two other main US banking agencies have indicated their intent in proposing principles in six areas of climate-related financial risk management for banks with more than $100 billion in assets.

One of these areas is scenario analyses — forward-looking exercises that assess bank and market exposures, potential losses and resilience under a range of hypothetical climate scenarios. They are intended as an "exploratory risk-management tool," according

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to Martin Gruenberg, head of the Federal Deposit Insurance Corporation, or FDIC. The proposals say guidance for scenario analyses is being considered for a number of large banks.

The FDIC plan, published in March last year, said: “Some financial institutions, including many large financial institutions, are considering climate-related risks and would benefit from additional guidance as they develop capabilities, deploy resources, and make necessary investments to address climate-related financial risks.”

Gruenberg expanded on this wording in October, saying scenario analysis “is intended for the large institutions, particularly for those that cross multiple communities, and is not intended for smaller institutions.”

In covering banks with at least $100 billion in assets, the plans would currently apply to 32 banks, ranging from JPMorgan Chase at the top to North Carolina-based First Citizens.

In common with the heads of the Fed and the Office of the Comptroller of the Currency, Gruenberg has stressed that the results won’t be factored into capital or supervisory requirements.

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With regard to the pending proposals, the agencies will review public comments before deciding what to finalize. No timetable has been released.

The plans defer to bank management in developing scenario frameworks “in a manner commensurate to the financial institution’s size, complexity, business activity and risk profile.”

Still, the FDIC makes clear that it endorses large banks’ adoption of these frameworks “as an emerging and important approach for identifying, measuring, and managing climate-related risks, as well as risk-assessment processes related to credit, liquidity, operational, legal and compliance, and other financial and nonfinancial risks.”

BANKS’ RESPONSE

In a response to the FDIC, the main banking lobby group called for regulators to allow “flexibility” and “discretion” to banks in their development and use of scenarios.

“It is important that the final guidance acknowledge that there is significant variability and uncertainty of potential outcomes over longer time horizons,” the Bank Policy Institute wrote. “Supervisory expectations with respect to longer-term scenario analyses should allow for appropriate flexibility in approaches to developing and leveraging these analyses.”

The industry letter added that banks “should have the discretion to conduct scenario analysis at intervals that are appropriate to their size, business activity, and other factors, as appropriate.”

Shifting gears, the letter noted that banks are already “actively engaged” in developing scenario analyses by, for example, onboarding sophisticated acute risk models. These models seek to quantify asset and exposure impacts under severe scenarios.

“Any final guidance,” the letter said, “should recognize the exploratory nature of scenario analysis given the data gaps and the fact that models and methodologies are evolving.” Regulators’ expectations about specific frameworks should focus on “severe but plausible scenarios and not exaggerated scenarios,” it said.

PILOT

The Fed’s pilot program is designed to improve regulators’ and banks’ ability to “measure and manage” climate-related financial risks. It’s due to launch early this year and conclude around the end of the year.

The analysis will cover physical and transition risks that include firms’ portfolios of corporate loans and real estate. Scenarios will range from one based on current » policies to another with net greenhouse-gas emissions reaching zero by 2050.

Participating in the pilot are the six largest US banks: JPMorgan Chase, Bank of America, Citigroup, Wells Fargo, Goldman Sachs and Morgan Stanley.

During the course of the program, these firms are to analyze the impact of the scenarios on specific portfolios and business strategies. The Fed will gather quantitative and qualitative details on risk governance and risk-management practices; measurement methodologies; risk metrics; data challenges and lessons learned. The central bank will then "engage" with these banks to build capacity for managing climate-related financial risks.

The Fed plans to publish insights from the pilot at an aggregate level without any firm-specific information.

Ceres, a non-profit organization trying to advance sustainability in capital markets, called in December for the pilot eventually to be expanded to about 60 banks. Results of this subsequent analysis should be incorporated into the Fed's supervisory review of each financial institution, it said.

This review, Ceres added, should include "capital consequences."

UNITED KINGDOM

The Bank of England originally planned to subject the UK's largest banks and insurers to what it called a climate stress test in the second half of 2020, but postponed that to June 2021 due to the pandemic. The exercise used scenarios as a learning exercise to determine global warming's impact on financial stability.

Called the Climate Biennial Exploratory Scenario, it focused on information-gathering without intent to set capital requirements. The exercise was intended as a learning exercise that sought to help participants improve their management of climate-related risks.

The results, released last May, showed that climate risks could cause a "persistent and material" annual drag on bank and insurer profits of 10 to 15 percent on average. "Losses of this magnitude could make individual firms, and the financial system overall, more vulnerable to other future shocks," the BOE report said. Still, it added, the firms would remain solvent.

The banks saw themselves facing loan default losses of more than double normal levels should the government act too late to mitigate climate change. The institutions predicted credit losses of an additional 110 billion pounds ($135 billion) over a 30-year horizon. About 40 percent of those losses would be realized in the first five years of transition.

Results also showed that climate-risk impacts would be highest for banks' wholesale and mortgage exposures.

One recurrent theme among participants, the report said, was a lack of data on many key factors needed by participants to manage climate risks. Another was a wide range in quality of different approaches taken across firms to modeling these risks.

"All participating firms have more work to do to improve their climate risk-management capabilities," the report said.

After the original 2021 edition, the stress test is now due to run every other year.

EUROPE

In October 2021, the European Central Bank published its methodology underlying the climate risk stress test due to take place the following year among 104 banks.

The results, released last July, showed that major eurozone banks could face credit and market risk losses of more than 70 billion euros ($75 billion) over three years if smacked with high carbon prices and extreme weather events.

This figure includes only the risks to 41 of the banks that provided projections, resulting in a "significant" underestimate of banks' actual risk.

A more orderly green transition, where strict emissions-cutting legislation was introduced early, would significantly lower losses, the report said.

Most banks tested — 60 percent — didn't have proper stress-testing frameworks for climate risk. Only 20 percent consider climate risk when granting loans, the findings said.

Banks also were hampered by a lack of solid data reported by industry, in large part because legislation on emissions disclosure is either new, undeveloped or not fully harmonized. ■

With the building blocks of EU green finance rules now in place, focus shifts to the fine detail

EU regulators have agreed the overarching legislation for green finance, but this year will see the focus shift onto how rules apply. From disclosure rules to which investments count as green, rulemakers and companies face a range of compliance challenges.

By Kathryn Carlson

With several major pieces of EU green finance legislation now agreed, in particular on disclosure and classification of green investments, attention is shifting to the "how" of rolling out the rules this year.

That's both for rulemakers working on pinning down the details of the scope of new disclosure and reporting standards, and for companies adjusting to new compliance challenges and rules that could well flip the switch on which types of financial products can be considered sustainable.

Three of the main pillars supporting the EU's new green finance supervision regime are now partly or fully in place.

First, disclosure rules for asset managers and investment advisers began to apply on Jan. 1 under the Sustainable Finance Disclosure Regulation. Second, corporate disclosure rules under the Corporate Sustainability Reporting Directive, or CSRD, saw final approval late last year, with the first disclosures set to be required in 2025. Third, a draft set of technical standards on the nitty-gritty of reporting under the CSRD has been drawn up, and the European Commission expects to adopt the completed standards in secondary legislation in June.

Those draft technical standards, drawn up by a standards body known as the European Financial Reporting Advisory Group, are currently out for EU member states to give feedback on them. Efrag is also working on sector-specific standards for industries such as mining and energy production, with the commission likely to adopt these next year.

Part of the controversial EU Taxonomy for Sustainable Activities — which classifies which financial activities count as a sustainable investment — started applying in January. It had been approved last summer, but only after a months-long political battle that saw heated debate among legislators and climate NGOs walking out of an advisory group on the law, with much of the controversy focused on the taxonomy's inclusion of some gas and nuclear projects as eligible for sustainable investment.

Since the political drama — which continues in one form, as Austria has launched legal action over it — the European Commission has been quiet on a potential future "social taxonomy" that would designate socially sustainable economic activities.

Meanwhile, the EU's proposed standard for green »

bonds is still in the final stages of negotiations. The voluntary standard will ensure that any bonds issued with the "EU green bond" label must allocate their proceeds to green economic activities — those aligned with the sustainable taxonomy.

Although a deal was expected last year, questions over the proportion of proceeds that must be invested in green activities, as well as requirements for other sustainable bonds issued in the EU, have held up discussions. A deal is now expected in the first half of this year.

LOST IN TRANSLATION

For the EU's partners, the transition to a fully-fledged supervisory regime for sustainable finance has not always been a smooth one.

In fact, it has been downright bumpy at times, not least as the bloc continues to pursue a different approach to environmental disclosures than international standard setters. Under the CSRD, the EU uses a "double materiality" approach, where a company's impact on the climate is measured as well as the impact of climate change on the company's activities.

That goes significantly further than promoted by the International Sustainability Standards Board, which has opted for a "single materiality" approach, just including the latter measurement.

More detail on exactly how far the EU's approach will differ will become clear once the respective standards are published. The ISSB aims to publish its first two standards this year, and the EU standards are also expected this year.

One particular recent piece of EU legislation giving foreign financiers a headache is its Corporate Sustainability Due Diligence Directive.

These due-diligence rules will require large corporations — and potentially their financial service providers, an issue of some controversy — to identify and prevent negative environmental and human-rights impacts across their own operations and their value chains, with the risk of sanctions or civil liability cases if they don't.

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The catch comes due to the commission's proposal including non-EU finance firms in the scope of the rules. For example, as long as it wants to do business in the EU, a US bank investing in Brazil would need to assess the climate impact of the activities it is investing in and potentially change its relationship with the Brazilian firms if harmful effects are found.

Investors are irked that the non-EU activities of non-EU companies could be captured by the bloc's rules. A final deal has not yet been agreed, although when EU governments agreed their own negotiating position on the rules in December, major carveouts for the finance industry were won at the eleventh hour.

If these due-diligence requirements for foreign firms operating in the EU remain in the final version of the law, it will certainly make waves across the global finance industry.

> *EU financial supervisors are increasingly turning their attention to "greenwashing" — selling products with claims of environmental credentials that they actually don't meet. A raid on Deutsche Bank-owned asset manager DWS over suspected greenwashing in June put the spotlight on the practice.*

GREENWASHING

EU financial supervisors are increasingly turning their attention to "greenwashing" — selling products with claims of environmental credentials that they actually don't meet.

A raid on Deutsche Bank-owned asset manager DWS over suspected greenwashing in June put the spotlight on the practice, with EU financial services chief Mairead McGuinness calling the raid a "wake-up call" for companies overstating claims about their sustainability.

The European Securities and Markets Authority has opened a call for evidence into greenwashing, indicating that it could see future supervisory action.

Another ESMA consultation is on which types of investment funds should be able to label themselves green, including on potential future minimum thresholds of green investment. The supervisor is considering an 80 percent threshold for funds to describe themselves with the term "environmental, social and governance," or a 50 percent threshold to use the term "sustainable" in their name, as well as considering "minimum safeguards" for investments managed by the funds. For thresholds not met, funds could have to be renamed, making them less attractive to green-minded investors.

The finance industry is also on notice after its poor performance in supervisors' stress-testing exercises. The European Central Bank found in a climate stress test in July that eurozone banks had spotty climate data, poor stress-testing frameworks and a high exposure to the most-emitting industries.

Pensions and insurance regulator Eiopa found similar results for pension providers in its climate stress test, finding that in the event of a " a sudden, disorderly transition to a green economy as a consequence of the delayed implementation of policy measures," the value of their assets would fall by 12.9 percent, and that only 14 percent use environmental stress testing in their own risk management.

The ECB warned in December that banks with climate risk-related shortcomings can expect "deep dives to follow up," compliance reviews and targeted on-site inspections until 2025.

While no immediate regulatory response is likely to come from the stress tests, the finance industry will be in the spotlight as their weaknesses in rolling out the green transition are laid bare — which could well incentivize legislators to take action in future with regulatory sticks such as increased capital requirements. ■

In wake of FTX implosion, crypto policymakers go back to the drawing board

The collapse of FTX, a crypto exchange valued at more than $30 billion whose owner is now being investigated for fraud, has renewed pressure on policymakers to regulate the sector. But lawmakers need to be mindful that they don't inadvertently legitimize consumer investment in the risky and volatile assets by giving crypto the "halo" effect of regulation.

By Phoebe Seers

Sam Bankman-Fried may have inadvertently done crypto policymakers a favor. The spectacular implosion of his exchange, FTX, at the end of last year has highlighted weaknesses and gaps in regulatory frameworks that were on the way to being fixed, but crucially not yet implemented.

Details are still emerging as the bankruptcy and criminal proceedings against FTX's founder progress, but international standard setter the Financial Stability Board has already said that crypto's largest failure to date has signposted vulnerabilities that need attention. The UK government just this month published its proposal to regulate cryptoassets, and it has tried to address the risks that have emerged but has left many of the big questions unanswered, while also exposing gaps in the EU's supposedly comprehensive framework.

While FTX has renewed pressure on governments to get laws in place that will address some of the mismanagement that went on at that exchange — and is likely to be going on at others — lawmakers should also be mindful of not inadvertently encouraging more consumers to enter a market plagued by volatility and vulnerabilities by providing the "halo," or legitimizing effect, of regulation.

Moreover, as countries work at different speeds to gets laws on statute books, burgeoning evidence of regulatory arbitrage is only likely to harden. International standard setters are going to have their work cut out trying to achieve a degree of consistency in approach.

ADDITIONAL WORK

FTX, valued at more than $30 billion at the start of 2022, filed for bankruptcy in November. Since then, Bankman-Fried has been charged with defrauding investors.

The US Securities and Exchange Commission says Bankman-Fried secretly diverted customer cash to his hedge fund, Alameda Research, gave that fund special treatment on the FTX platform with an unlimited "line of credit" provided by FTX customers, and hid the risk stemming from FTX's exposure to overvalued, illiquid assets, for example the FTT token minted by the exchange.

The downfall of one of the world's largest exchanges, which was able to dupe high-profile investors including Sequoia Capital and SoftBank, has brought new attention to vulnerabilities in cryptoassets that, while perhaps known, hadn't been given sufficient attention »»

The downfall of one of the world's largest exchanges, which was able to dupe high-profile investors including Sequoia Capital and SoftBank, has brought new attention to vulnerabilities in cryptoassets that, while perhaps known, hadn't been given sufficient attention in work on regulating the sector.

in work on regulating the sector — much of which has been ongoing for several years now.

The FSB, which will publish its final recommendations for regulating cryptoasset activities in the middle of this year, has been clear that there are lessons to be learned from events.

It has highlighted as a particular concern the "bundling" of different services, such as brokerage, custody, proprietary trading and issuance of tokens all under one roof. This behavior can lead to a concentration of risk, as well as conflicts of interest and potential misuse of client assets, the FSB said in December.

Apparently, however, the EU's regulation on Markets in Crypto Assets, or MiCA — the final text of which was agreed last year — allows such bundling, while the UK is still on the fence. Its proposed regulatory regime notes the concern around what it calls "integrated business models," which it says are "prevalent," but instead of offering a solution the UK government simply says it will give "further consideration" to "whether and how existing controls on combinations of activity in traditional finance could be applicable."

The SEC says FTX used its client assets to fund its hedge firm, Alameda Research. Improperly segregated client assets were also a feature in the Lehman Brothers bankruptcy 15 years ago, and in the aftermath of the financial crisis, lawmakers introduced strict regulations within traditional finance to ensure that a firm held client money separately from its own so that if it failed, the client's funds would be protected. It seems inevitable now that crypto will face similar restrictions.

Moreover, FTX had no board of directors, and it appears that there were major problems with corporate governance, business culture and decision-making processes. Even the world's largest crypto exchange, Binance, currently has no official headquarters, a move that is said to be aimed at dodging scrutiny. In response, accountability and transparency will feature high up on the regulatory agenda.

INTERNATIONAL DIVERGENCE

Since FTX's implosion — although not necessarily because of it — the FSB has stressed the importance of improving international cooperation to minimize the risk of fragmentation and regulatory arbitrage, where firms set up their operations in jurisdictions with the least onerous requirements.

FTX, incorporated in Antigua & Barbuda, moved its headquarters from Hong Kong to the Bahamas in September 2021, citing the favorable regulatory environment. Most of the traffic to FTX's website came from users in South Korea, Singapore and Japan.

Achieving international coherence on cryptoassets is arguably more vital than it has been with other financial services. Would-be crypto investors are just as likely to get investment advice online over TikTok and YouTube as they are from a regulated financial adviser in their home jurisdiction.

But as some countries move faster and are more exacting than others, it is inevitable that less-scrupulous firms will look to take advantage of more relaxed regulatory environments while they can.

And while the EU's MiCA, which is unlikely to come into force until 2024, introduces a strict licensing regime for firms that want to target customers in Europe, there is nothing to stop an EU citizen buying crypto from an unlicensed firm offshore, an issue called "reverse solicitation," which the EU has identified as potentially problematic.

WHAT'S IT ALL FOR?

While a use case for stablecoins backed by fiat currency as a novel payment method appears reasonably clear-cut, when it comes to unbacked cryptoassets — such as the FTT token that FTX created, or Bitcoin — the objective is less obvious.

Unbacked tokens have a value that is too unstable for them to be used as a means of payment, so they're primarily of interest to investors. And interest is rocketing, but that hasn't yet resulted in great outcomes.

Lobby group UK Finance reckons between 10 percent and 11 percent of adults in Britain owned a cryptoasset in 2022, nearly double the figure from the previous year. In the US, that figure is around 20 percent, according to NBC.

Yet they are not always going into the market with their eyes wide open. In December, an official from the UK's financial markets regulator told lawmakers that nearly 70 percent of young people thought that if a crypto investment fails, they would be protected by compensation. They won't be.

The Financial Conduct Authority already thinks that the very narrow remit it has over crypto — to register UK-based firms for anti-money laundering purposes — has led to a "halo" effect that raises unrealistic expectations of consumer protection.

And after the wild swings that crypto has experienced — globally falling in value by about 70 percent last year and taking down several firms beyond FTX — evidence seems to be piling up that crypto is unlikely to be a suitable investment product for many, and possibly most, retail investors.

Lawmakers need to be very careful that in regulating it, they aren't inadvertently legitimizing a volatile and vulnerable market. They must also be clear and forceful in getting the message across, about where the buck stops when it comes to compensation if a company fails.

Regulators have at least found ways to strongly discourage would-be investors from products that lend themselves to abuse, or are too risky, such as speculative mini-bonds. Following the high-profile failures of London Capital & Finance and Blackmore Bond, the FCA introduced rules that these types of investments can only be promoted to investors that firms know are classified as "sophisticated" or "high net worth."

At the end of 2020, the FCA banned the promotion and sale to retail investors of crypto derivatives and exchange-traded notes. However, the UK government appears to be moving in the opposite direction. It recently issued an exemption for cryptoassets from the FCA's strict regime for financial promotions, which does away with a requirement that adverts are approved by an FCA authorized firm.

The distributed-ledger technology underpinning cryptoassets may well have value in mid- and back offices, in maintaining ledgers and offering settlement and clearing services in a way that is faster, more resilient and removes intermediaries.

But with the cryptoassets themselves, lawmakers acknowledge that they're still undecided. Recently, the UK's minister for financial services, Andrew Griffith, wouldn't deny that unbacked cryptoassets could ever be more than a "get rich quick" scheme.

But in the language of the generation that is most likely to own such digital tokens, they are being spurred on to regulate them regardless by FOMO — fear of missing out. ■

Are Asia's financial hubs aligning on crypto regulatory approaches?

Singapore, Hong Kong, Tokyo and Seoul have been experimenting with different approaches to getting the balance right between tightening consumer and money-laundering safeguards and allowing financial innovation to flourish. In the wake of last year's crypto crashes, they show signs of ending up with more similarities than differences.

By Jet Damazo-Santos, Toko Sekiguchi & Jenny Lee

Toward the end of October last year, Singapore — once seen as something of a haven for cryptoassets in the Asia-Pacific region — outlined how it planned to limit retail investors' access to cryptocurrency trading.

Just a few days later, Hong Kong announced that it planned to start giving retail investors access to virtual assets, reversing a stringent regulatory policy that had turned off a number of crypto firms.

Japan, like Hong Kong, is also recalibrating. Its early welcome for cryptocurrencies and subsequent cases of security breaches and fraud that plagued crypto exchanges turned it from a regulatory trailblazer to a risk-averse nation. But Japan is now opening its arms to stablecoins in a bid to attract fintech entrepreneurs again.

On the other hand, South Korea's government is now scrambling for ways to impose tighter controls on unfair trade practices and boost investor protection as it reels from a devastating series of events last year: notably, the crash of the TerraUSD and Luna cryptocurrencies,

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followed by the bankruptcies of hedge fund Three Arrows Capital, broker Voyager and exchange FTX.

These contrasting policy directions demonstrate the differing paths that Asia's leading financial hubs have been taking to find the delicate regulatory balance between assisting financial innovation to flourish while ensuring sufficient safeguards are in place.

But in the wake of that string of collapses suffered by the sector last year, crypto investors and businesses might find that these financial hubs will eventually converge on more regulatory similarities than differences.

SINGAPORE

Business-friendly Singapore has been clear about its ambitions to be a center for blockchain-based initiatives, dubbed a "Web3" hub. But a series of policy turns to the right over the past year have brought accusations that it is being contradictory or sending mixed signals.

"Singapore wants to be a Web3 hub, and then simultaneously say: 'Oh, we're not really going to allow retail trading or self-hosted wallets to be available'," Coinbase CEO Brian Armstrong said at the Singapore fintech festival in November. "Those two things are incompatible in my mind."

In January 2022, the Monetary Authority of Singapore, or MAS, surprised the industry by issuing guidelines to discourage cryptocurrency trading by the general public. This led to several Bitcoin ATMs across the city-state suddenly shutting down.

In October, it laid out planned restrictions for retail access to crypto products, such as requiring prior assessments of a customer's knowledge of the inherent risks.

For the central bank, a financial regulator widely seen as progressive and supportive of innovations, the lines it is drawing are clear, and last year's crypto crashes underscore the need for them.

"If a crypto hub is about experimenting with programmable money, applying digital assets for use cases or tokenizing financial assets to increase efficiency and reduce risk in financial transactions, yes, we want to be a crypto hub," central bank managing director Ravi Menon said at the same fintech festival. "But if it is about trading and speculating in cryptocurrencies, that is not the kind of crypto hub we want to be."

But as well as speculative trading, Singapore has also been tightening is licensing and anti-money laundering rules over the crypto space. Under a licensing regime introduced in January 2020, only 10 digital payment token service providers had been given licenses as of August 2022.

The central bank's latest proposal could see the release this year of a licensing requirement for large non-bank issuers of stablecoins, which would subject them to the same anti-money laundering requirements applicable to banks, but with higher financial and prudential standards.

This follows legislative amendments last year that already gave the central bank stronger oversight over crypto service providers, largely to address the money-laundering risks posed by Singapore-based crypto companies that only offer their services abroad.

> *While Singapore has been tightening its regulatory screws, rival financial hub Hong Kong has been rethinking its overly strict requirements in a similar bid to become a regional crypto hub.*

HONG KONG

While Singapore has been tightening its regulatory screws, rival financial hub Hong Kong has been rethinking its overly strict requirements in a similar bid to become a regional crypto hub.

The city was once home to the headquarters of some major crypto businesses, but a voluntary licensing regime for virtual asset service providers — introduced in 2019 — saw only one successfully pass its rigorous vetting process. A perception that the government was increasingly hostile to cryptocurrencies even led FTX to leave it in 2021 for the Bahamas — with later developments at that exchange appearing to vindicate Hong Kong's approach.

"As certain crypto exchanges collapsed one after another, Hong Kong became a quality standing point for digital asset corporates," Hong Kong financial secretary Paul Chan Mo-po told a Web3 forum this month.

But recognizing that virtual assets are an integral part of the future of financial innovations, the city in October announced a new policy approach for the sector, with plans for a new licensing regime that would allow retail access to crypto trading.

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The announcement drew quick comparisons with Singapore's approach, especially given the timing. But a closer look at the regulatory changes this month show that the two jurisdictions appear to be meeting somewhere in the middle.

On Jan. 11, Hong Kong passed a new licensing regime for crypto exchanges that will subject providers to the same anti-money laundering legislation that traditional financial institutions follow.

The same day, Hong Kong's securities regulator said it would propose certain tokens that retail investors could access for trading, as well as plans to put in place protections for investors. The Securities and Futures Commission's new head, Julia Leung, is also known to have called for stricter crypto regulation.

> *In recent months, the Japanese government has been reassessing its approach to cryptoassets. Last summer, stablecoins were brought under regulation for the first time, and the financial services regulator last month revealed a further policy shift.*

JAPAN

Japan was the first country to legalize cryptocurrencies by writing them into law as a means of fund settlement in 2016, which also required exchange operators to register with the country's financial services regulator. Intended to protect consumers from fraud, it was the result of one of the first major cases of crypto-exchange frauds, in 2014, where the operator allegedly stole his clients' accounts.

This official recognition of virtual currencies quickly turned Tokyo into a crypto hub, and at one point the majority of Bitcoin trades were conducted in yen. But the tide quickly turned after a cyber-heist of crypto coins worth more than $500 million at Tokyo-based exchange Coincheck in 2018 prompted a tightening of Japan's rules.

Changes to the country's tax laws made blockchain-based assets, including crypto tokens, prohibitively expensive for startups to issue, resulting in an exodus of fintech entrepreneurs.

In recent months, however, the Japanese government has been reassessing its approach to cryptoassets. Last summer, stablecoins were brought under regulation for the first time, and the financial services regulator last month revealed a further policy shift, governing the rules of stablecoin issuance and trades within restricted businesses, with details to be worked out in the year ahead.

But Japan, like Singapore and Hong Kong, is continuing its effort to close loopholes in its anti-money laundering rules that have been repeatedly criticized by the Financial Action Task Force.

Japan's attempt to fine-tune its crypto rules come as the country experiments with a unified digital coin, led by traditional companies with regulators as observers. The struggle to balance consumer protection while allowing for new fintech initiatives is vital to an economy with a shrinking population whose survival depends on innovative businesses.

SOUTH KOREA

The cryptocurrency market in South Korea, too, is reeling from the devastating effects of the crypto winter following the meltdown of stablecoin TerraUSD and its support coin Luna, plus the bankruptcy of FTX, as well as the controversy that erupted locally over the delisting of Wemade's Wemix tokens.

This string of unfortunate events, which wiped out billions of dollars of investor money, has convinced the country's lawmakers and regulators that action must be taken without delay to protect investors and end unfair trade practices by digital asset businesses.

Already, there are more than a dozen pieces of crypto legislation pending in parliament.

But the proposal by Yoon Chang-hyun of the ruling People Power Party, drafted together with the Financial Services Commission, or FSC, and the proposal by Back Hye-ryun of the main opposition Democratic Party of Korea will be the focus of upcoming legislative review.

These bills largely share the same goals: to define digital assets and punish unfair trade practices, such as the use of non-public information, market price manipulation and fraudulent trading, with penalties including fines of three to five times the amount of profits made or losses avoided, and jail terms of a year or more.

Crypto exchanges would also be barred from arbitrarily blocking users' deposits and withdrawals of digital assets and be required to self-monitor, » including being obliged to monitor and report abnormal transactions under the proposals.

The proposals, most significantly, would give the FSC the power to surveil and inspect the market, conduct investigations into unfair trading practices, and even impose sanctions.

Despite bipartisan backing, the proposed legislation failed to make headway last year. Discussions were set to begin in January, starting with a subcommittee of the National Policy Committee, but lawmakers were held up discussing other bills. Further progress is now expected in February. The proposed regulations are aligned with the incumbent government's wider endeavor to establish a sweeping regulatory framework for cryptocurrencies.

A taskforce launched by the government in August last year is currently looking at issues such as the legal nature and rights of digital assets, countermeasures against crimes involving digital assets, financial-stability concerns related to digital assets, taxation issues, the issuance and listing of digital assets, and protections for investors.

The need for new crypto regulations was first brought up by South Korean President Yoon Suk-yeol during his campaign for the presidency early last year. That was also one of his 110 key policy tasks announced in May, that would create "a climate where the virtual-asset market can expand responsibly based on investor trust."

Regulations for cryptocurrencies in South Korea as they stand now are contained in an amendment to the Act on Reporting and Use of Certain Financial Transaction Information, which requires crypto trading platforms to obtain an information-security certificate and provide users with real-name accounts. This drove several exchanges out of business. The restriction on anonymous trading went into effect last year to prevent money laundering, embezzlement and other crimes.

Despite the different trajectories that Asia's financial hubs have taken to figuring out how to regulate the crypto sector, then, their respective regulators do appear to be converging around the same key issues: the need for comprehensive licensing frameworks, guardrails against money laundering and other financial crimes, as well as protections for investors, all while making sure financial innovations can continue to take place. ■

Big Tech's appetite for financial services rings alarm bells for regulators both global and national

Plans by technology giants to enter the crypto space have been abandoned. But they continue to set their sights on traditional financial services products, including payments, and potentially types of credit services. Regulators globally are beginning to take action over fears of anticompetitive behavior, financial stability risks and consumer detriment.

By Neil Roland & Fiona Maxwell

Large technology companies are finding themselves in the regulatory spotlight globally as they continue to set their sights on offering financial services.

After a failed attempt by Meta Platforms to launch its own virtual currency, the technology giants are focusing on traditional financial offerings such as payments, but may branch out into lending or insurance. This move has led global regulators as well as national supervisors to voice fears of anticompetitive behavior, financial stability risks and consumer detriment.

Big Tech — generally understood as encompassing Amazon, Apple, Google and Meta, as well as sometimes Microsoft and PayPal — has been put on notice for inclusion in the financial services regulatory framework, as regulators around the world increasingly fear plans to offer the same services as financial companies, while evading the tough rules that applies to them.

Last year, the Financial Stability Board, an international standard setter, warned that the rapid market dominance of just a few technology giants could give rise to negative financial stability implications.

The FSB touted the benefits of Big Tech giants and fintech companies moving into the financial services space — including reducing costs and improving financial inclusion — but it is also concerned that it could result in limited competition and increased risk taking. Financial stability could see risks stemming from incumbent players seeking to push the boundaries to maintain market share and retain their customers, the FSB believes.

Alongside the FSB's international work, regulators in the US, UK and EU are developing their own thinking.

UNITED STATES

In the US, financial regulators' concerns about Big Tech companies center on their use of consumer data as they branch into payment platforms such as Apple Pay, Google Pay, PayPal and Venmo.

Rohit Chopra, head of the US Consumer Financial Protection Bureau, or CFPB, has voiced apprehension that tech giants with payment platforms will gobble up consumer financial data to help their other business lines. "Big Tech firms can tie their payment platforms to their social media offerings or their mobile operating systems," he told lawmakers in December 2022.

Chopra, who has taken the lead among US authorities on Big Tech's expansion into finance, has » also questioned whether tech giants' other business interests give them an unfair advantage over financial firms that would stifle competition and user choice.

Separately, he has expressed disquiet as more Big Tech firms — along with credit-reporting companies and data brokers — develop credit scores and background dossiers on individuals.

"I'm worried that we're shifting to a more social-scoring environment that really you only see in places like China and other similar jurisdictions," Chopra told the lawmakers in same hearing of the House of Representatives Financial Services Committee. "Accuracy and disputes [become] a core issue when people have background reports that are sometimes falsely matched to a criminal record."

In 2019, US authorities got a wakeup call about Big Tech's plans in finance when Facebook announced its Libra digital currency proposal, which has since been scotched. Current concerns about payment apps stem from their growing foothold in the payments system. These apps serve as a conduit for transactions estimated at trillions of dollars.

ARBITRARY ACTION

The growing dominance of a small number of payment platforms that include Big Tech companies has raised fears that they can act arbitrarily against some participants.

"The CFPB has heard considerable concern about payment apps kicking off users, or even claiming the ability to reach into their accounts and fine users without a clear reference to any legal infraction," Chopra said at the hearing. "And so what you're seeing in Big Tech firms is, really, they have enormous power to elevate or suppress some users over others. I think that's very scary."

He cited PayPal's suggestion last October that it could fine users $2,500 for promoting misinformation, an idea that sparked a backlash among Republican lawmakers and regulators. PayPal has since backtracked.

Chopra, a former aide to Democratic Senator Elizabeth Warren, also noted worries among some market participants that payment platforms will hike fees on small banks, merchants and consumers. Credit unions and small banks have filed class-action lawsuits against Big Tech-operated payment platforms.

He has called on the US Congress to ensure that payment systems are "neutral and non-discriminatory"

by eliminating the incentive for them to use payments to favor their other interests. Lawmakers also should explore limitations on the "collection, use and sharing" of personal financial data, he has said.

In 2021, the CFPB initiated a study of the impact on privacy, fraud and discrimination of Big Tech's entry into consumer payments. The agency has issued orders for information to Google, Meta's Facebook, Amazon, Apple, PayPal and Block about their consumer-payment plans.

"Little is known publicly about how Big Tech companies will exploit their payments platforms," Chopra said at the time. One concern is that these apps have the potential to disclose more information to intermediaries than do traditional credit-card systems.

Chopra has said he plans to release a series of analyses to Congress, based on his agency's findings, in the coming months.

EUROPE

In the UK, regulators want to start a conversation on the potential risks and benefits of Big Tech entering the financial services world, and have so far only published discussion papers on the topic.

But policy will come. In October, the Financial Conduct Authority said it would develop a regulatory approach for the UK in the first half of this year, after it collates the responses to its more informal discussion paper.

The regulator gave some good insight on its thinking in the discussion paper, and it doesn't necessarily bode well for the technology giants. For the FCA, primary risks center around competition, with Big Tech companies potentially able to exploit their huge market share and data on consumers to gain more customers in the financial services space — to the detriment of competition.

For the UK's FCA, primary risks center around competition, with Big Tech companies potentially able to exploit their huge market share and data on consumers to gain more customers in the financial services space — to the detriment of competition.

In the UK, as it stands, no Big Tech company has market power in the area of financial services. Their forays remain on the retail side with regulatory permissions for payments, such as Apple Pay and Google Pay.

Google and Meta also have e-money permissions, and Amazon and Apple have some consumer credit authorizations. But no company has ventured into the traditional banking space, such as products or services in deposits, mortgages or pensions.

The FCA is concerned that this might change over time. Its view is that in the short term, a Big Tech company could partner with an incumbent financial services firm, but that over time it could branch out and provide direct competition. With millions of customers and brand recognition globally, a technology company could offer serious competition to banks.

In that event, the regulator fears a tech company could engage in "exploitative conduct" by setting high prices to business partners, preventing competitors from accessing or remaining in the market or reduce quality to the detriment of consumers.

In the EU, signals are much the same, with financial-services chief Mairead McGuinness saying the European Commission "stands ready" to legislate on Big Tech. Legislation has already been finalized on "digital operational resilience in the financial sector," or DORA, which limits the financial risk of banks and other institutions that outsource data to technology companies.

There are clear competition questions here, too, as two-thirds of global cloud services are provided by Amazon, Microsoft and Google. The UK is in the process of putting in place similar rules for major cloud providers.

Time is of the essence, as technology becomes more sophisticated and its usage continues to grow. The trend of digitalization in finance soared in 2020, as the Covid-19 pandemic saw consumers working and shopping remotely, and shunning cash as fears abounded that banknotes could spread the virus. Use of digital wallets grew in 2020 to 44.5 percent of all online transactions, from just 6.5 percent in 2019.

Generally, technology companies fall outside the scope of financial services regulators. So one solution could be to regulate the activity, rather than the entity. In other words, the financial supervisory arm would extend to any company offering financial services, even if it's a side business. ■

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