UK regulators set out approach to crypto and Decentralised Finance

AT A GLANCE

March 2022

What's new?

- The UK regulatory authorities published a number of documents on cryptoassets and decentralised finance (DeFi) on 24 March 2022.
- The Bank of England's Financial Policy Committee (FPC) issued Financial Stability in focus: Cryptoassets and decentralised finance, on the financial stability implications from crypto and DeFi and the appropriate regulatory response.
- The PRA sent a Dear CEO letter to banks and PRA investment firms, setting out the PRA's expectations around cryptoassets. The regulator asked firms to provide information on their current and planned exposure to cryptoassets by 3 June 2022.
- The FCA also published a Notice to all FCA regulated firms with exposure to cryptoassets, reminding firms of their obligations.

What does this mean?

- The publication of the documents provide further details on the UK's developing approach to the regulation of crypto and DeFi and indicate the importance policy makers place on the topic.

FPC views

- The FPC considers the current financial stability risks associated with crypto and DeFi to be limited, but with the potential to increase.
- The FPC identifies several potential challenges around systemic institutions, operational risks, growth of activity outside the regulatory perimeter and difficulties associated with regulating new forms of firms and business models. The FPC is monitoring these risks.
- According to the FPC, as crypto and DeFi develop, new regulatory frameworks (both domestically and internationally) will be required to ensure sustainable innovation. Where crypto activity is economically equivalent to activity undertaken by the traditional financial services sector, the regulatory perimeter should be adapted to ensure it is regulated in the same way.
- The BoE intends to consult on its proposed regulatory model for systemic stablecoins and systemic wallets in 2023, subject to the outcome of a HMT consultation.

PRA views

- The PRA acknowledges that no single part of its framework fully captures crypto risks, but it sees a combination of the measures set out below as adequate to address the risks posed by crypto until an overarching framework is agreed internationally.
- **Risk controls.** The PRA expects firms to reflect the risks posed by crypto activities in their risk management frameworks. Crypto risks should be considered by the board and senior executive management. A Senior Management Function (SMF) should review and sign off on the risk assessment framework for crypto.
- Firms should explore using stress tests to address the uncertainties in modelling the relationship between different crypto exposures.
- The PRA notes that a number of aspects of the **Pillar 1 framework** are relevant to crypto exposures. In many cases holdings of crypto will be classed as an intangible asset and deducted from CET1.

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- From a **market risk** perspective, the PRA states that for the vast majority of crypto positions a capital requirement of 100% of the position will be appropriate. Firms should be conservative in assessing diversification and hedging benefits.
- The PRA is of the view that most **counterparty credit risk** crypto exposures should be mapped as 'other risks' under the SA-CCR framework. The PRA also asks firms to assess whether the SA-CCR framework captures all risks associated with crypto, and notes that supervisory teams will be monitoring SA-CCR exposures.
- Firms should assess the risks posed by crypto under the **Pillar 2 framework**. Depending on the nature of a firm's activities this should cover market, credit, counterparty and operational risk as well as other risks not generally considered under the Pillar 2 framework.
- Operational risk is particularly relevant to certain crypto activities, with greater risks of fraud and cyber attack. Where firms outsource certain crypto activities they should consider their residual liability and ability to gain control of assets.

FCA views

- The FCA reminds firms of its requirements: obligations under the Money Laundering, Terrorist Financing and Transfer of Funds Regulation, and ensuring consumers understand which crypto activities are regulated and which are not.
- Firms should have systems and controls to counter financial crime. Firms should review if firms they interact with are listed on the FCA's Unregistered Cryptoasset Businesses page.
- As per the FCA's previous Dear CEO letter, firms should assess the risks posed by a customer whose wealth or funds derive from the sale of cryptoassets or related activities, using the same criteria applied to other sources.
- The FCA reminds firms subject to the IFPR of the obligations to assess and mitigate the potential for harm, including from crypto activity. Firms subject to FG20/1 should consider this guidance when assessing and managing risks from cryptoassets.
- Where a firm accounts for a cryptoasset as an intangible asset, it will likely need to deduct this asset from its regulatory capital. The FCA will consider whether updated prudential requirements for crypto are required.
- The FCA notes that where cryptoassets are a specified investment, firms carrying out regulated activities involving custody of these assets are likely to be subject to the CASS regime.

What does this mean for firms?

- Those banks that have non-negligible exposures to crypto, provide crypto services or plan to have or do either in the next two years, have been asked to provide information on these to the PRA by 3 June 2022.
- The request covers a broad range of activities and risk types. Many firms may find the deadline challenging, but the PRA is likely to use the information received to inform policy making, so engagement may prove beneficial in the longer term.
- It is unsurprising that the FCA has chosen to emphasise its expectations on preventing crypto being used for financial crime purposes in the current context. The FCA's publication follows a recent statement with other authorities on sanctions and the cryptoasset sector. Firms with exposure to these risks are likely to face close scrutiny from supervisory teams to ensure they are adequately managing them.
- Any change to the regulatory perimeter will be a decision for the Government. However, the FPC's position on the regulatory perimeter means it is likely that some crypto firms which are not subject to direct regulation in the UK are likely to come into scope in the future.

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