

## The crypto-asset world is sobering up

(Tomoko AMAYA, Vice Minister for International Affairs, Financial Services Agency, Japan, published in the Eurofi Magazine on April 26, 2023)

1. **Are we in the midst of another temporary crypto winter or is the current market downturn the sign of more structural fragilities? What are the lessons learned from the recent dislocation of certain cryptoasset providers and stablecoins? Have they revealed significant vulnerabilities of the crypto ecosystem?**

It is not a crypto winter right now. Rather, the crypto-asset world, including service providers, investors and other stakeholders, is waking up from its drunkenness.

Recent market turmoil, including the collapse of Terra, Celsius, and FTX, has revealed the truth about reality and vulnerabilities of self-proclaimed "stablecoins," liquidity and maturity mismatches, excessive leverage, misuse of client assets, and conflicts of interest. It also exposed the illusion that most of what once appeared to be growth was supported by unsustainable business models.

These structural vulnerabilities are similar to those inherent in traditional financial activities, and some crypto-asset activities are not unlike "Ponzi schemes." While various regulatory and supervisory measures address these structural vulnerabilities in the traditional financial sector, few jurisdictions have taken such measures for the crypto-asset sector.

This has led to a number of disruptions in the crypto-asset sector, but so far spillover to the financial system and the real economy has been limited. However, I believe that if the crypto-asset sector continues to grow and strengthen its interconnectedness with the traditional financial system and the real economy, it could threaten global financial stability.

2. **What are the key objectives of the Japanese cryptoasset framework and does it address the types of fragilities exposed by the failure of several CASPs and crypto lending platforms in 2022? Can new policy developments be anticipated in Japan with regard to cryptoassets?**

Financial regulators need to consider three major policy perspectives concerning the risks posed by rapidly evolving crypto-asset markets: financial stability, user protection, and AML/CFT. These are not necessarily mutually exclusive. User protection, such as providing users with sufficient information as well as protecting their assets, and AML/CFT, such as knowing your customers, can contribute to financial stability by enhancing user confidence. Regulations should be comprehensive and commensurate with the risks, while also harnessing the potential benefits of underlying technologies. In Japan, the FSA has centralised jurisdiction over all three policy perspectives and has been developing a comprehensive regulatory framework for them since the FSA introduced a regulatory framework for

crypto-assets in 2016.

For example, virtual asset service providers (VASPs) are required to use highly reliable methods, such as cold wallets, to manage and protect customer's crypto-assets separately from their own, and to undergo external audits of the status of their segregation management. VASPs are also required to have their financial statements audited, report them annually to the FSA, and disclose them publicly. Therefore, even after the bankruptcy of FTX Trading Ltd., its Japanese subsidiary, FTX Japan, successfully protected client assets, and clients have had access to their funds since February of this year. In addition, the regulation and supervision of VASPs includes establishing a conflict of interest management system, notifying in advance crypto-assets to be dealt with, and preventing unfair acts. As a result, trading platform networks with complex and opaque intertwining of various functions, as seen in some jurisdictions, have not developed in Japan.

While the existing regulation of "gateway" operators has been effective, this does not mean that all activities that have caused problems recently, including crypto-asset lending, are regulated and supervised in Japan. Future development in the crypto-asset ecosystem is yet to be determined in some areas, such as decentralised finance, which many jurisdictions recognise as a challenge.

The FSA aims to harness the benefits of the technology underlying crypto-assets amid the rapidly changing nature and form of crypto-asset transactions, while ensuring that the social economy is not exposed to the risk of disruptions. To do this, the FSA will continue to take a forward-looking and comprehensive approach, including considering new regulation where necessary, taking into account international regulatory and supervisory discussions.

**3. Is there a need for global coordination on this topic and if so on which issues in particular? What can be expected from the work underway at the FSB and IOSCO levels in this regard?**

Given the cross-border nature of crypto-assets, it goes without saying that there is a need to strongly promote consistent and effective regulation and supervision across jurisdictions to avoid market fragmentation and prevent regulatory arbitrage.

In light of the recent market turmoil, the press release of the Financial Stability Board's plenary meeting in December 2022 mentioned the urgency of advancing the policy work to establish a global regulatory and supervisory framework. The potential threats to financial stability posed by crypto-asset activities and markets highlight the urgent need for effective regulation and supervision.

The FSB's high-level recommendations, which are currently being finalized, are an important step towards building international regulation, supervision, and oversight of the risks posed by crypto-asset activities and markets. These recommendations will cover all crypto-asset activities and entire stablecoin arrangements and will provide a comprehensive regulatory framework to address structural vulnerabilities in crypto-asset markets. As well, IOSCO's work is critical to the practical application of the FSB's high-level recommendations by securities regulators.

One of the G7's top priorities for the financial sector is to address the vulnerabilities of crypto-asset

activities and markets. As Japan assumes the G7 Presidency this year, our utmost priority is the finalization and consistent and effective implementation of the FSB's high-level recommendations.

In light of the recent market turmoil, such as the failure of FTX, I believe it is important to identify key issues that need to be immediately addressed on a global basis. These issues include ensuring redemption rights, segregation of client assets, and proper governance of crypto-asset service providers. It is important to then consider early on the consistent and effective implementation of these key issues. In promoting consistent and effective implementation of the FSB's high-level recommendations, I also believe that, in addition to cooperation between the FSB and standard-setting bodies, including IOSCO, and between authorities and private stakeholders, engagement with jurisdictions that are not FSB members is essential.

**4. How is digitalisation impacting financial value chains and the structure of the financial industry (e.g. in terms of fragmentation, emergence of new types of partnerships with tech players, role of multi-activity platforms and players such as bigtechs...)? What are the implications of these evolutions and of the emergence of tech players and mutli-activity groups in the financial sector in terms of regulation and supervision (e.g. need for a more holistic approach, extension of oversight or regulation to non-financial players,...)?**

In the area of cloud computing, on one hand, the use of outsourcing is expanding globally, while on the other hand, a small number of tech players are dominating the market. Thus, while the entities involved in financial services are diversifying and decentralising, their relationships are becoming more complex and opaque, and financial stability concerns such as new forms of concentration risk are emerging.

For regulators and supervisors, to promote innovation while mitigating risks in these circumstances, the guiding principle is "same activity, same risk, same regulation."

Regulatory perimeters are critical to putting this principle into practice. A typical example is the treatment of outsourced providers and third parties. Regulating these parties has many challenges due to the long and complex supply chain for the operations of financial institutions and the global reach of third parties.

Furthermore, there are cases where financial institutions and non-financial institutions together form an ecosystem in which each entity provides financial services through interactions with another. In such cases, it may be challenging to determine the regulatory perimeter because the financial function cannot be captured simply in outsourcing or third-party relationships.

Addressing these challenges may require cooperation and collaboration with a variety of stakeholders, including in the private sector. In this regard, I would like to share, for your reference, initiatives regarding the "travel rule" (TR) by the FATF's Virtual Asset Contact Group (VACG), which the FSA has co-chaired.

To address the risk of money laundering and terrorist financing, the TR requires VASPs to conduct

screening, submission, and record-keeping of both originator and beneficiary information for virtual asset transfers. When the TR for virtual assets was introduced in the FATF Standards in 2019, most private sector stakeholders argued that implementation of the TR was not technically feasible with virtual assets.

The FATF, through its newly established VACG, conducted a series of public-private dialogues, identified issues to be solved, and published more granular guidance on the TR as well as monitoring reports to support private sector implementation. As a result of these initiatives, the private sector has developed technological solutions for the TR, although many of them have some deficiencies that are still to be addressed. I think this experience illustrates how collaboration with diverse stakeholders can solve challenging issues.