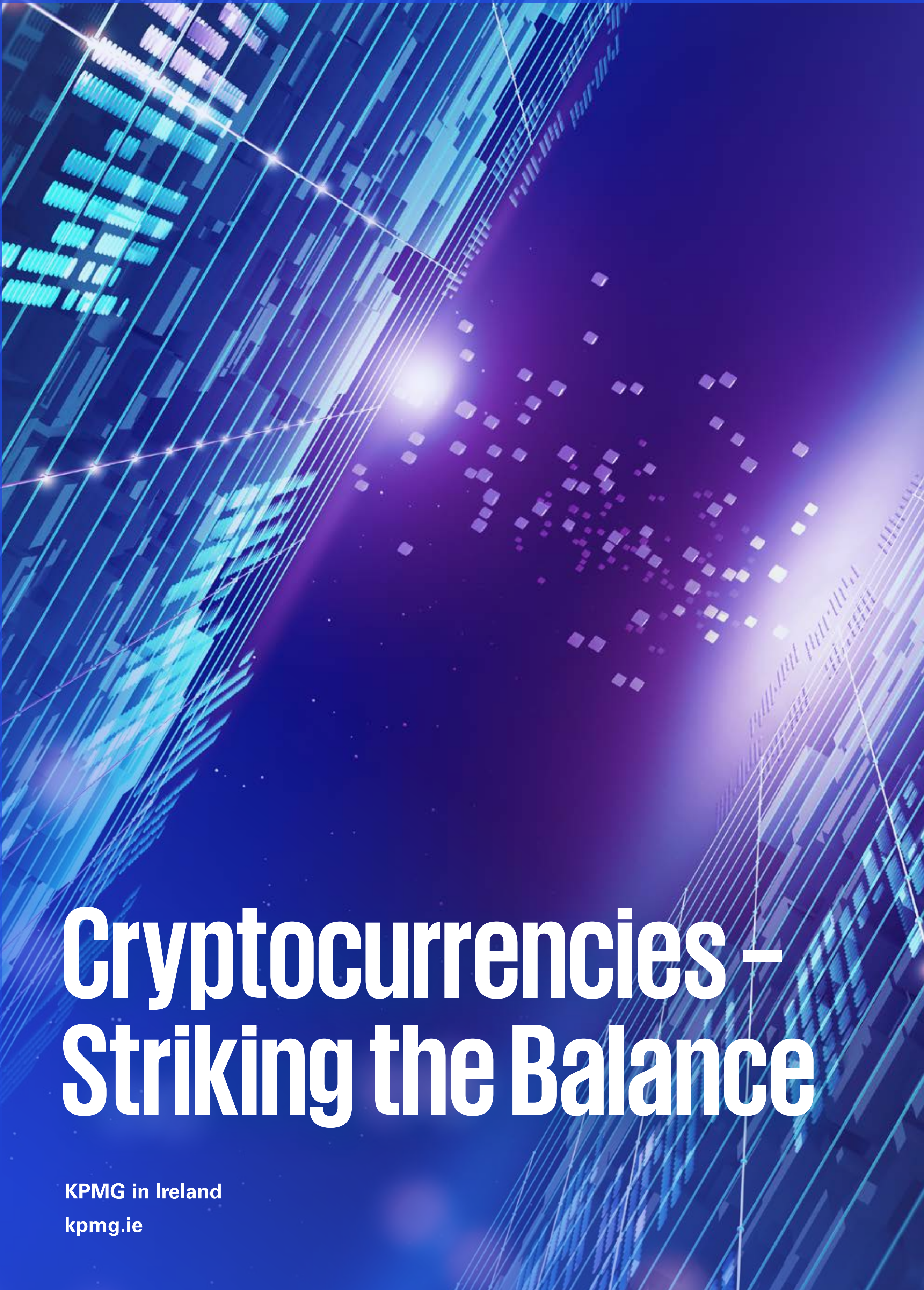

Cryptocurrencies – Striking the Balance

KPMG in Ireland

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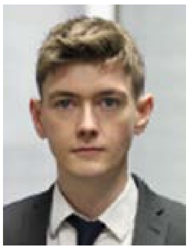

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01 Summary

The emergence of cryptocurrencies as an investment class may present several benefits despite the numerous challenges associated with this relatively nascent asset class and related technologies. In particular, the emergence of cryptocurrencies presents valuable lessons for the EU for increasing participation in capital markets and would benefit from further studies to examine if replication or integration is possible.

We are enthused by the potential benefits of the measured introduction of cryptocurrencies for Ireland and the EU and encourage political and regulatory consideration of the following:

- Continuing engagement, consultation, and relationship building with stakeholders should be an overarching priority. This will promote transparency and trust between stakeholders

- Linked to the point above, cryptocurrencies and the underlying market infrastructure are not deeply understood across wider stakeholder groups and further investment in education is possibly warranted, particularly with consumers. National Competent Authorities such as the Central Bank of Ireland has so far published some focused education pieces on cryptocurrencies. We suggest there is a possibility to include cryptocurrencies in the Central Bank's mandate on financial education and literacy, particularly as the market develops and more retail investor demand increases.

- Openness towards innovation is a must. Market-led innovation has the potential to transform the investment landscape in the EU and should be encouraged and welcomed;

- Emerging regulatory frameworks should be timely, targeted and proportionate. In addition to the upcoming Markets in Crypto-Assets Regulation (MiCA), further exploring if existing regulatory frameworks like MiFID II (Markets in Financial Instruments Directive/Regulation) can be adapted to strengthen market infrastructure and consumer protection;

- Promote trust amongst investors by making use of enforcement provisions in the money laundering and terrorist financing regime, as necessary and on a proportionate basis; and

- Promote the use of blockchain in non-crypto settings by establishing sandboxes, education, training and encouraging sector-specific uptake.

02 Background

During 2021, all industries continued to face the challenges of Covid-19. As we issue this report, Covid-19 restriction are being lifted which is great for many sectors including the asset management industry.

Blockchain, the underlying cryptographic technology developed in the 1990s popularised by Bitcoin, is a peer-to-peer ledger-type database duplicated across multiple computers known as nodes. Each node stores identical datasets grouped into blocks. Every block keeps record of a finite number of transactions, each with unique identifiers. When a block reaches its storage capacity it is closed and linked to the most recently closed block proceeding it, thus forming the 'blockchain'. Subsequent transactions are recorded in a new block which itself will close and link to the blockchain when it reaches capacity. The integrity of the blockchain is made possible by the decentralised nodes validating the information held in blocks.

Bitcoin, one of the first and most popular cryptocurrencies, was created in 2009 by pseudonymous individual or collective known as Satoshi Nakamoto. Bitcoin and other 'altcoins' around this time shared an objective of resolving real-world issues emerging from the growth of transacting online, such as unreliable and insecure record keeping and reliance on financial institutions.

03 Cryptocurrency current landscape

Since the creation of Bitcoin in 2009, and from 2018-2020 in particular, the popularity of cryptocurrencies has grown exponentially. There are over 12,000 different cryptocurrencies in circulation, with more than 1,000 launched each month in-part because of the low barriers to entry in launching cryptocurrencies. This is largely due to the growth in value of popular cryptocurrencies: in 2010 one Bitcoin was worth $0.0008 USD, reaching a high of $69,000 in 2020 and a current value of just under $20,000 today.

Cryptocurrencies are today more likely to be known for its volatility fuelled by an online community of speculative investors, pump-and-dump 'Finfluencers', crypto trading gurus, and a cohort of counter-culture early adopters. The volatility and broad-church of investors have resulted in a public perception more commonly associated with 'get rich quick' pyramid schemes than a credible asset class. Similarly, early concerns with money laundering, black market utility, and a number of high-profile incidents have done little to instil confidence in potential investors and regulators alike. Furthermore, the environmental impact caused by the significant energy consumption and subsequent C02 emissions needed to issue cryptocurrencies (which are 'mined' by solving complex algorithms) is a legitimate criticism.

04 Emerging trends

While the number of EU-based would-be retail investors investing in cryptocurrencies is behind the global average, the participation of EU retail investors in cryptocurrency investing could be seen as a positive sign for the EU's Capital Markets Union. This cohort of investors have historically avoided capital market products in favour of retail deposits compared to global averages, however the popularity of cryptocurrencies amongst retail investors suggests a latent appetite for capital market products when access and information is readily available, as is the case now for cryptocurrencies.

From a product perspective, as the market for cryptocurrencies develops and matures, development has largely tracked traditional capital market products. For example, crypto derivative and future contracts, indices, funds and similar have become available. Amidst unpredictable and rapid volatility, a category of cryptocurrency called stablecoins were developed as a more reliable store of value that allows investors to hold funds in a cryptocurrency pegged to an underlying asset such as US Treasury bills, however concerns over transparency and client account segregation has created some uncertainty amongst investors. Inevitably, the utility and popularity of digital currencies has resulted in some monetary authorities developing digital central bank currencies, including the European Central Bank which is currently analysing the potential use and benefits of a digital Euro. Depending on the outcome of the analysis, a digital Euro may be issued for the first time around 2026.

From a technology perspective, the emergence of blockchain as a secure and trustworthy decentralised ledger presents many opportunities for commerce and government: smart contracts, land registry, transparency, and accountability in public spending, supply chain management, combatting money laundering / terrorist financing and more.
The growth of cryptocurrencies brings with it job creation through the establishment of cryptocurrency exchanges and custodians. Binance, a popular cryptocurrency exchange, had trading volumes of $9.5 trillion of a market total of $14 trillion in 2021, while traditional asset institutions such as BNY Mellon have established cryptocurrency custodial services.

05 Regulatory landscape

The emergence of cryptocurrencies presents challenges to regulators across the world. As an emerging concept, it fell outside many established consumer protection, money laundering and market infrastructure regulatory frameworks.

The use of cryptocurrencies to facilitate money laundering and terrorist financing was an early concern, particularly given its use on the 'dark web' and some of this concern whilst reduced, continues today. Changes to the EU's money laundering and terrorist financing regime enacted in 2021 introduced the concept of Virtual Asset Service Providers, which brought cryptocurrency exchanges, custodians, and issuers in scope. Staying with the EU, the MiCA Regulation proposes a regulatory framework that, amongst other things, introduces passporting to cryptocurrency service providers and establishes conduct of business rules. The United Kingdom has announced its intentions to create a global hub of crypto-asset technology, with a regulatory framework expected to be announced over the coming months. The approach by the United States has been piecemeal but a bipartisan bill setting out the most comprehensive regulatory framework to date was recently introduced in the US Senate. The bill proposes regulatory oversight by the Commodity Futures Trading Commission instead of the Securities and Exchange Commission. This would see cryptocurrencies treated more as commodities rather than securities, a move that may lessen the regulatory burden on cryptocurrency service providers. Elsewhere, some jurisdictions such as Mexico and China have taken a more conservative approach by limiting or outright banning cryptocurrencies, respectively.

As countries move to regulate cryptocurrencies, the risk of regulatory arbitrage remains high. Different priorities in jurisdictions have resulted in diverging regulatory regimes which may create uncertainty or other unintended consequences. The role of supranational standard-setters such as IOSCO and BCBS will continue to be important, assuming mandates allow for the development of meaningful principles in this space. Furthermore, regulators and standard-setters may struggle to keep apace with innovation and development in the cryptocurrency space; novel products, technology, and quickly changing landscapes require a flexibility and responsiveness that may be challenging for traditional structures.

Furthermore, cryptocurrencies may have a potentially transformative impact on retail investor behaviours – there is demand for 24/7 trading, conflicts of interest from exchanges performing multiple roles must be managed, poorly informed and qualified influencers are promoting and providing investment advice, and the line between regulated and unregulated activities continues to blur.

06 KPMG digital assets team services

Cryptocurrencies represent the emergence of new technologies, asset class and financial instruments, invigorated investor behaviour and innovations in market infrastructure which we encourage all firms to explore. There are opportunities for traditional financial services providers and new crypto-only service providers, as well as risks and challenges to be tackled by legislators and regulators. KPMG's Digital Assets team is connected to the wider KPMG international network and we can help you.

- to explore the potential benefits brought about by cryptocurrencies and underlying technologies;
- to prepare for existing or upcoming regulatory, audit, and tax requirements;
- to gain Central Bank of Ireland authorisation as a new entrant or as a traditional financial services firm extending your product and service offering.

Over the coming months, the KPMG Digital Assets team will be publishing insights into cryptocurrencies and other digital assets including regulatory change, the crypto environment in Ireland and internationally, and the underlying technology. In the meantime, feel free to contact the Digital Assets team using the contact details below. We are just as happy helping small-team start-ups as we are with the largest international financial institutions.

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