Bank of Russia

CRYPTOCURRENCIES: TRENDS, RISKS, AND REGULATION

Consultation paper

Moscow
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Please send your comments regarding the issues covered in the consultation paper and your suggestions through 1 March 2022 to: mmm1@cbr.ru, bondarenkooy@cbr.ru, burkovayua@cbr.ru.

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EXECUTIVE SUMMARY

1. This consultation paper addresses cryptocurrencies (unbacked cryptocurrencies and stablecoins), that is, digital currencies as defined in Russian legislation,[1] as well as digital financial assets (DFAs) that may be used in a foreign jurisdiction to make payments (money substitutes).
2. Over the past year, the market of cryptocurrencies surged globally. In December 2021, its overall market capitalisation reached $2.3 trillion, which corresponds to approximately 1% of global financial assets. The proportion of payment transactions in cryptocurrencies is negligible as compared to the figures for conventional payment systems. However, owing to anonymity in transactions, money substitutes are extensively used for illegal activities. The involvement of traditional financial intermediaries in the cryptocurrency market is currently limited, but volume of trade with derivatives and shares of exchange-traded funds (ETFs) related to cryptocurrencies is growing and decentralised finance (DeFi) ecosystems are evolving.
3. According to some estimates, the amount of Russian citizens' transactions with cryptocurrencies reaches $5 billion per year. Russian individuals are active users of online cryptocurrency trading platforms. Moreover, Russia is one of the global leaders by mining capacity.
4. In the long run, the potential of using cryptocurrencies for settlements seems limited. The rapid growth of their market value is predominantly spurred by speculative demand and expectations of a further rise in their prices, which leads to the formation of a bubble in the market. Cryptocurrencies also have signs of a financial pyramid as increase in their prices is largely driven by demand demonstrated by new market participants.
5. The growth of cryptocurrencies use creates threats for Russian retail investors, financial stability and threats associated with the use of cryptocurrencies for illicit activities:
   - High volatility and proliferation of fraud in cryptocurrency trading creates for individuals risk of losing a significant portion of their investments and even of becoming a debtor in case of leveraged trading.
   - Just as dollarization, cryptoization limits monetary policy sovereignty, which might force central bank to permanently maintain a higher key rate in order to contain inflation. This will reduce the affordability of credit to both households and businesses.
   - The spread of cryptocurrencies could make people withdraw their savings from the Russian financial sector and, subsequently, decrease its capability to finance the real sector and potential economic growth reducing the number of jobs and potential for household income increase.
   - Cryptocurrencies are extensively used in illegal activities (money laundering, drug trafficking, terrorist financing, etc.). The widespread use of cryptocurrencies creates a favourable environment for criminal operations, extortions and bribery and is a challenge to the global Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) system. It is impossible to ensure a full transparency of cryptocurrency transactions.
6. There is currently no single global approach to cryptocurrency regulation, and cryptocurrency transactions in many countries are in the 'grey' area, but there is a general trend towards regulation tightening:
   - A number of countries have already prohibited the use of cryptocurrencies (particularly, China) or are planning to do so (e.g. India), some countries (for example, China, Iran) have also banned cryptocurrency mining.
   - Some jurisdictions permit the operation of cryptocurrency exchanges, but are gradually tightening AML/CTF and other requirements for them.

[1] *Federal Law No. 259-FZ, dated 31 August 2020, 'On Digital Financial Assets, Digital Currency, and on Amending Certain Laws of the Russian Federation'.*

- Major regulators are releasing warnings for consumers notifying them of excessive risks inherent in investment in cryptocurrencies.
- Regulators in the countries where stablecoins are used as an alternative to investment funds are focused on the elimination of regulatory arbitrage in this regard.

7. Potential risks to financial stability provoked by cryptocurrencies are significantly higher for emerging market economies, including Russia, particularly due to a traditionally higher propensity for dollarization and insufficient level of financial literacy. Advanced economies, especially reserve-currency countries, can afford to be more tolerant to cryptocurrencies at the moment, while gradually expanding the scope of their regulation.
8. Unbacked cryptocurrencies are subject to tougher regulatory approaches than stablecoins. Nonetheless, the coordinated response by the major countries to prevent the launch of the global stablecoin Diem (Libra) that could become a more serious threat to their financial systems proves that regulators are extremely cautious about stablecoins as well.
9. In order to mitigate threats associated with the expansion of cryptocurrencies, the Bank of Russia proposes the following amendments to the Russian legislation:
   - Establish liability for the violation of the statutory ban on using cryptocurrencies as a mean of payment for goods, works and services sold and bought by Russian residents, whether legal entities or individuals.
   - Prohibit the organisation of the issue and/or the issue and the organisation of circulation of cryptocurrencies (including by cryptocurrency exchanges, cryptocurrency exchange offices, and P2P platforms) on the territory of the Russian Federation and establish liability for breaching this ban.
   - Prohibit financial institutions' investment in cryptocurrencies and related financial instruments, as well as the use of Russian financial intermediaries and Russian financial infrastructure to conduct cryptocurrency transactions, and stipulate liability for violating this ban.
10. For some types of cryptocurrencies, mining involves, among other things, the issuance of a cryptocurrency and / or the receipt of a cryptocurrency as a reward for validating transactions. Mining cannot be ignored in the report, since it increases the involvement of the population and the economy as a whole in the cryptocurrency market. The Bank of Russia believes that the current scale and further spread of cryptocurrency mining in the Russian Federation entails significant risks for the economy and financial stability:
    - Cryptocurrency mining creates unproductive consumption of electric power, which threatens the power supply of residential buildings, social infrastructure and enterprises and the implementation of Russia's environmental agenda.
    - Cryptocurrency mining creates the demand for infrastructure needed to conduct cryptocurrency transactions, which exacerbates the negative effects of the spread of cryptocurrencies and creates incentives to circumvent regulation (Clause 9)[2].

In this regard, the Bank of Russia believes that the prohibition of cryptocurrency mining in Russia could be the best solution.

11. The Bank of Russia plans to enhance the system of regular monitoring of cryptocurrency transactions, including via cooperation with the home country regulators of foreign cryptocurrency exchanges, in order to obtain information about Russian clients' operations in foreign cryptocurrency markets.
12. In recent years, the Bank of Russia and many foreign central banks have been extensively deploying faster payments systems meeting individuals' and companies' needs in instantaneous settlements. Moreover, central banks, including the Bank of Russia, are developing central

[2] *It is necessary to take into account that cryptocurrency mining on the global scale induces a range of additional negative effects for the global economy. Specifically, mining creates extra demand in the market of hardware causing its shortage. Accordingly, this might fuel prices for not only hardware, but also products / services in all areas actively using hardware, which contributes to acceleration of global inflation.*

bank digital currencies (CBDC), that is, a new payment infrastructure which will enable people, businesses and the government to conduct instantaneous transactions with minimal fees. Hence, the benefits of cryptocurrencies which make them attractive as payment instrument for operations other than money laundering and other illicit activities, namely high speed, convenience, relative low cost, could be realized and are already being realized through creation and development of faster payments systems and by national digital currencies in the future.

13. The potential of cryptocurrencies as an investment instrument can be further implemented more efficiently through the use of digital financial assets issued in accordance with Federal Law No. 259-FZ, dated 31 August 2020, 'On Digital Financial Assets, Digital Currency, and on Amending Certain Laws of the Russian Federation' that are an innovative investment instrument and, in contrast to cryptocurrencies, guarantee investor protection.