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Treasury Committee

By online submission

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Dear Sir/Madam

Re: Treasury Committee inquiry into crypto-assets

We welcome the opportunity to provide input on the Treasury Committee's inquiry into crypto-assets, exploring the role of crypto-assets in the UK, as well as the opportunities and risks they bring to consumers and businesses. The EMA represents FinTech, BigTech and technology firms engaging in the provision of alternative digital payment services, including the issuance of e-money, e-money tokens, and cryptoassets. Our members include leading payments and e-commerce businesses providing online payments, card-based products, electronic marketplaces, and increasingly cryptocurrency exchanges and other cryptocurrency related products and services. The EMA has been operating for over 20 years and has a wealth of experience regarding the regulatory framework for electronic money and payments. A list of current EMA members is provided at the end of this document. We have a monthly cryptoasset working group that meets to discuss issues of regulatory significance for the cryptoasset sector.

We would be grateful for your consideration of our comments, which are set out below.

Yours faithfully

A handwritten signature in blue ink that reads 'Thaer Sabri'. The signature is written in a cursive style with a long horizontal stroke at the end.

Dr Thaer Sabri
Chief Executive Officer
Electronic Money Association

I To what extent are crypto-assets when used as digital currencies (such as Stablecoin) likely to replace traditional currencies?

- 1.1 The likelihood of any new means of payment replacing an existing product, let alone the entire infrastructure is very low. It is more likely that new products will serve roles that current products are ill equipped to do, or from which they are absent.
- 1.2 This applies equally to crypto-assets as it does to other innovate means of payment, say for example those based on open banking principles.
- 1.3 Current uses of stable coins have revolved around their use as a means of making faster and more immediate transfers in order to purchase other crypto tokens, enabling more efficient and instant investment decisions to be made. Where fiat-like payments are desired, but also with a need for distributed ledger technology or programmability, then some stable coins can provide an effective solution.
- 1.4 The evolution of stable coins into a more mainstream means of payment will, absent other factors, be a gradual process and will need to compete for this role with existing and new payment products and services.
- 1.5 CBDCs may also offer competition for stable coins and particularly given their Central Bank issued status and risk mitigation that that would offer. This however will require a joint effort by private and public bodies and is likely to be a complex undertaking.

2 What opportunities and risks would the introduction of a Bank of England Digital Currency bring?

- 2.1 **Opportunities:** Central Banks describe desired outcomes to include better financial inclusion, the digitisation of cash, and more advanced technological offerings. Some others regard CBDCs as meeting a political objective, for achieving sovereignty and national independence for a payment system. In all cases, a retail CBDC would be a new category of payment product for retail customers that could complement existing payment service providers' ('PSP') product portfolios.
- 2.2 The opportunities for PSPs on the other hand are in the offering of a new payment product that perhaps possesses distinct characteristics from other products that are offered. The most obvious attributes for CBDCs are the absence of market risk on the one hand and the guarantee of merchant acceptance on the other.
- 2.3 Other opportunities that will be presented by CBDCs depend on the design of the product, its payment services functionality, the distribution models that are adopted for getting it into the hands of retails users, and the incentives that will be offered to PSPs to invest in the infrastructure, in the business case, in product development, marketing etc.

- 2.4 It is recognised, that such products may compete with existing PSP products and services and this potential conflict will need to be reconciled at an early stage. Failing to incentivise distributors who are in effect the product developers, marketeers and implementors will doom the product from the outset.
- 2.5 It should also be noted that many of the intended outcomes may also be realised through private payment system initiatives, or indeed through a CBDC issuance programme that relies entirely on the private sector for its development, with the central bank only making the electronic value available in a technology agnostic manner. This increases the incentives for the private sector whilst managing the risk to the central bank.
- 2.6 **Risks:** The risks associated with CBDCs are shared with most payment products, with some exceptions. Below are some of the categories of risk that are worth noting:
 - 2.7 Business related: the success of any new payment product hinges on a number of factors including the payment opportunities that it seeks to fulfil, and the competing products that it must contend with. It must either find opportunities that are not well served, or fulfil its function in a manner that is considerable better than that of the competition.
 - 2.8 Competition related: these recognise the impact a central bank issued product will have on the existing landscape, and the advantages it will have, both perceived, and actual. Distortions to the marketplace will need to be managed.
 - 2.9 Technology related: this could form part of the USP of the CBDC, or may act to limit its utility. This is one of the most complex issues and it may argue for a technologically neutral approach.
 - 2.10 Privacy: the prospect of having one's every transaction observed, stored and analysed in perpetuity is dystopian, and yet within reach. Users' right to conduct their lives in a modicum of privacy must be maintained in an open civil society, with compromises made only where the financial crime risk warrants such transparency.
 - 2.11 Reputational: the success of the product will be seen as the success of the central bank, and vice versa. This means that public perception of the Bank may be influenced by its launch of a product that will only partially be within its control.

3 What impact could the use of crypto-assets have on social inclusion?

- 3.1 Crypto-assets have the potential for a significant impact on both social and financial inclusion.

- 3.2 Crypto-assets appear to be broadening both the delivery and usage of digital finance as a whole - providing greater access to affordable financial products and services such as payments, savings, credit, and insurance.
- 3.3 They have increased the ability of individuals, including the under-banked, to participate in the financial system. They have given rise to grass-root, community and peer-driven financial inclusion projects, with open-source technology developments that have broader benefits. Various public blockchain protocols and networks also have the promise of more inclusive participation. This could create a new ecosystem funded and managed by individual participants.

4 Are the Government and regulators suitably equipped to grasp the opportunities presented by crypto-assets, whilst at the same time mitigating against the risks?

- 4.1 The government has engaged with the crypto asset industry at an early stage. It has sought to cultivate a supportive environment, and has simultaneously not rushed to introduce legislation. This has encouraged a range of developers and businesses to be based in the UK. The anti-money laundering registration process has been slow in granting registrations to service providers and this could benefit from review.
- 4.2 HMT has taken a deliberated approach to the introduction of legislation and has resisted the temptation to regulate at an early stage of the market's development. Similarly, the scope of the limited legislation that has been proposed addresses those products that are better developed, and which could present a risk of consumer detriment. This is a preferable approach to for example that taken in the EU of legislating for all crypto assets, presenting the twin problems of legislating before the market has stabilised and of seeking to address a diverse set of services that can be very distinct. HMT on the other hand proposes to legislate for stablecoins which can be used as a means of payment in the UK.
- 4.3 We also welcome the recent announcements of the intention to develop a global hub for crypto-assets in the UK.
- 4.4 There are however a number of challenges facing crypto asset service providers in the UK. The FCA cryptoasset registration regime is in need of significantly greater resource to ensure firms' applications can be reviewed within a reasonable period of time. The waiting time is currently in excess of 1 year, making the offering of business in the meantime impossible and the cost of waiting prohibitive. This may reflect a scarcity of qualified personnel and would benefit from resolution.

- 4.5 Separately, crypto asset service providers will invariably need to operate one or more bank accounts, and the banking sector has largely denied applications for banking services to all but the largest crypto asset service providers. Even the largest have found it almost impossible to get banking services, to the extent that when the largest provider Coinbase's application for a bank account with a clearing bank was accepted, it made front page news on the Financial Times.
- 4.6 This latter issue continues to plague the FinTech sector as a whole and may be the single biggest barrier to business and innovation that the UK has. Bank accounts are essential utilities for businesses while banks continue to apply various commercial tests that reflect their own risk appetites, acting therefore as a brake on innovation in the financial services sector. Government could provide respite by making access to banking services a right for all businesses and all individuals, as for example is the case in France.

5 What opportunities and risks could the use of crypto-assets—including Non-Fungible Tokens—pose for individuals, the economy, and the workings of both the public and private sectors?

- 5.1 Crypto assets describe a broad range of products based on the distributed ledger technology but having diverse functions and attributes. Some may be analogous to centralised technology-based products and will exhibit familiar risks, while others may offer new functionalities or services that will need to be assessed individually. In many cases however, the technology creates opportunities for direct participation or for alternative models of governance that bring new opportunities and risks. Finding the appropriate models for regulating decentralised governance, peer to peer transfer functionalities, the fragmented roles of service providers is key. Risks that are often hyped however relate more to the market volatility of assets, and the temptation of easy profits that flow from that. These are in turn accelerated by the direct accessibility to the technology, and the ability of anyone with the appropriate skills to create and bring a crypto asset tokens to the market.
- 5.2 The challenge is to allow such new functionalities to develop, whilst curbing the excesses of the behaviour or introducing disincentives for the abuse of such attributes.
- 5.3 NFTs offer new opportunities for creators of art, music and others to monetise their work and to make it directly available to those interested in acquiring it. This has already changed the lives of ordinary small artists and enabled many to make a modest living from their creative work.
- 5.4 NFTs are records of rights and representations of objects such as art, videos or other intellectual property, and can vary in the extent of the rights they embody or transfer upon sale. They have some common attributes however that gives them their utility: they are recorded on a blockchain which enables the history of their creation and sale to be examined by anyone, they can be transferred independently of any third party, and can enable the artist to be rewarded at every sale, and not only the initial sale.

- 5.5 The rights (if any) that any single NFT confers on its owner vary, with a diverse range of uses possible. As the Law Commission has pointed out in its recent consultation paper on digital assets, “NFTs can become a powerful technological structure that can be used to link to — and to transfer — other legal rights to things external to crypto-token systems.” To protect the potential of NFTs to structure legal relations in novel ways, regulation of this area should proceed cautiously and be fact-based. Early over-regulation runs the risk of restricting development in this area and deter participants who would benefit from their functionality from engaging with NFTs.
- 5.6 One risk associated with higher value NFTs that has already been identified is that of price manipulation, where the value of the NFT may be subjective and hard to quantify.

6 How can distributed ledger technology be applied in the financial services sector?

- 6.1 There are a number of applications for DLT within the financial services sector:
- 6.2 Making payments faster and more efficient. This is particularly relevant to settlement and clearance mechanisms alongside international remittance, which are often expensive and cumbersome. Utilising DLT, transactions can be made directly from payer to payee or payer’s PSP directly to payee’s PSP, without the need for intermediaries or clearing and settlement mechanisms. Significant operation efficiency for both the financial services sector and customers ensues, alongside significant decreases in costs.
- 6.3 Enhancement of data collection and storage. DLT provides opportunities to enhance customer experience in a number of ways, particularly in terms of data. Processes such as customer onboarding and KYC can be optimised significantly through storing customer data on decentralised networks, eliminating repetitions, and allowing simultaneous information sharing for open banking and open finance purposes.
- 6.4 Record keeping and security. As above, DLT presents unique opportunities to ensure data storage is efficient and secure for institutions such as a bank. It prevents the need for paper records and computer systems, particularly for customer data, which may be vulnerable to damage and other such issues. It also optimises data retention and recall, with the potential to recall required information from safe, ‘deep’ storage almost immediately.

7 What work has the Government (and its associated bodies) done to understand, prepare for and, where relevant, encourage changes that may be brought about by increased adoption of crypto-assets?

- 7.1 The Government, and bodies such as the Bank of England and the FCA, have held a number of public consultations, soliciting views and opinions from the crypto-asset sector as a whole. While this is positive, responses to these consultation have been delayed, and the policy outcomes do not always align with those set out by industry.

- 7.2 The FCA has also recently undertaken some ‘crypto sprints’, to encourage industry participation to help it resolve specific, pre-selected issues. This is encouraging, and should be continued and expanded to allow a larger number of participants, as well as a broadening of the key focus areas alongside the ability for the industry to nominate the areas of interest for discussion.
- 7.3 These are of course also instrumental in ensuring that FCA staff become familiar with and engage on many of the novel issues that arise.

8 How might the Government’s processes – for instance the tax system - adapt should crypto-assets be adopted more widely?

- 8.1 The government could consider the development of a more tailored and internationally competitive tax framework for crypto assets, to minimise disruption or onerous obligations in establishing taxable assets, events and charges.
- 8.2 Separately, the registration or a future licensing system for crypto-asset firms could be made clearer, more transparent and provide for predictable outcomes. To this end, the regulator will need to be effectively resourced to determine applications in a timely and considered manner.

9 How effective have the regulatory measures introduced by the Government - for instance around advertising and money laundering - been in increasing consumer protection around crypto-assets?

- 9.1 The government updated the Money Laundering Regulations, introducing a new registration regime for crypto-asset service providers. While the legislation itself is effective and proportionate, outlining responsibilities and requirements for firms to counter the threat of money laundering and terrorist finance, the registration regime itself has presented significant issues, as outlined in Question 4 above.
- 9.2 We also have particular concern around the planned approach to advertising and crypto-asset financial promotions. We are supportive of a financial promotion regime for crypto-assets - to ensure they are advertised in an appropriate manner, and the sector as a whole supports the maintenance of such standards. However, the current proposal may harm the potential for innovation and UK competitiveness.
- 9.3 The planned approach of making a firm’s own financial promotions subject to third-party sign off is both impractical and disproportionate. It is also disruptive to business and runs counter to the objective of developing a culture of compliance within the firm. Many such third parties do not currently have the requisite knowledge and understanding to adopt an informed opinion about the promotions and it should not be the role of the firm to educate other service providers.

- 9.4 Both registered and un-registered cryptoasset firms will be required to contract with FCA authorised firms. Only FSMA Part 4A authorised firms, to be able to approve cryptoasset financial promotions, subject to approval under a new, dedicated FCA gateway. This also creates concerns around scarcity – there may only be a small number of potential ‘approver’ firms who are in a position to seek approval and able to exhibit the necessary expertise to be deemed capable by the FCA to approve crypto-asset financial promotions.
- 9.5 This may also raise competition and pricing concerns as a small number of approver firms determine the ability of the crypto sector as a whole’ ability to advertise. We urge a reconsideration of this approach which has the potential to create a significant negative effect on the crypto-asset sector in the UK.

10 Is the Government striking the right balance between regulating crypto-assets to provide adequate protection for consumers and businesses and not stifling innovation?

10.1 Please refer to our response to Question 4 above.

11 Could regulation benefit crypto-asset start-ups by improving consumer trust and resilience?

- 11.1 Regulation, when introduced at an appropriate time and in a proportionate manner has the potential to introduce discipline and formality to an otherwise technology driven business, providing both investors and users with additional confidence. It can go a significant way to bringing about those objectives of regulation such as stability, integrity, good governance and resilience. Consumer protection is likely to be enhanced and financial crime deterred.
- 11.2 From a consumer perspective, the presence of regulation leads to increased trust and reliance on firms and service providers. It encourages greater adoption and participation, with the likelihood of financial protection and legal recourse to funds in case of insolvency or other types of firm failure. It provides a high degree of assurance, with the knowledge that firms are regulated and supervised by financial authorities and subject to governance and oversight.

12 How are Governments and regulators in other countries approaching crypto-assets, and what lessons can the UK learn from overseas?

12.1 Regulators around the world are adopting a variety of approaches to crypto assets.

- 12.2 Singapore has fast become a global hub for crypto-assets, with the financial regulator (the Monetary Authority of Singapore) operating a regulatory framework which is clear and easy to navigate. It has introduced a six month grace period for potential applicants, allowing crypto-asset firms to operate while they pursue a regulatory license. Alongside this, Singapore has also adopted a favourable tax regime for crypto-assets, with no capital gains tax and no tax on goods and services paid for in crypto.
- 12.3 Portugal has become a leading destination for crypto asset service providers in Europe. As well as a favourable tax regime, with no income or capital gains tax on crypto profits, the government pursues a policy of actively attracting and retaining both cryptoasset service providers and individual traders. Existing initiatives, such as the Golden Visa program allowing non-EU citizens to qualify for a residency permit and eventually a passport, have also been effectively extended to the crypto-asset sector.
- 12.4 Germany has become an attractive destination through a legislative interpretation that has provided a means for crypto asset service providers to be regulated under the current financial services regime on the one hand, and a favourable tax outcome on the other. Tax rules for example encourage retention of ownership of crypto-assets for a significant period – with all gains on crypto-assets held for more than a year becoming exempt from taxation, as well as income derived from staking for a period of ten years or longer also being tax free.
- 12.5 The UAE has more recently established itself as a favourable jurisdiction for crypto-assets, with an openness to digital assets as a whole and a desire to establish itself as the destination of choice for crypto-asset firms. Recent initiatives include the launch of a regulatory framework for virtual assets including cryptocurrencies, alongside the establishment of the world's first dedicated regulatory authority for cryptoassets -Dubai's Virtual Assets Regulation Authority. Emirates, the national airline, has announced plans to accept payment in crypto-assets, and the government has committed to utilising the benefits of distributed ledger technology in the provision of a range of public and governmental services.
- 12.6 One of the highest profile adopters of crypto assets is El Salvador which has invested in creating a payment infrastructure which allows crypto-assets to be accepted as a means of payment and has adopted Bitcoin as legal tender – though the success of this initiative is yet to be proven.

13 The environmental and resource intensity of using crypto-asset technology.

- 13.1 Some aspects of the crypto-asset technology have resulted in a poor environmental outcome, cantering mainly around the proof-of-work consensus establishment mechanism. This is not however the only means of authentication and consensus building, with a general move towards proof of stake and other mechanisms that do not require the same computational input to achieve consensus for transactions.

- 13.2 Ethereum, the second-largest crypto network, is set to make this switch to proof of stake in the coming months, and this forms the basis for many DeFi and stable coin initiatives. There is an expectation that the industry will migrate to a more efficient and environmentally friendly model over time.

- 13.3 Alongside this, a number of environmentally friendly and energy efficient protocols have emerged, such as Cardano and Nano. There remains a huge appetite and a desire for the industry as a whole to become more efficient, and future developments will continue to minimise the adverse environmental impact crypto-assets may have.



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