Group Briefing

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European Banking Authority Issues Opinion on 'Virtual Currencies'

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On 4 July 2014, the European Banking Authority ("EBA") issued an opinion on 'virtual currencies' ("VCs") (the "Opinion")[1], in which, in summary, it called for the introduction of a comprehensive regulatory regime governing their use and suggested that national regulators discourage credit institutions, payment institutions, and e-money institutions from buying, holding or selling VCs, thereby 'shielding' regulated financial services from VCs until such a regime is in place.

The EBA is part of the European System of Financial Supervision and works to ensure effective and consistent prudential regulation and supervision across the European banking sector, hence its interest in virtual currencies[2].

The Opinion is cautious in its tone, echoing the tone of the 'Warning to Consumers on Virtual Currencies', dated December 2013[3], stating at the outset that the objective of the Opinion is to allow the organisation to "*identify risks arising from financial activities, prioritise them, and take mitigating action, if required*".[4] However, the Bitcoin Foundation, responding to the Opinion, warned that "*if [the approach recommended by the Opinion] were adopted, it would come at a significant cost to the people of Europe*".[5] This note is written by Irish lawyers and as such we note that this cost could weigh especially heavily on Ireland, which has a focus on promoting itself as a preferred location within the EU for the fostering and growth of innovative financial services.[6]

The purpose of this note is to outline the key points from the EBA Opinion and offer some brief analysis of its recommendations.

DEFINITIONS

The Opinion begins by offering definitions for some of the key terms that are used throughout the report. An uncontentious definition of 'Virtual Currencies' sees them defined as "*a digital representation of value that is neither issued by a central bank or public authority nor necessarily attached to a FC [fiat currency], but is used by natural or legal persons as a*

1 *http://www.eba.europa.eu/documents/10180/657547/EBA-Op-2014-08+Opinion+on+Virtual+Currencies.pdf*

2 *http://www.eba.europa.eu/*

3 *https://www.eba.europa.eu/documents/10180/598344/EBA+Warning+on+Virtual+Currencies.pdf*

4 EBA Opinion on 'virtual currencies', at p. 21.

5 *https://bitcoinfoundation.org/2014/07/will-europe-listen-to-europe/*

6 A recent example of this is the launch, on 11 March 2014 of Ireland's first financial technology start-up programme ('NDRC FinTech') by Minister for Communications, Pat Rabbitte. The programme was established in association with blue chip firms and financial services enablers, Bank of Ireland, Enterprise Ireland, Mediolanum and State Street. Speaking at its launch, NDRC CEO, Ben Hurley stated: "*Over the last 30 years Ireland's international financial services sector has grown into one of the world's finest and, alongside Ireland's vibrant start-up ecosystem, is well positioned to be a leading centre for innovation. NDRC FinTech will harness the best ideas from those interested in the financial services industry, partner these people with experts and set about creating dynamic, sector-changing tech companies.*" See NDRC's announcement regarding the programme's launch at: *http://www.ndrc.ie/news/financial-services-sector-set-transformation-irelands-first-financial-startup-programme-ndrc-fintech/*

means of exchange and can be transferred, stored or traded electronically". The EBA is careful to distinguish VCs from other forms of value such as e-money, which is stated to be covered by the EU E-Money Directive, and Fiat Currency ("FC"), which is issued by (and, it is implied, backed by) a central bank or public authority. Even in this initial part of the Opinion, the cautionary attitude of the EBA towards VCs is evident, as it states: "*the definition of VC above reflects the fact that [their] functions are, at least currently, not comparable in terms of quality [with an FC]*".

BENEFITS OF VCS

The Opinion goes on to identify the 'Potential Benefits' of VCs. The advantages listed are categorised into economic benefits (such as improved transaction time, improved transaction costs, certainty of payments received, contributing to economic growth, and 'financial inclusion'), and individual benefits (such as security of personal data and limited interference by public authorities). Understandably the Opinion is EU centric in focus and caveats advantages such as improved transaction costs, improved transaction time and 'financial inclusion' by stating that these will be much less pronounced within the EU due to EU measures such as the Single Euro Payments Area ("SEPA") and the Payment Accounts Directive.[7] The conclusion reached by the EBA is that "*in summary, many of the potential benefits are likely to materialise outside the EU, in regions where the payment infrastructure may be less developed or trustworthy*".

The Opinion's reluctance to recognise the advantages of VCs is further evidenced in its statement that "*what unites most of the advantages is that, at this stage of the development of VCs, many remain hypothetical, as the advantages have often not (yet) materialised*". One exception noted by the EBA, is the advantage of use for those operating in the criminal sphere.[8] However, the criminal fraternity are likely far bigger users of traditional currencies than VCs. Also, any innovative concept which is an early stage of its development will have benefits that have yet to be realised. This in itself can hardly be viewed as a weakness.

RISKS OF VCS

The Opinion next identifies and enumerates the risks associated with VCs. Over 70 are listed, and are categorised into: risks to users; risks to other market participants; risks to financial integrity; risks to payment systems in FCs; and risks to regulators. Each hazard is classed as 'low', 'medium' or 'high' threat, based on "*a tentative and preliminary assessment of factors such as the probability of a risk to materialise, the severity of the impact should the risk materialise, and an assessment of the anecdotal evidence available, such as bankruptcies of specific exchanges, cases of VC theft, etc.*".[9]

The methodology employed by the EBA when identifying and categorising the stated risks can be criticised on a number of grounds. The Bitcoin Foundation have roundly criticised the "*blunt*" 'high'/ 'medium'/'low' risk ranking system, which they consider a "*serious weakness*" of the Opinion and one which "*prevents effective prioritization of risks, and it makes it appear as though there is "too much to be done"*".[10] Further, many of the risks identified in the Opinion stem from the fact that VCs are, at present, unregulated and not subject to any form of legislative or other control. The question for the financial services sector, both market players and regulators, together with government and other interested parties, such as the tech sector (given that VCs are tech dependent) and consumer protection agencies, is how best to deal with VCs, in particular from a regulatory perspective, in the short, medium and long term. The correct approach may well evolve over time. Much of the commentary on the Opinion concentrates on its short term recommendations.

PROPOSAL FOR REGULATORY REGIME AND SUGGESTED INTERIM RESPONSE

The Opinion goes on to call for the EU to take concerted action and develop a regulatory regime governing the use of VCs. In this regard, both a long term and a short term strategy are outlined. The Opinion's proposed long term response identifies the structures and procedures that, in the opinion of the EBA, must be put in place if VCs are to grow and flourish. These include the introduction of a requirement that all VC schemes be regulated as a financial service accountable to the relevant national or EU regulator, the introduction of customer due diligence requirements in connection with VC transactions, the introduction of fitness and probity standards for individuals and entities involved in VC related activities, capital requirements for entities that hold VCs on behalf of others, an obligation on such entities to provide evidence of secure IT systems, and, finally, a global regulatory approach.

Recognising that a comprehensive regulatory framework would be "*highly resource intensive…[and would] take considerable time to develop, fine tune and implement*", the EBA, in the interim, recommend that national financial regulators 'shield' regulated financial services from VC schemes by discouraging credit institutions, payment institutions and e-money institutions from buying, holding or selling VCs. It is possible that these recommendations will have little effect, given the understood current position that few regulated financial service providers' deal with VCs. As recently remarked by the UK Digital Currency Association: "*The UKDCA is not aware of any banks in the UK that hold, accept or transact with bitcoin, other digital currencies nor offer banking facilities to digital currency businesses and service providers*". [11] Notwithstanding this, it is submitted that a lack of existing regulation is not adequate reason to stifle the development of VCs. If one is of the view that VCs are ultimately a beneficial development, then, rather than halting their growth on the basis that the law is

[7] The text of which was approved by the European Parliament in April 2014. A copy of the text as approved can be found here: *http://www.e-ma.org/emaweb/wp-content/uploads/2014/04/PADECONApr2014.pdf*

[8] EBA Opinion on 'virtual currencies', at p. 16

[9] EBA Opinion on 'virtual currencies', at p. 21

[10] *https://bitcoinfoundation.org/2014/07/04/will-europe-listen-to-europe/*

[11] *https://www.ukdca.org/index.php/news/9-news/40-the-ukdca-response-to-the-eba-s-proposal-for-a-regulatory-regime-for-virtual-currencies*

not keeping up, national and European regulatory bodies should better focus their energy on developing the law to meet ongoing challenges.

CONCLUSION

The cautious attitude exhibited by the EBA is understandable, up to a point. Restraint in assessing new and untested methods of payment is to be expected. However, the Opinion, we believe, goes further than is necessary given the role of the EBA, in essentially recommending that financial services providers not engage with VCs. A more balanced approach may have been for the EBA to set out objectively the pros and cons of VCs as they saw them at this point and, either, invite submissions from interested parties or, given the potential scale of VCs, set up a permanent or semi-permanent forum, reflecting interested parties, to monitor and comment on the area. The area is fast evolving, but currently without a clear regulatory framework or terms of reference.

VCs have the potential to transform both the international financial services sector and the individual's relationship with money. Instead of seeking to 'shield' our existing financial institutions, we should embrace these tides of change and the new opportunities they bring. It is to be hoped that Ireland can be at the forefront of this movement.

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