**Response to the Call for Evidence: The Crypto-asset Industry**

**Dr Matthew Robert Shillito (Lecturer in Law)**

**The School of Law and Social Justice, University of Liverpool**

Dr Matthew Shillito is a Lecturer in Law at the University of Liverpool. His research identifies and develops issues and themes in the areas of financial and dark web crime, with a particular focus on how the law regulates the use and abuse of digital currencies. In September 2016, he completed his PhD thesis, entitled ‘*Criminal abuse of non-traditional payment methods: A comparative analysis of the application of anti-money laundering and counter-terrorist financing frameworks in the UK, US, and Australia*’. The thesis specifically focussed on how the law was developing in each jurisdiction to tackle the emerging threat of Bitcoin and other digital currencies. Dr Shillito is developing a book on this area, in light of developments since his thesis was completed. He also has a meaningful body of publications and conference presentations focussing on legal issues surrounding the use of crypto-assets, and in 2016/17 through a joint N8 funded research project with Greater Manchester Police and colleagues at other academic institutions, helped to develop a handbook for the Metropolitan Police on how to deal with cryptocurrencies uncovered during the course of criminal investigations. Dr Shillito teaches an undergraduate Banking Law course to circa 250+ students and has developed several lectures on cryptocurrencies, which have a particular focus on a range of different crypto-assets and the risks they present to consumers due to the lack of regulation and protection in the area.

**Question 1: To what extent are crypto-assets when used as digital currencies (such as Stablecoin) likely to replace traditional currencies?**

It seems unlikely to me that privately issued crypto-assets will ever replace traditional currencies. To increase their appeal, there would have to be the introduction of robust regulation focussing on transparency and accountability, as well as a significant reduction in the volume of crypto-assets available. At present, there is too much failure, crime, and scandal for any particular crypto-asset to gain mass adoption. The current scale and significance of which calls into question the business viability of privately issued crypto-assets. To change this robust regulation with a focus on transparency and accountability would need to be introduced and lead to a meaningful long-term reduction in crypto-asset failure, crime, and scandal. Even then, there is no clear evidence that this would lead to mass adoption.

In any event, it is not clear why any sovereign nation would want to create an environment where a privately owned crypto-asset replaced its own fiat currency.

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

A central bank digital currency is likely the only means to mass adoption of digital currency by UK citizens. It removes a number of the risks presented by privately issued digital currencies, whilst retaining many of the benefits (as well as providing new).

Opportunities:

* **Financial inclusion** – Accessible finance, provided by the central bank. That said, this benefit is most likely to be felt in developing countries.
* **Would offer the opportunity for everyone to harness the benefits of digital currencies, without many of the drawback**s. In particular, they would be more trustworthy.
* **Real-time payments**.
* **Faster and cheaper payments**.
* **Removes the need for reliance on private entities in our financial system**.
* **To retain the prominence of the pound** – ultimately, if private cryptocurrencies were to take off, then the value of the pound could diminish.
* **Gives government greater control over the financial sector**.
* **Greater control over lending practices**.

Risks:

* **Financial exclusion** – should this become the main, or only way, of conducting financial affairs then the tech may in effect exclude particular groups of individuals
* **Significant costs in terms of development and implementation which may not pay off**.
* **Perception** – individuals may not like government exuding more control over our finances.
* **Privacy** – how details and transaction data will be secured and stored.

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

In the UK, the opportunity for crypto-assets to do anything particularly meaningful in terms of social inclusion beyond that offered by the formal financial sector is limited. Anti-money laundering requirements will still provide the most significant barrier to financial services, and there is no reason that the requirements should be any different for crypto-assets, than they are for traditional bank accounts. The arguments are different inn a developing country where the barriers to entry are largely different e.g. distance to local branch, which can be negated by the uptake of crypto-assets.

Where, crypto-assets could provide a benefit in the UK is around lending – De-Fi / Ce-Fi lending tends to be more available than traditional forms, and at better rates. If a CBDC was to be developed, then the government would have greater control over lending practices and the ability to stimulate the economy.

**Question 4: Are the Government and regulators suitably equipped to grasp the opportunities presented by crypto-assets, while at the same time mitigating the risks?**

Fundamentally, the same barriers that inhibit the traditional financial system will inhibit crypto-assets. It is likely however, to be more profound in the crypto-asset sector due to newness and the burden of financial investigations in the sector. It is oft commented that regulators are under-resourced in fighting financial crime, that is only exacerbated by this new medium.

Governments slow, ad hoc, approach in developing a strategy has also inhibited it to date. Whilst some announcements e.g. around minting an NFT, seem ill-advised.

**Question 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?**

Opportunities:

* Greater control over own finances.
* Access to greater interest rates / cheaper borrowing.
* Quicker transaction times.
* Easier cross-border activity.
* Tech / app development that makes finance more intuitive.
* Digital property rights.
* Smart contracts.

Risks:

* Exposure to new kinds of financial loss / manipulation.
* Less transparency.
* Less accountability.
* Exposing individuals to less trusted businesses / entities.
* Financial crime that is more difficult / expensive to investigate.

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

No view offered.

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

Government have engaged in a few cryptocurrency consultations since 2015, however these have not always led to meaning change, or resulted in the kind of follow-ups that were promised. To that extent, a cryptocurrency strategy appears to be developing slowly and in an ad hoc manner. However, it is pleasing to see engagement becoming more regular in the last two years, and to see the Law Commission undertaking work in the area.

The ‘crypto-sprints’ organised by the FCA are also an example of good practice in the sense that it increases engagement with the sector. That said, these could be perhaps criticised as being an echo-chamber in which crypto growth and favourable treatment are promoted, the one sided focus of attendees.

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

No view offered.

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

AML measures introduced by the UK are necessary in terms of meeting international obligations, and have been a proportional response to the threats posed by crypto-assets. In particular, the Travel Rule and de-minimis limit (£1000) for its application is a sensible measure which avoids overburdening the sector.

As ever, with developing technology, there are still gaps that emerge as new issues arise. A particular focus going forwards need to be on consumer protection for individuals engaging with stablecoins and crypto-lenders / crypto-banks. Practices and contractual terms offered by some operating in that sphere unfairly load market risk on to consumers, as well as permitting bad practice e.g. withholding of funds and a lack of transparency around backing of assets.

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

It would be fair to conclude that regulatory response to crypto-assets has been slow but steady. For the best part of a decade, the sector has had almost unlimited scope for innovation. If we compare for instance the development of mobile phones or automobile tech with cryptocurrency since Bitcoin’s inception in 2009, it is staggering that i) uptake is still comparatively low and ii) that the sector is still looking for its USP / its key use cases. It is imperative, moving forward, that the sector has to be on a level playing field with the financial services sector which it is aiming to compete with. At present, regulatory and enforcement deficiencies are still leading to scandal and crime (see for instance, issues surrounding the backing of certain ‘stablecoins’, and the bankruptcies of a number of ‘crypto-banks’.

By way of an example, it is entirely unpalatable that certain ‘crypto-banks’ reserve the right to withhold deposits either temporarily or permanently from consumers when there are unfavourable market conditions. They should be obliged to either return on demand (like traditional banks) or publish clearer criteria around withholding funds.[[1]](#footnote-1)

One factor that does need considered, is how traditional Bank’s approach cryptocurrency usage by their customers. At present a large number are choosing to de-risk in line with their anti-money laundering (AML) obligations and either prohibit payments to and from crypto-exchanges, and / or refusing to provide banking services to business operating in the crypto-sphere. Current regulation enable them to do this, if government considers encouraging growth of the crypto sector a necessity, then it should consider the negative impact of AML obligations and how they may be used as an excuse to inhibit growth of the crypto sector.

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

Regulation can play a significant role in improving consumer trust and resilience, but it must be proportionate. Regulation adds a level of legitimacy and security to any technology, and crypto-assets are no different. It is also important to note the role that enforcement and international coordination play in this mix. Just having regulation is insufficient to protect consumers and improve trust, there needs to be meaningful action should a crypto-asset fail or defraud customers, and that may entail working with overseas law enforcement / financial supervisors.

It is also important to caution that too strict an approach could diminish the appeal of crypto-assets particularly in terms of profitability and efficiency, as well as creating barrier to entry.

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

No view offered.

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

There can, at present, be little doubt as to the energy inefficiency of the crypto-asset sector (as a whole).[[2]](#footnote-2) There are however, some good initiatives within the sector for a greener future. Principally, some cryptocurrencies are moving from proof-of-work to the proof-of-stake consensus mechanism which reduces their carbon footprint – Ethereum, for instance, is due to make this change this year and they suggest the change will result in 99.5% less energy usage.

A narrative which is underexplored is the extent to which the carbon footprint of crypto-assets is ‘worse’ that of the formal financial sector. To some degree, this is irrelevant at the moment given the current differences in scale. But, going forwards if the government sees crypto-assets replacing some / all the functions of the formal financial sector, then an in-depth study into the carbon footprint of both is needed.

Should government decide to push ahead with crypto innovation and encouraging its adoption, then it may be wise to pursue methods for encouraging participants in the crypto sector to utilise green energy (e.g., financial incentives, championing green-crypto providers, or introducing a greater tax levy for non-green crypto).

1. For more, see: Matthew Shillito, ‘Crypto banks’ savings rates are ten times greater than high street, but are they safe?’ (the Conversation, June 2021) <https://theconversation.com/crypto-banks-savings-rates-are-ten-times-greater-than-high-street-but-are-they-safe-163026?utm\_medium=Social&utm\_source=Facebook#Echobox=1624031053> [↑](#footnote-ref-1)
2. For good, worked examples, see: OSTP (2022). Climate and Energy Implications of Crypto-Assets in the United States. White House Office of Science and Technology Policy. Washington, D.C. September 8, 2022. <https://www.whitehouse.gov/wp-content/uploads/2022/09/09-2022-Crypto-Assets-and-Climate-Report.pdf> [↑](#footnote-ref-2)