Bank Pulse: Does EU crypto regulation lay out the red carpet for banks?

As crypto markets are brought under the regulatory umbrella, banks may find it easier to enter the field. Yet a number of issues still need to be resolved

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The introduction of an EU regulatory framework for crypto assets edged one step closer in March as the European Parliament adopted the Markets in Crypto Assets Regulation (MiCAR). We discussed the layout of MiCAR extensively here, but in this article, we focus on the implications for banks.

As crypto markets have grown and developed in recent years, so has bankers' interest in them. Some banks are openly pondering the idea of offering crypto-related services, and some have stuck a toe in the water. The arrival of MiCAR would certainly make it easier for banks to offer crypto-related services, should they wish. MiCAR will make sure that separating the good and regulated from the potentially bad and ugly becomes a lot easier for customers, but that also applies to banks. They can transact and partner with fully regulated crypto counterparties. But it's by no means plain sailing from here onwards. Here are a few considerations for banks:

- **Prudential treatment**: MiCAR does not include the prudential treatment of crypto-exposures on banks' balance sheets. That will be covered instead by the EU Capital

Requirements Regulation, which in turn is based on guidance by the Basel Committee. A first Basel consultation ran last year, but it will be some time before the framework is fleshed out.

- **DeFi**: Should banks want to step into "decentralised finance" (DeFi), they will find that MiCAR has very little to say on lending and borrowing based on crypto protocols.
- **Stablecoin issuance**: MiCAR stipulates that stablecoin issuance requires an e-money license (for small stablecoins) or a banking license. Arguably this makes banks well-placed to consider issuing stablecoins from a regulatory perspective. Yet bank stablecoin issuance will likely have to take place via a separate, dedicated legal entity. The reason is that a stablecoin issuer is only allowed to invest in a restricted set of high quality and liquid assets, unlike a "normal" bank. So it is unlikely that an existing bank will be allowed to issue stablecoins alongside its deposits. In theory, some form of ring-fencing could be applied like with covered bonds or asset-backed securities, yet this does not appear to be what the drafters of MiCAR had in mind.
- **Business model**: While interest remuneration on stablecoin liabilities is prohibited, the restriction to high-quality liquid assets means that the interest margin to be made is limited. There may be a better business in offering stablecoin-related services to clients, than in issuing them.
- **Uncertainty**: The strong power MiCAR bestows on central banks to effectively ban stablecoin if they become too influential is a sword of Damocles hanging over any stablecoin initiative.
- **Central bank competition**: While Facebook has given up on its Libra/Diem initiative that motivated policymakers' restrictive approach to stablecoins, policymakers are not all of a sudden becoming stablecoin fans. The European Central Bank (ECB) is researching a central bank-issued "digital euro", which is a potential direct competitor to euro-stablecoins. ECB president Christine Lagarde has said she is "confident that we will move ahead" with the digital euro.
- **Sustainability**: Banks have to work out how they can reconcile their sustainability objectives with crypto energy use. If crypto energy use were to find its way in the EU taxonomy regulation one way or another, banks may face further incentives to engage in some crypto activities, but not in others.

While upcoming EU crypto regulation is a very welcome step forward and a key prerequisite for regulated financial institutions, it does not address all questions. For example, MiCAR has very little to say about DeFi lending. Another important question is to what extent stablecoins and central bank digital currencies will be allowed to co-exist. How crypto assets will be integrated into the EU's sustainability framework will also shape traditional financial institutions' presence in crypto services.

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