

Business

Regulator seeks feedback to enhance regulation of fiat-referenced crypto-asset arrangements

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(June 27, 2023, 11:28 AM EDT) -- Nearly five years ago, the Financial Stability Board (FSB) concluded that crypto-assets do not pose a material risk to global financial stability (see "Crypto-asset markets: Potential channels for future financial stability implications," FSB). Since 2018, different sources of risk have emerged in the crypto world which have brought forward new operational, cyber and governance concerns that could threaten Canadian and global financial systems (see "2021 Global Financial Stability Report," International Monetary Fund (IMF), p. 45).

Global stablecoins (GSCs) are a specific type of crypto-asset that maintain a stable value relative to a certain asset (most typically the U.S. dollar) or a pool or basket of assets and are distributed on trading platforms in exchange for a monetary value (otherwise known as fiat currency) (see "Crypto-assets and Global Stablecoins," FSB). Fiat-referenced crypto-assets (FRCs), or cash-based GSCs, are typically the most prevalent type of GSC and are fully backed by cash or liquid and safe assets, such as bank deposits and banknotes, and redeemable by the issuer at face value (see "Global Financial Stability Report," p. 47).

While GSCs offer an alternative means of payment and store value, the dollarization of these digital assets can impede effective implementation of regulatory measures by central banks, and lead to financial stability risk in global and domestic markets because of the variability in value (see "Global Financial Stability Report," p. 45). For example, in 2022, some of the largest GSCs in the world dropped significantly from their par value to the U.S. dollar (see "Global Financial Stability Report," p. 12), likely influenced by the bankruptcy of FTX in November 2022 (see "Global Financial Stability Report," p. 12). The unpredictability and variability of cryptomarket activities has garnered attention from Canadian decision-makers, financial institutions, international organizations and other

industry stakeholders.

Within the Canadian context, the Bank of Canada has previously expressed concern with the risk that FRCs pose to holders, the Canadian financial system and the economy (see "Potential benefits and key risks of fiat-referenced cryptoassets," Bank of Canada). When considering the potential effects of the fluctuation in value of FRCs, the interconnectedness of such assets to broader financial systems, and the lack of regulation and disclosure of FRCs, it may be that a stronger regulatory response is warranted in Canada.

Interim regulatory steps in Canada

The Office of the Superintendent of Financial Institutions (OSFI) issued an interim crypto exposure advisory in August 2022, effective at the beginning of a federally regulated financial institution's (FRFIs) fiscal Q2 2023 reporting period, with early adoption encouraged (the Interim Advisory). The Interim Advisory describes and categorizes crypto-asset exposures and sets out the expected capital

and liquidity treatment of exposures to crypto-assets (see "Interim arrangements for the regulatory capital and liquidity treatment of cryptoasset exposures," OSFI).

The Interim Advisory is the first step among many important measures that are outlined in OFSI's Digital Innovation Roadmap (see OSFI's Proposed Short-and-Medium Term Roadmap for an Evolving Digital Landscape) that seeks to advance notable policy work in this field, create a broader regulatory framework, develop supervisory practices to monitor conduct and engage with relevant stakeholders.

International recommendations

On Oct. 11, 2022, the FSB released a proposed framework for the international regulation of crypto-asset activities, pursuant to which certain high-level recommendations were introduced to improve international and domestic regulation, supervision and oversight regimes of crypto-asset activities (see "FSB proposes framework for the international regulation of crypto-asset activities," FSB). The recommendations are based on the principle of "same activity, same risk, same regulation" thus emphasizing the importance of a consistent and comprehensive approach to regulating crypto-asset activities.

The high-level recommendations can be grouped into three main principles:

1. Governance and risk management framework
 - e.g., FRC arrangements meet all applicable regulatory, supervisory and oversight requirements of any jurisdiction in which they operate before commencing operations in that jurisdiction.
2. Redemption rights, stabilization mechanism, and prudential requirements
 - e.g., the issuer of an FRC arrangement ensures there is an effective stabilization mechanism in place, clear redemption rights, and that it meets prudential requirements in order to maintain a stable value at all times and to mitigate run risks.
3. Data collection, record-keeping, and reporting
 - e.g., FRC arrangements have measures in place to ensure the completeness, accuracy and reliability of data, and have timely, complete and ongoing access to relevant data and information, wherever the data is located.

Next steps: Call for input from FRFIs on international recommendations

OSFI is now seeking input from FRFIs on the recommendations introduced by the FSB to help develop a Canadian-made risk management strategy for FRFIs that engage in crypto-market activities (see "Consultation on international recommendations related to, and risks posed by, fiat-referenced cryptoasset arrangements and activities," OSFI).

In addition to broad feedback, OFSI has invited responses to the following questions:

1. Are the international recommendations and OSFI's existing risk management expectations that relate to prudential regulation appropriate for FRFIs to address the risks associated with FRCs?
2. What potential gaps to complying with the recommendations do you see with respect to OSFI's current guidelines and advisories, if any?
3. Are there any key inherent risks to FRFIs that are not listed in Annex B of the consultation document? Considering OSFI's current guidelines and advisories, where do you see potential gaps to addressing these risks?
4. For what reasons might entities involved in FRC activities be interested in operating within, or staying out of, OSFI's regulatory regime?
5. Are there any other comments or considerations that you feel should inform OSFI's potential development of risk management guidance expectations on FRCs and activities, including with respect to custody issues (e.g., custody of cryptographic keys, tokens, or reserves, etc.)?

Feedback was requested by June 16, 2023.

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