Crypto-assets: To ban or not to ban?

Financial regulation is about striking the right balance between enabling innovation and ensuring customer protection

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Cryptocurrencies, or more correctly crypto-assets, may be a nightmare for regulatory policy but they are a columnist's delight! The number of op-ed words on this topic, just in the recent weeks, may now equal the purported number of Indian investors in these assets. However, the topic is important and multi-dimensional enough to justify one more column.

Crypto-assets in taxonomic rank are more like a genus and not a species. Put simply this is not a homogeneous group — and the characteristics and utility of one token, say Bitcoin, may be very different from another, say XRP. This divergence in qualities lends itself towards the confusion surrounding their classification — while some exhibit properties akin to securities, several do not.

Their origins may be as a (better) replacement for fiat currency— that is, as a medium of exchange. But the current difficult policy and regulatory questions in India arise in the context of cryptos as assets — that is, as a store of value. The argument for a ban on these is that, these are, (digital) assets with (arguably) no underlying value, that trade (almost exclusively) on speculation — rendering them an extraordinarily volatile asset class for the retail investor. Yet value, like beauty, lies in the eyes of the (be) holder. If 20 million Indians (and mostly young) hold these assets, then this expression of economic freedom needs to be respected and the argument to ban this needs to be made more carefully.

Over the past many decades in India, financial sector regulation has followed recurring patterns when confronted with a "disruptive innovation". In the heydays of socialism, the dominant instinct was to ban products that were not considered socially desirable. For example, the preamble to the erstwhile Forward Contracts (Regulation) Act, 1952, was explicitly "An Act to provide for the prohibition of options in goods" until its repeal in September 2015. However, risk management experts tell us the options in goods serve an important economic purpose and sure enough, options in goods were finally allowed in India in January 2020.

Post-liberalisation India moved from outright bans to "controls". For example, the 1998 expert committee on derivatives recommended controlled opening up of this market with a prohibition on some derivatives, for example, individual stock futures. Four years later, this was permitted, when the harmlessness of this "innovation" was established in the eyes of the regulator through observation of markets in other countries. The stock futures market on the National Stock Exchange now trades a daily volume of Rs 85,000+ crore!

Illustration: Binay Sinha

This approach towards financial sector "innovations" — of exerting restrictive control, while waiting and watching, is often justified as prioritising the immediate goal of investor protection. This has some merit, but should by no means be the automatic path to be taken by regulators. This is simply because this approach damagingly comes at the risk of stifling benign innovation, which could carry the weight of lost opportunities downstream. It will be useful to recall that many of the fintech products leading the charge towards financial inclusion and improving delivery of financial services today were not seen with the same confidence a few years ago. There were odd calls for their bans then, which thankfully were not acted upon. It is also useful to remember in this context that like fintech, there are strong links between crypto-assets and India's sunrise industry, IT services.

The Supreme Court's restraint of the Reserve Bank of India in *Internet and Mobile Association of India v. RBI* serves as a timely reminder to regulators and lawmakers that any action that restricts any occupation, trade or business must be reasonable, and within the scheme of Article 19(1)(g) of the Indian Constitution. In other words, unless there are unavoidable, tangible harms that necessitate a blanket ban on crypto-assets,

judicial scrutiny is likely to be tough. The burden of proof that rests on the government to show that larger public interest warrants a prohibitory approach in respect of these assets, has not yet been discharged.

If regulation, and not banning, is the agreed way forward, it is important to understand the reasons why Indian regulators did not act immediately on regulating this emerging, nay exploding, asset class. Regulators are bound by their existing mandates under their parent legislation on what they can and cannot do. When we consider “crypto-assets”, neither the RBI nor the Securities and Exchange Board of India (Sebi) are specifically empowered to deal with it. Reportedly, Indian regulators are fighting over turf— this time arguing that it is outside their respective turfs.

In part anticipation of this, the Financial Sector Legislative Reforms Commission in March 2013 had said that “the present arrangement has gaps where no regulator is in charge”.

Presciently, it noted that “over the years, these problems will be exacerbated through technological and financial innovation”. Based on this and other relevant considerations, the report recommended the setting up of a unified financial agency that would implement consumer protection law and micro-prudential law for all financial firms other than banking and payments. It is time for us to revisit the unified financial regulatory architecture so that we are not looking for the right agency to regulate an activity while unregulated activity thrives often at the expense of gullible consumers.

To sum up, usually innovation happens by taking liberties on the margins of law. It is often the regulatory framework that has to find a way to catch up and regulate it. Given the characteristics of crypto-assets, regulators ought to build capacity in, both, the technological and economic aspects of crypto-assets. When such assets are regulated, the extent to which investors/consumers are protected will depend on how much the regulator understands the asset. Fundamentally, the points of market failure in crypto-assets leading to risks for consumers are similar to those in other financial products and services. These are cyber security breaches, loss of savings, deceptive/unfair practices etc. However, the decentralised management of crypto-assets may also trigger unique points of market failure. Developing regulatory capacity to understand and monitor this activity is crucial for customer protection as well as preserving the incentive for innovation and entrepreneurship.

The writer is professor NCAER, member of a few for-profit and not-for- profit boards and former civil servant