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Banks and investors are apprehensive that the growing presence of crypto assets (CAs) could shake the edifice of European banking, impacting core activities like lending, deposit taking, trading, and investments. Those concerns may not be entirely misplaced, especially for banks that are digital laggards, but they are for the sector in general.

I am less concerned when it comes to banks that have made visible progress in comprehensive digital restructuring and which are keeping their eyes open to the transformative megatrends underway. Such groups are clearly better positioned for the emerging crypto world and may in fact find opportunities in it. Besides, as highlighted below, monetary authorities and financial regulators seem to be taking the growing presence of crypto assets seriously. This is encouraging.

To assess the crypto challenge for European banks, I am looking at cryptocurrencies and smart contracts/decentralised finance separately, although they are inherently linked. I also summarise a key EU regulatory initiative on CAs.

Cryptocurrencies vs central-bank digital currencies.

Blockchain-distributed private cryptocurrencies – Bitcoin, Dogecoin, Ether etc. – will not shake the solid foundation of fiat money: deposits, loans and transfers through regulated financial intermediaries (which in Europe are mostly banks).

At this time, they have mainly a store-of-value function (as trading, speculative, and investment products); much less a medium-of-exchange function – although more businesses in the US and elsewhere are now accepting Bitcoin as payment, from swanky purchases like Tesla cars and NFT art to booking trips through Expedia.

But as long as governments and central banks refuse to stand behind them – which is very much the case – cryptocurrencies will at best play a marginal transactional role. Governments and regulators poured cold water on the attempt by a Facebook-led consortium, announced nearly two years ago, to establish Libra (recently renamed Diem), a private digital currency referenced by high-quality assets.

A rumoured plan of the consortium may now be for Diem to become a white-label provider of central-bank digital currencies. This suggests that the initial project may have turned increasingly elusive, although it continues to be pursued.

Overall, I believe that private cryptocurrencies, as much as they will become more mainstream beyond crypto enthusiasts, will not compete against, let alone push aside, central-bank fiat money. Especially since as central banks in both developed and emerging markets are in various stages of investigating or even implementing their own digital currency initiatives.

Both the Bank of England and the ECB are pursuing digital currency investigations, with the aim to creating general-purpose digital pounds and euros. In the US, the Boston Fed is undertaking a research project on a digital dollar together with MIT – with first findings expected in a couple of months. China is at a more advanced stage, with a digital yuan already being launched in a few cities; the government having worked on this project secretly for a few years.

Smart contracts and decentralised finance

Banks should feel marginally more discomforted by the development of smart contracts, processed by a permissionless distributed ledger in open digital ecosystems like Ethereum. Smart contracts are self-enforcing agreements – structured as software with built-in legal compliance and controls – between participants over the internet who do not know or trust each other. When the pre-defined rules of the contract are met, the agreement is automatically enforced by majority consensus of the blockchain network.

What could raise questions about the future of the banking industry as we know it is the extent to which smart contracts may take hold of peer-to-peer (P2P) financial transactions, bypassing intermediaries such as banks. And thus, in time, threatening a source of core revenues for banks.

Decentralised finance (DeFi) – an increasingly popular term in the US – includes decentralised applications built on top of distributed ledgers and related to financial transactions using crypto tokens (payments, exchanges, sales, lending, insurance, derivatives, etc.).

However, the viability of DeFi in its current form in a European context is doubtful. First, although the DeFi environment exists and will keep improving, it is unlikely to be adopted on a large scale by businesses and individuals beyond a relatively narrow category of techno enthusiasts (investing in CAs is ipso facto not part of DeFi).

Second, to the extent that it will be carried out solely outside of the fiat-money system – which is in fact the *raison d'être* of the technology -- it should remain marginal compared to mainstream financial transactions. Third, and perhaps crucially, are regulatory barriers which, as shown below, make it hard to implement across Europe.

Having said that, smart contracts on permissionless blockchains may be increasingly used for financial agreements and transactions not based on CAs, which in fact is already the case in a growing number of instances. Therefore, the threat remains for P2P to bypass intermediaries such as the banks. This threat is more virtual now, but improvements in smart-contract technology and wider acceptance may turn it into a real threat for some financial intermediaries. Not so much where they risk being taken off the map but rather as a threat to core revenues.

Larger banks, especially those reaching high levels of technology sophistication, are well aware of this, and the use of blockchain is actually increasing within these groups. Including for debt issuance. Earlier this month, the European Investment Bank announced that it is preparing the issuance of a new bond through blockchain, using Goldman Sachs, Santander, and Société Générale as advisors. The latter two have already issued bonds using blockchain technology. The first blockchain-based bond came in 2018, from the World Bank.

As distributed ledger technology –a by-product of CAs but not uniquely applicable to them – is adopted on a wider scale, smaller and less sophisticated banks will find it difficult to compete. Especially as this is only one element of digital transformation. But, again, this is more an issue of some banks technologically lagging others, not of the banking sector being disrupted by CAs arriving via different channels.

State of crypto asset regulations in the EU

The European Commission's Digital Financial Package, adopted last September, includes a proposed regulation on CAs, the Markets in Crypto Assets Regulation (MiCA), which will supersede all national regimes related to this asset class. MiCA introduces requirements related to the issuance, offering and marketing of CAs, including the prevention of market abuse.

Overall, crypto regulation aims at four key objectives: providing legal certainty, supporting innovation, protecting the customers, and preserving financial stability. MiCA will apply to three categories of CA (tokens):

1 Asset-referenced tokens (including the proposed Diem)

2 E-money tokens (used as a means of exchange and pegged to a fiat currency).

3 Other CAs (a catch-all category including Bitcoin). Any CAs that constitute a financial instrument or equivalent (e.g. security tokens, e-money, structured deposits, etc.) would be covered by existing financial markets regulations (e.g., MiFID), not by MiCA.

Importantly, across the EU, CAs will have to be issued and managed solely by legal entities called CA service providers (CASP), to be authorised and supervised by national competent authorities. To the extent that CAs are classified as "significant" – meaning a large customer base, a high number of transactions, or a market cap exceeding EUR 1bn – CASPs will be supervised directly by the EBA, with annual re-assessments.

The obligation under MiCA that CASPs be legal entities will be a major hurdle for the European development of DeFi, in which issuance is decentralised, with no identifiable issuer. In addition, there are also requirements for CASPs on disclosure (publication of a detailed white paper before issuance) and capital size, which could keep away small players without the resources to comply with MiCA.

If the CASP is a credit institution already authorised under the Capital Requirements Directive (CRD), it will not require a separate CASP authorisation. This provides an inherent advantage to banks, which through passporting can even now issue, market and transact CAs across the entire EU.

Overall, MiCA looks like a very comprehensive set of regulations for the growing CA segment, which could serve as a blueprint for other countries' CA regulations, including the US.

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