Banking

Hong Kong central bank sees path ahead to rein in stablecoins

The proposed scope of regulated activities entails international stablecoin issuers to be licensed and have a detailed strategy to operate in Hong Kong SAR

By **Karry Lai**

January 24 2022

The Hong Kong Monetary Authority (HKMA) has launched a consultation on regulating stablecoins that market participants expect to eventually lead to harmonisation in how global regulators control asset-linked stablecoins as they proliferate. The proposal has led many to question how the HKMA will align these regulations with the jurisdiction's new and existing regulatory regime, and whether extraterritorial provisions can be built in to rein in

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The Hong Kong Monetary Authority (HKMA) has launched a consultation on regulating stablecoins that market participants expect to eventually lead to harmonisation in how global regulators control asset-linked stablecoins as they proliferate. The proposal has led many to question how the HKMA will align these regulations with the jurisdiction's new and existing regulatory regime, and whether extraterritorial provisions can be built in to rein in those that ignore the regime.

"The HKMA will likely look to align with the FSB [Financial Stability Board] and CPMI-IOSCO guidelines on stablecoins to ensure wider regulatory harmonisation," said Musheer Ahmed, founder and managing director at fintech advisory firm Finstep Asia. "The approach from individual jurisdictions is still evolving, however many regulators have voiced similar concerns to stablecoins as the HKMA. It is important the HKMA finds the balance in regulatory oversight and fostering innovation."

Jurisdictions around the world are looking closely at regulating stablecoins. In the US, the President's Working Group on Financial Markets has proposed that stablecoin issuers should be required to be insured depository institutions. In the UK, the HM Treasury's consultation on crypto-assets noted that stablecoin operators, issuers and service providers that reach systemic scale would be subject to regulation by the Bank of England.

"If the HKMA can act quickly on its proposal to license the majority of stablecoin activities, it will cement its lead in digital assets which also includes central bank digital currencies (CBDCs)," he said. "The race is on, but whether through HKMA regulation or from another country like the US, stablecoins' 'wild west' days are over."

Asset-backed stablecoins are expected to be even more important than CBDCs in the future. "The approach on asset-backed stablecoins in all major jurisdictions will eventually become very similar, except mainland China where stablecoins won't be allowed in the foreseeable future," said Yifan He, CEO at Red Date Technology, a blockchain-focused fintech company. "Most central banks are exploring CBDCs, but I believe that in the next five years, regulated asset-backed stablecoins will be much more important than CBDCs. I am glad that the HKMA is looking into this."

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Scope of regulated activities

The HKMA has indicated its intention to focus on activities related to payment-related stablecoins with particular attention on asset-linked stablecoins rather than algorithm-based stablecoins. It noted that "existing stablecoins are mostly asset-linked and predominantly pegged to the US dollar, and compared to algorithm-based stablecoins, asset-linked ones appear to be more prevalent in the market".

"Any central bank should only focus on asset-linked stablecoins, which are truly payment-related and have relatively low risk," said He. "Any other stablecoins, such as those linked with cryptocurrencies, should be considered securities, not payment-related."

Turrin agreed and said: "The HKMA has it right by focusing on asset-linked stablecoins as they are the most prevalent form whereas algorithmic stablecoins appear to be falling somewhat out of favour due to their higher risk profile."

The HKMA has proposed a list of activities that it intends to license by expanding the scope of existing regulation or introducing new legislation. These include the issuance, creation or destruction of stablecoins; validating transactions and records; storing the private keys providing access to stablecoins; and transmission of funds.

"I support all the activities to be licensed by the HKMA," said He. "Allowing non-government entities to issue payment-related stablecoins is always a big step for any central bank or government, every step should be regulated at least in the beginning."

"When the industry becomes more mature," he continued. "Some regulations may be lifted, such as facilitating redemption and transactions, and storing private key services."

The list of regulated activities nicely captures the activities of the stablecoin industry, said Turrin. "While the paper

It is evident that the HKMA is most concerned with payment-related stablecoins and wants to regulate their interaction with market participants in Hong Kong SAR, both retail and institutional.

“This is quite significant and draws out the need for many players to get a licence from HKMA, not just the issuers and managers of stablecoins,” said Ahmed. “Given the need for institutions to set up entities to carry out the relevant activities, it will mean that international stablecoin issuers will need to have a detailed plan and strategy to operate in Hong Kong SAR, and not just rely on providing these services remotely or through partners.”

This means firms will need to potentially create new nodes that specifically cater to the Hong Kong SAR market. “Most fiat-backed stablecoins are based in the US, with their treasury being stored in US assets so they may need to potentially create treasuries locally in Hong Kong SAR, but they can do so given that Hong Kong SAR is a major hub for US dollar flow in Asia,” said Ahmed. “We need some clarity from the HKMA given some of these activities, such as validation and transmission of funds, are essentially executed by software programmes that govern stablecoins.”

The number of activities proposed to be regulated could prove to be somewhat onerous for current stablecoin players. “On the other hand, given the HKMA intends to increase investor protection and monitor and mitigate associated risks with stablecoins, the regulations will mean only serious players who are keen to grow in the Hong Kong SAR market will participate, deterring the players who are keen to stay away from regulatory oversight,” he said.

It will also mean that other players in the digital asset space who were previously not regulated, such as entities engaged in validating transactions and records, and in storage of private keys providing access to stablecoin, will now need to be regulated and deal with associated regulatory obligations and costs.

However, Joshua Chu, consultant at ONC Lawyers, pointed out that regulators wishing to regulate stablecoins should keep in mind that a regulator is only the master of its own jurisdiction. “By denying companies outside of the jurisdiction a licence, investors who still want access to the market will find ways around it,” he said. “In the absence of a cross-border agency, driving operators away from Hong Kong SAR might not be the way to go.”

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Regulatory challenges

The HKMA faces the same challenge as many other jurisdictions in trying to squeeze stablecoins into existing regulatory frameworks. Work is already underway to introduce a virtual asset service provider (VASP) licensing regime in 2022. Changes will also need to be made to the existing Payment Systems and Stored Value Facilities Ordinance (PSSVFO) system that covers stored value facilities (SVF).

“While the proposed VASP regime is for securities and financial services, the SVF is for payment-related

An overhaul of the regulations is expected to encompass stablecoins. “It would seem impossible to fit stablecoins into the SVF framework, which was designed for stored value cards like Hong Kong SAR's ubiquitous octopus card,” said Turrin.

The proposed VASP regulations which is being designed with the intent of enhancing AML and CTF (counter-terrorist financing) would seem a more natural fit. However, these regulations would “require a thorough overhaul” to capture stablecoins and their “voluntary opt-in nature will certainly be the first thing to go”.

However, implementation will be difficult as some coins could potentially be used within Hong Kong SAR, with total disregard for the laws in place. “It will be interesting to see if HKMA will build in extraterritorial provisions to the law which allows it to go after stablecoins that ignore the licensing scheme,” said Turrin.

SFC and HKMA will need to harmonise the regulatory framework so that there is no ambiguity on regulatory oversight for these specific activities, similar to how the regulators have aligned oversight in the banking industry. “There will likely be harmonisation on the AML and client onboarding guidelines,” said Ahmed. “Some overlaps could occur when it comes to activities such as staking in the digital asset world.”

As for the SVF regime, there are only limited number of licences issued and these are straightforward under a single licence. However, the proposed regulations are more nuanced and aim to separately license sub-activities in the end-to-end stablecoin process.

“It will be interesting to see what the capital requirements will be for the stablecoin licence, given that the capital requirements in SVFs are relatively low (HK$25 million/$3.2 million) as SVF licensees are essentially holding and managing transmission of fiat capital,” said Ahmed. “Secondly, the HKMA will need to also consider covering activities of lending of stablecoins, which is different to the SVF license where there are no lending activities.”

The consultation paper could elaborate on what the HKMA’s regulatory strategy is for existing stablecoins. “Pending future regulation, will any regulator be pursuing any current stablecoins that are derivatives, SVFs, debt securities or deposit products?” said Urszula McCormack, partner at King & Wood Mallesons. “There needs to be a focus on how Hong Kong SAR will choose to differentiate between different types of custodians going forward.”

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