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The need to regulate cryptocurrencies is loud and clear

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In March 2020, in a magisterial judgement, the Supreme Court set aside a circular of the Reserve Bank of India (RBI) that banned regulated entities from providing any service related to the purchase and sale of virtual currencies. Although the SC reaffirmed RBI's power to regulate such currencies, it said any restraint or regulation must be exercised with proportionality and responsibility, backed by adequate empirical evidence. This set the stage for the regulation of cryptocurrency. Rather than stifle innovation, regulation must foster the development of this sector for it to fulfil its potential for financial inclusion. It can aid international remittances and reduce transaction costs in payment services, all of which were recognized by the Financial Action Task Force (FATF) as far back as 2014, even while warning of the risks of money laundering and terror financing. Regulation should fill the breach, following the SC judgement, removing uncertainty while also mitigating the risks presented by cryptocurrency.

Whether any product, service or activity merits regulation and supervision depends on the risk of potential market failures or externalities that could imperil financial stability. In addition, asymmetries of information and negotiation power could create the need to protect consumers and investors from abuse. Cooperation between sectoral and jurisdictional regulators will prevent regulatory arbitrage.

Cryptocurrencies present a multiplicity of risks, some of them unique to such assets. Most crypto-assets are not backed by tangible assets or other securities, and may have no clear intrinsic value (stablecoins are exceptions). This weakens price discovery and heightens the risk of market manipulation. The lack of comparable information on such products, together with intrinsic technological complexities, warrants regulatory attention on consumer protection, and adequate disclosure and transparency.

An FATF report to the G-20 underlined anonymity and layering as intensifying the risks of money laundering and terror financing, particularly so in the context of anonymous peer-to-peer transactions through unhosted wallets. Disintermediated transactions may allow efficiencies, but also the circumvention of anti-money laundering rules.

Non-unique crypto risks may include the operational risk of hacking, as also the usual market, credit and counterparty risks—in the absence of regulatory protections such as deposit insurance or a liquidity facility from central banks—that non-bank finance products grapple with, too.

Cryptocurrencies could suffer firesales, which could have systemic implications, as with some other financial products. Crypto-service providers could face bankruptcy, especially if their clients' coins and tokens are mingled with their other assets, in the absence of a regulatory framework that requires a remote custody arrangement. If the service provider is a regulated bank, crypto-asset holdings could make the resolution of its insolvency more complex, which in turn could have wider financial-stability implications.

A regulatory system must be in place before we can address the question of taxing crypto trades

Crypto-asset providers and issuers are increasingly engaging with traditional financial institutions and modifying the competitive landscape, thus giving rise to prudential risks that could spell contagion risks. A global fintech survey conducted by the International Monetary Fund and World Bank in early 2019 found that most jurisdictions agree that while crypto-assets present risks to investors, they do not yet threaten financial stability. In March 2019, the Basel Committee on Banking Supervision released a statement on crypto-assets saying that their growth could raise concerns of financial stability. Regulators must therefore consider monitoring these developments to analyse emerging risks and identify significant vulnerabilities.

It is clear that regulators should take a proactive approach to address the above concerns.

India's central bank could deploy a range of measures to develop regulation that harnesses the potential of this emergent technology. Its regulatory sandbox could experiment with the development of crypto products in a controlled environment. This will help enhance confidence among market stakeholders and also build regulatory and supervisory capacity, while permitting empirical evidence to be garnered on possible risks. The innovation hub to be set up by RBI could also encourage the use of blockchain crypto-products for financial inclusion. As a matter of regulatory governance, RBI should put out proposed regulations for public discussion, engage industry players and conduct a regulatory impact assessment of such rules. This will enhance the quality of regulation as well as give cryptocurrency greater legitimacy. Finally, RBI could also mine the potential of regulatory technology (or 'regtech').

It is also pertinent to note that depending on what RBI permits in terms of cryptocurrency transactions, the likely impact of the same from a taxation perspective shall also have to be examined. On a prima facie basis, unless a specific dispensation is granted to cryptocurrencies, it appears that goods and services tax (GST) shall be payable on their trades, unless they are specifically included in the definition of 'financial instruments' (such as a wallet, payment system or security) and are therefore not to be classified as 'goods'. However, the actual leviability of GST can be determined only on the basis of what is regarded as permissible from a regulatory perspective.