



## **Discussion Paper: Proposed Approaches to Regulation of Crypto Assets in The Bahamas**

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November 7, 2018

# 1 Executive Summary

When referring to the various types of tokens, international regulatory convention has settled on “crypto assets” rather than “cryptocurrencies”. The Central Bank supports this nomenclature, as it clearly distinguishes between central bank issued fiat currency, and private sponsored innovations that rely on cryptographic or distributed ledger technology.

This paper describes the proposed regulatory posture on crypto assets and related instruments for supervised financial institutions (SFIs) under the remit of the Central Bank of The Bahamas. This includes the application of the Exchange Control (EC) regime. Section 6 provides interested stakeholders with an opportunity to comment on the framework.

The Central Bank will impose constraints on the range of crypto instruments in which SFIs may transact--either directly on balance sheet or from an associative point of view. The Bank will also prohibit direct convertibility between Bahamian dollar (B\$) currency or officially sanctioned B\$ crypto instruments and foreign currency denominated crypto assets or non-resident sponsored instruments. This is consistent with the current EC requirements. For transactions involving Bahamian residents and non-residents, commercial banks (authorised dealers) are still charged with conversion into and out of domestic currency.

The Central Bank has identified scope for amendments to the Payments Instrument (Oversight) Regulations, 2017 (PIOR). This will ensure comprehensive coverage of both Bahamian dollar and foreign currency denominated crypto payments instruments. However, it is likely that only Central Bank sponsored digital currencies, or payments instruments fully backed by Central Bank issued currencies or legal tender deposits, will be eligible for issuance by licensed payment services providers.

Crypto assets and the associated technological platforms (such as distributed ledger technology), may offer fast, accurate and secure record keeping. They may also allow for increased payment efficiency (in-country and cross-border), with lower transaction times and costs. Because transactions can be made on a peer-to-peer basis without financial intermediaries, these technological advances can readily be used by unbanked populations. This has the potential to increase financial inclusion worldwide.

The Central Bank supports a modernized financial services sector, with focus on financial technology (fintech) innovations. The regulatory framework must evolve in an appropriate and proportionate fashion to support these developments. In so doing, the sector’s competitive posture must be enhanced--without compromising the integrity or international reputation of The Bahamas. Or, undermining the financial safety of Bahamian households. These considerations are consistent with international best practices and influence the Central Bank’s proposed approach to crypto products.

The regulatory oversight for fintech product innovations is shared between the Securities Commission of the Bahamas (SCB) and the Central Bank. Although this is a collective undertaking, the Commission is leading the effort to determine which product innovations fit into the securities industry space. Their results will further define the range of instruments and practices in which Central Bank SFIs can engage.

## 2 Understanding Crypto Financial Instruments

In the fintech space, crypto financial instruments can assume a variety of features, each with different purposes. While the term “cryptocurrencies” has been widely used to denote instruments that simulate money or central bank issued currencies, it has also covered broader categories of digital tokens originating from “initial coin offerings” (ICOs).

The “crypto” label is derived from the cryptographic technology and algorithms used to provide features such as secure, authenticable, immutable records on the existence, origin and ownership of instruments, where ownership rights are conferred through digital tokens or “coins”.

These digital tokens can represent a range of assets, such as: actual ownership in companies or ventures; earnings streams or interest payments; entitlement of access to services; or entitlement of use for payments. Based on the distinct features, or intended use, the most common forms are: (i) payment; (ii) security; and (iii) utility tokens. However, some products are not easily classified.

**Payment tokens:** Commonly known as a cryptocurrency, a payment token can be a store of value and a unit of measurement (e.g. Bitcoin).<sup>1</sup>

As digital representations of value, payment tokens can be traded. Like central bank issued currency, they are supposed to function: (i) as mediums of exchange, (ii) units of account, and (iii) stores of value. However, they do not have legal tender status, are not guaranteed by any jurisdiction, and face well-documented challenges meeting these three functions.<sup>2</sup> They also lack the capacity to be used by their issuers, or owners, to support “lender of last resort” operations.

**Asset-backed or security tokens** are a digital representation of an actual asset or revenue stream. They may also include rights to exchange the tokens for the physical asset, or for equity or debt interests in the entity.

**Utility tokens** represent a right to a good or service, similar to a gift card (e.g. StorjCoin).

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<sup>1</sup> <https://www.oecd.org/finance/OECD-Blockchain-Primer.pdf>

<sup>2</sup> Mark Carney, 2018, “The future of money”. Speech given to the Inaugural Scottish Economics Conference, Edinburgh University 2 March 2018. <https://www.bankofengland.co.uk/-/media/boe/files/speech/2018/the-future-of-money-speech-by-mark-carney.pdf>

In the crypto asset space, the regulator must determine whether according to the underlying features or use(s) of digital tokens, they meet the characteristics of financial products and services that are already regulated. In those instances, they will attract similar or “like” regulatory treatment.

### 3 International Regulatory Expectations

As with all innovations, the introduction of payments focused crypto assets and enabling technological improvements poses some risks. In addressing these, the Central Bank intends to take an approach which aligns with best practices on oversight of crypto instruments, as elaborated by international standards setting bodies (SSBs) and multilateral authorities. These include the Financial Stability Board (FSB), International Monetary Fund (IMF), the International Organisation of Securities Commissions (IOCSO) and certain committees operating under the umbrella of the Bank for International Settlements (BIS): the Basel Committee on Banking Supervision (BCBS) and Committee on Payments and Markets Infrastructures (CPMI).

These bodies have highlighted several important areas of concern. Those concerns which do not relate to the essential properties of money can be countered through regulation. However, the other challenges are risks which consumers and investors must consider when holding, or transacting with, crypto assets.

The key challenges raised by SSBs include the following:

- *Tax evasion*—When conducted on a peer-to-peer basis, cross-border transactions using crypto assets tend to be anonymous. This creates opportunities for individuals to evade tax.
- *Unstable valuation caused by fluctuating demand*—The absence of central issuers with mandates to guarantee stability, combined with the constant influx of new crypto assets into the marketplace leaves them susceptible to large valuation changes, including a collapse to zero value.<sup>3</sup>
- *Fraud*—The sale of these assets via initial coin offerings (ICOs) is mostly unregulated, leaving consumers susceptible to fraud. Consumer protection advisories have been issued by a number of authorities, warning customers that by investing in crypto assets they are vulnerable to theft, hacking, phishing and investment fraud.
- *Scalability*—Maintaining decentralised, “trustless” systems has led to volatile, unpredictable transactions costs. Therefore, payment tokens do not always prove cost effective for low-value transactions. There is also uncertainty about the length of time that it takes to confirm transactions. When coupled with price volatility, these attributes diminish their usefulness as reliable stores of value or mediums of exchange.

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<sup>3</sup> <https://www.bis.org/publ/arpdf/ar2018e5.pdf>

- *Money laundering and/or terrorist financing*—Decentralised systems are especially vulnerable because of anonymity risks. In many instances, there is no name or other customer identification attached to the crypto asset; no trusted central server or service provider, or issuing authority; no central oversight body; and no available anti-money laundering (AML) software to monitor and identify suspicious transaction patterns. The inherent pseudonymity of virtual currencies, combined with their global reach, make them ideal vehicles to conceal the identity of the originators of fund transfers, and the destination of end-users. Because they permit transfers where senders and recipients may not be adequately identified, crypto assets can be, and have been, used to facilitate money laundering and terrorist financing. The Financial Action Task Force (FATF) has already provided some guidance on managing the risks of virtual currencies when they function as payment products and services.<sup>4</sup>

In addition to AML/CFT considerations, SSBs have focused on investor protection standards, advocating that regulations should treat crypto products and services similarly when they serve like purposes as products provided through the regulated financial sector. However, fragmented regulatory approaches at the international level could make it difficult to manage emerging risks in the fintech arena.

## 4 Developing a Bahamian Approach

The Central Bank's considerations will vary depending on the type of token involved, limited in some cases to Exchange Control Regulations, in others to the Payment Systems Act, 2012, and yet others to prudential considerations for the Central Bank's supervised entities (SFIs). Additional adaptations will be made in consultation with the SCB regarding its SFIs, and the evolution of regulatory standards for the securities industry generally. That said, when the instrument's purpose is to confer digital access rights as a utility token, there may be no obvious connection to the Central Bank's remit, other than the application of the Exchange Control Regulations. This would also be the case for asset-backed/security tokens, where the determined jurisdiction of the SCB may also apply.

### 4.1 Payments Instruments

For **payment tokens**, the Central Bank assesses that the regulatory treatment of the crypto asset would be captured by the provisions of the Payment Systems Act, 2012 (PSA). The PSA defines a payment instrument as "any instrument, whether tangible or intangible, that enables a person to obtain money, goods or services or to otherwise execute payment transactions." The Act does not confine itself to the currency denomination of the instrument, even though its regulations (the PIOR), specifically address Bahamian dollar (B\$) instruments. Therefore, we accept that the

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<sup>4</sup> <http://www.fatf-gafi.org/media/fatf/documents/reports/Guidance-RBA-Virtual-Currencies.pdf>

PIOR will have to be amended to close any gaps concerning domestic payment services in foreign currency instruments. In any event, non-fiat based instruments in B\$ are already within the scope of the regulations.

The PIOR already address many of the concerns articulated by the SSBs, such as reserve requirements, liquidity and consumer protection. The regulations also stress the fitness and propriety of individuals who provide electronic money services, safety and soundness of operations, and anti-competitive practices—especially when operations become systemically important. Thus, any business contemplating operations in, or from within The Bahamas would have to demonstrate safe and sound business practices; show that they have systems in place to measure, monitor, and adequately control market and other risks; and ensure that they have in place auditable policies, practices and procedures to prevent the use of their services for criminal purposes. The PIOR are also explicit about AML and related safeguards that apply to payment services.

The Bank will not sanction issuance of B\$ payment tokens in any format which deviates from the current framework in the PIOR. That is, obligations must always have identical value to Bahamian dollar funds held to the account of the subscriber to the payment services. The Bank will take the same approach to any instrument that appears to function as a B\$ payment instrument and is valued on any intrinsic basis other than the amount of B\$ used to acquire it. This eliminates the prospect of any non-central bank issued (or backed) digital payment instrument.

## 4.2 Treatment of Central Bank Supervised Financial Institutions (SFIs)

The Central Bank is taking a conservative stance on SFIs' exposure to crypto-instruments. Although these institutions may establish some direct exposures to certain crypto assets, they must be fully aware of the attendant risks, and maintain the appropriate frameworks to manage them. Stringent capital and liquidity standards will apply. As a starting position, in the absence of clear evidence of fundamental value, net long positions in crypto assets held on SFI balance sheets must be deducted from CET1 capital for capital adequacy purposes.

### 4.2.1 Issuance of ICOs

As banks have successfully raised funds through initial public offerings (IPOs) in the past, ICOs for asset tokens and security tokens that have similar properties as shares would be supported. Conversely, direct issuance or sponsorship of non-fiat linked payment tokens will not be supported. Banks are already empowered to issue electronic money, linked to either credit or deposits, which can be disposed of digitally. Banks may exploit blockchain technology to manage such claims more efficiently, subject to extant regulations and guidance on outsourcing risks.

#### 4.2.2 Sponsorship/Promotion of ICOs

SFIs may act as sponsors or promoters of ICOs, as long as they create no on balance sheet obligations, or fall within the range of prohibited payment tokens. They may only act as agent in these offerings to facilitate sales on a best-efforts basis. In such cases, the prior consent (or non-objection) of the Central Bank must be obtained. In reviewing proposed sponsorship of ICOs, the Central Bank will determine whether the offering would meet the definition, and satisfy the requirement of a sanctioned instrument under the PSA, or be subject to any regulatory oversight criteria that the SCB may establish. If the instrument falls outside the scope of either regulated framework, the Central Bank may still object to the ICO on the basis that it poses unmanageable risk to the SFI or The Bahamas.<sup>5</sup>

An ICO will be considered sponsored by a central bank SFI where any of the following criteria is met:

- The offering creates a direct claim on or obligation of the SFI;
- The SFI underwrites or guarantees the offering;
- The SFI sells or markets the offering; or
- The marketing of the offering either implies an association with, or carries the endorsement of, the SFI.

#### 4.2.3 Acceptance of Crypto-Deposits/Assets from Clients

Supervised entities may only accept crypto assets from clients to keep in custodial arrangements. When accepting these assets, they are required to conduct comprehensive due diligence, with additional scrutiny of: (i) the source of funds used to acquire the crypto assets; and (ii) the origination of the assets, whether obtained via a transfer or mining activities. The SFIs should also obtain a list of beneficiaries and signatories on the crypto asset custody account.

Banks are not to accept “cryptocurrency” deposits on balance sheet, or to extend such loans to customers. Also, given the price volatility and uncertainties around valuation, crypto assets held “in custody” cannot be pledged as collateral for other loans. Similarly, banks are not to extend credit to clients for the purchase of crypto assets.

SFIs will likely be prohibited from conducting transactions involving crypto assets (such as Monero, Particl, Dash and Zcash) that are intentionally designed to hide details about end users’ identity. When new clients wish to use custodial services, they must satisfy enhanced customer due diligence (CDD) requirements, and where applicable, provide their public key to confirm that they are the beneficial owner of the crypto asset. These and other safeguards are to ensure that ALL banks operating in and from within The Bahamas do not facilitate crypto assets “in custody”

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<sup>5</sup> These may include inadequate AML/CFT safeguards, potential exploitation of consumers/investors protection gaps, and anonymity features.

from clients wishing to engage in tax evasion, money laundering, terrorism financing, or other illicit activity.

#### 4.2.4 On Balance Sheet Investments in Crypto assets

SFIs may only invest in crypto assets and/or entities heavily exposed to crypto assets with shareholder funds—not client deposits. When doing so, they will be precluded from holding instruments that are designed to remain anonymous. When considering investment in permitted assets, a rigorous due diligence process should be conducted to understand the relevant risks, and the transaction should be approved at the board-level.

#### 4.2.5 Prudential Treatment of Exposures

The Central Bank’s prudential treatment of crypto assets held by SFIs will be aligned with the Central Bank’s treatment for higher risk category assets. As such, if an SFI invests in crypto assets, a direct deduction will be made to Common Equity Tier 1 (CET1) capital. Aside from capital considerations, investments in crypto assets would be subject to other prudential standards such as those that related to large exposures, market risk etc., as applicable.

Because they exhibit high price volatility and relative illiquidity, payment focused crypto assets are considered riskier than fiat currencies. Such holdings will not be included in the stock of high quality liquid assets. Instead, they would fall into the category of “other assets” for the purposes of the Basel III liquidity requirements, and would not be considered readily accessible to meet obligations that are coming due. By implication, crypto assets would not be eligible to meet reserve requirements or liquid assets requirements.

Our initial findings suggest that the accounting treatment of many crypto assets will meet the definition of intangible assets and are, therefore, within the scope of International Accounting Standards (IAS) 38. When purchased, the crypto asset will be measured at cost. Thereafter, it may be measured using the cost method or revaluation method. Under the cost method, any loss in value would be reflected in the profit and loss statement. The revaluation method would only be used if there was an active market for the crypto asset. Under this method, the statement of financial position would reflect its end of period fair value, with increases in fair value recorded in other comprehensive income, and decreases recorded as profit or loss.<sup>6</sup> Notwithstanding these initial considerations, there appears to be no definitive accounting treatment for crypto assets at this time. The Central Bank will invite input from the Bahamas Institute of Chartered Accountants (BICA) to obtain more insight into how international accounting firms are categorizing and valuing crypto assets.

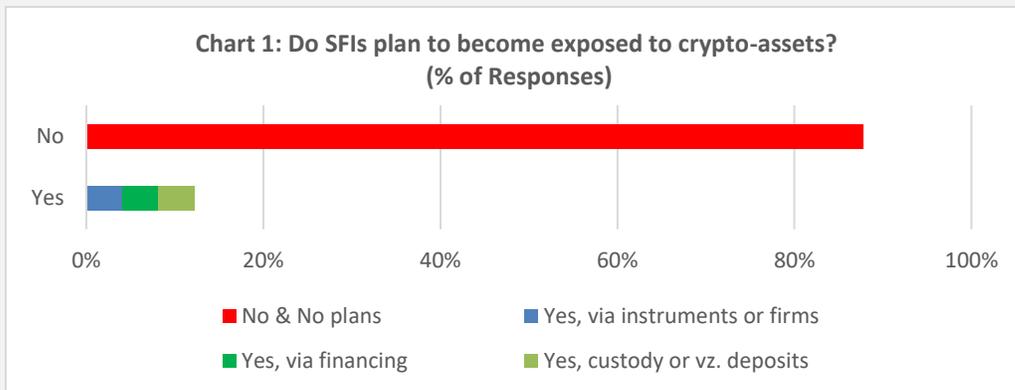
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<sup>6</sup> An Introduction to Accounting for Cryptocurrencies issued by the Chartered Professional Accountants Canada May 2018) <https://www.cpacanada.ca/en/business-and-accounting-resources/financial-and-non-financial-reporting/international-financial-reporting-standards-ifs/publications/accounting-for-cryptocurrencies-under-ifs>

### Box: Stocktake of Crypto Asset Exposures among Supervised Financial Institutions in The Bahamas

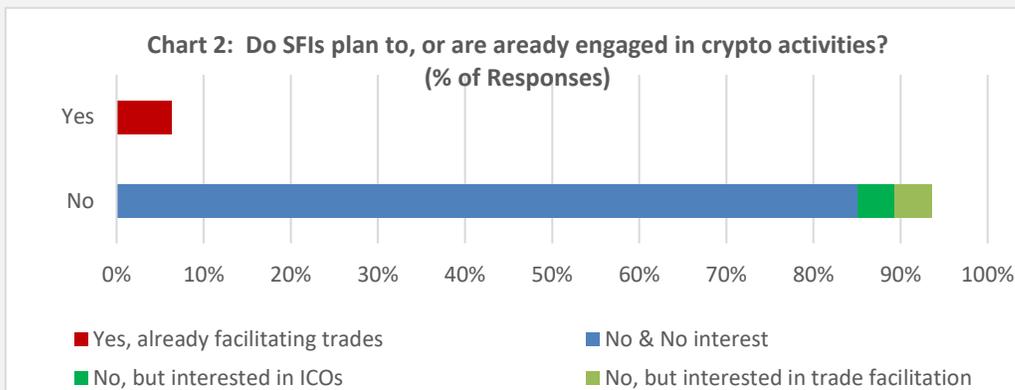
Over the period 17-26 October, 2018, the Central Bank of The Bahamas conducted a crypto assets survey of all banks and trust companies. There were 49 respondents to the survey, approximately half of the supervised public entities (or SFIS). The results indicate extremely minimal involvement and very limited intentions to engage in crypto asset exposures or activities. A limited number of institutions have already adopted corporate level policies, suggesting minimal appetite for entering the space.

As to disclosed activity, virtually all of the respondents (94%), indicated that their institution had no exposure to crypto assets. Only one entity disclosed some involvement on a custodial basis for clients. Two other SFIS reported that they had facilitated the purchase of crypto assets on their trading platforms and over-the-counter.



Source: Central Bank of The Bahamas Survey

Generally, even where a corporate level policy was not present, Bahamian banks and trust companies did not plan to venture into the crypto asset space. In particular, approximately 84% of the respondents (41 SFIs) indicated that they were not planning to become exposed to crypto assets in the future. There were 8 respondents that wanted to have exposure to crypto assets; but 6 of them had no corporate policies in place to govern these intended activities.



Source: Central Bank of The Bahamas Survey

Of the 8 respondents that wanted to have exposure in the future, 3 respondents indicated an interest in providing services to clients through (i) financing the purchase of crypto assets; (ii) holding such assets in custody; and (iii) accepting cryptocurrency deposits. There was an interest by 4 respondents in facilitating clients in their purchase of crypto assets through the issuance and promotion of an initial coin offering (ICO) of payment tokens, trading platforms and over-the-counter transactions. Further, 2 respondents indicated that their institutions planned to act on their own behalf, by investing directly in payment tokens and, to a lesser extent, indirect exposure through investments in companies heavily exposed to crypto assets.

17% of respondents (8 SFIs) had corporate level policies for dealing with crypto assets. Of those with policies, 2 respondents had plans to become exposed in the future, and the remaining 6 had decided by policy to avoid such exposures.

The survey feedback also revealed general interest in receiving regulatory guidance or clarity on the regulatory posture on crypto assets. This includes the application of AML/CFT standards and an understanding of how the regulations would apply to SFIs' involvement with various crypto asset instruments.

The Central Bank expects that SFIs risk management policies and procedures will be commensurate with the risks associated with direct and indirect exposure to crypto assets. However, the Bank reserves the right to require that SFIs liquidate such investments if concerns about risk management or capital allocations arise.

### 4.3 Exchange Control Considerations

The Exchange Control (EC) Regulations govern investments into and out of foreign assets and the convertibility of Bahamian currency to facilitate residents' movement into, and out of, foreign assets.

Unless they are denominated in Bahamian dollars and sponsored by resident entities, the Central Bank views crypto assets as foreign assets for EC purposes. Residents are entitled to invest in these as they would any foreign assets. In this case, the investments may only be funded with foreign exchange purchased through the investment currency market (ICM). The use of credit cards to purchase crypto assets does not negate the fact that there is an intervening settlement in foreign currency, and hence a sale of foreign currency.

The Central Bank already receives and processes requests to fund crypto assets purchased through the ICM. Pending reforms will transfer responsibility for direct purchases and sales of ICM to commercial banks. This revised framework is expected to improve monitoring and compliance on portfolio transactions, including instances where credit cards have been used to circumvent the ICM process. The existing investment currency framework provides access to investment currency, and allows residents to maintain foreign currency denominated trading accounts at trust companies (authorised agents). The bid rate refers to the premium payable by the applicant for the purchase of investment currency. The offer rate refers to the premium payable to the applicant on the initial approved investment amount, once the asset is sold and the proceeds of the sale are repatriated to The Bahamas. As at February 2018, the bid and offer rates are 5% and 2½%, respectively.

Whether by credit card or direct use of foreign exchange, only licensed commercial banks (authorised dealers), are permitted to supply foreign exchange for foreign portfolio investments, including crypto assets. Bahamian residents will not have the ability to buy tokens or coins on any exchange and settle in Bahamian dollars.

Subject to the range of domestic (Bahamian dollar) instruments permitted by the SCB, residents will be allowed to invest in local crypto assets. However, for EC purposes, direct investments in such assets by non-residents will remain prohibited, aside from general accommodations that already apply for “like” portfolio instruments under Exchange Controls. Current accommodations apply to cross-listed regional securities on BISX or similar regulated exchanges, and temporary residents on work permits. That said, non-fiat based payment tokens are impermissible Bahamian dollar crypto instruments.

## 5 Summary

In clarifying the proposed scope of prudential regulation, payments system regulation, and the applicability of Exchange Controls to crypto assets, the Central Bank is fully considerate of international regulatory standards. Standard setting bodies have taken a cautious approach in such critical areas as concealment of criminal activity, investor and consumer protection, and prospective financial stability risks. There has, however, been widespread recognition of the benefits of fintech, both for secure and efficient delivery of products and services, and as a more effective enabler of risk-based regulatory compliance. The Bank welcomes further dialogue with all stakeholders on these issues.

## 6 Issues for Stakeholder Comments

Stakeholders are invited to offer general comments in the following areas:

- Do stakeholders agree with the proposed prohibition on use of intentionally anonymous crypto assets?
- Given the proposed prohibition on acceptance of crypto-deposits and issuance of crypto currency loans, is there a view on the establishment of specialized non-fiat focused crypto asset banks?
- Is there sufficient clarity on Bahamian EC treatment of crypto assets involving non-financial entities and persons?

## 7 Feedback on Discussion Paper

We request that all feedback on this Discussion Paper be provided by the **15<sup>th</sup> December, 2018** and should be submitted to the following address:

Policy Unit  
Bank Supervision Department  
[policy@centralbankbahamas.com](mailto:policy@centralbankbahamas.com)