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Senate Standing Committees on Economics
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Dear Secretariat,

Inquiry into Digital Currency

The Australian Bankers' Association (**ABA**) welcomes the opportunity to provide a submission to the Inquiry into Digital Currency.

With the active participation of 24 member banks in Australia, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services.

The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

Innovation is a key driver of efficiency and productivity and the advancement of economic growth and prosperity.

Australian banks constantly monitor developments in financial services including the emergence of new technologies, products and services and are in regular dialogue with the relevant authorities and regulators. As a general principle, the banking industry in Australia welcomes competition and supports innovation in banking and financial services.

As innovation occurs, government and regulators should consider the need for appropriate safeguards to protect the safety and soundness of the financial system and ensure similar consumer protections apply to similar technologies, products and services irrespective of the provider or issuer. With digital currencies, particular focus needs to be directed to preserving the integrity of the financial system, preventing the criminal use of the payments system, protecting the tax base and protecting the personal and financial information of consumers.

What is digital currency?

The Reserve Bank of Australia (**RBA**) defines digital currencies or virtual currencies as "essentially electronic transaction ledgers that record claims and changes to the ownership of each unit of the 'currency'. A virtual currency system can therefore be used to facilitate payments between people choosing to use that system."¹

¹ Reserve Bank of Australia, Submission to the Financial System Inquiry, March 2014

A digital currency has units of value that are created and transmitted through electronic networks. There are no controls in Australia on the creation or use of digital currency. Anyone can create a digital currency and offer it as a means of payment.

Some digital currencies can only be used for a designated purpose within the electronic network; others are more open and may be used as a means of exchange for real or virtual goods and services, and used to remit value to another person.

Much of the recent attention has been focussed on virtual currencies such as Bitcoin, Litecoin and Dogecoin. However, the broader class of digital currencies also includes merchant loyalty programs such as airline frequent flyer schemes, and dedicated digital currencies used in online games and virtual communities.

The payment mechanisms associated with some digital currencies have operational similarities to conventional payments systems utilising electronically stored bank deposits, credit and debit card transactions and electronic payments.

However, a key difference is that digital currencies are not subject to regulation or oversight. The financial institutions which lie behind deposits and credit and debit card transactions are regulated and supervised by the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission and the Australian Competition and Consumer Commission. The payments system is supervised by the RBA. Actions to combat money laundering and the financing of terrorism are overseen by the Australian Transaction Reports and Analysis Centre (**AUSTRAC**). There are comparable regulatory frameworks in other countries.

There are several additional features which set digital currency apart from other regulated means of exchange:

- It does not have the status of legal tender. It is not issued by central banks, or governments.
- The unit of value can be transferred directly from peer to peer outside the established payment and banking systems.
- The price of a digital currency in real money may vary in the same way that the price of a national currency can fluctuate in value against the currencies of other nations. In contrast, other forms of legal tender within the domestic economy have a fixed exchange rate with currency. For example, a dollar of deposits in a bank, or a dollar of value on a credit or debit card, can always be exchanged for a dollar of currency issued by the central bank.

Risks

The lack of transparency and regulatory oversight raises a number of risks for users and also poses risks for the payments system, the integrity of the financial system and the erosion of the tax base.

Given the risks, there is a need for a clear and settled legal and regulatory framework for digital currencies. This framework should be harmonised with other global governments and should have an appropriate balance of regulation and flexibility to allow innovation.

The ABA does not support a self-regulation model for providers of digital currencies or participants in the digital currency industry.

Other governments are beginning to address these risks.

In May 2014,² the US Government Accountability Office issued a report on virtual currencies to the Senate Committee on Homeland Security and Governmental Affairs. This looked at emerging regulatory, law enforcement and consumer protection challenges. It recommended that the Consumer Financial Protection Bureau identify and participate in pertinent interagency working groups addressing virtual currencies.

In July 2014, the European Banking Authority³ issued an opinion on virtual currencies. It identified more than 70 risks including risks to users, risks to non-user market participants, risks to financial integrity, risks to existing payments systems, and risks to regulatory authorities. It concluded that managing these risks would require a substantial body of regulation.

In August 2014,⁴ the UK Government announced it would look into how virtual and digital currencies could or should be regulated. It will look at the potential which virtual and digital currencies have for encouraging innovation, as well as the potential risks.

The Canadian Senate Banking Committee has commenced a study to examine the use of digital currencies in Canada, to report on their risks, threats, and advantages, and to make recommendations on their use. The reporting date is 30 June, 2015.

Systemic risk – payment system integrity and stability

The payments system is a vital part of the financial system. The system is regulated by the authorities to ensure it is soundly based, secure, and that the community can trust that the value of the currency or the means of payment will be preserved. Maintaining confidence in the safety and efficiency of the payments system is crucial to the public's ongoing trust and willingness to participate in the payment and banking systems.

To ensure the integrity and stability of the whole system it is crucial that all channels of payment are subject to the same regulatory oversight. In particular, it is critical to have in place uniform client identification, information security and reporting processes across all payment platforms.

Financial crime risk

Banks and other participants operating within the regulated payments systems have made significant investments in technology and processes and are required to meet AUSTRAC's anti-money laundering (AML) and counter terrorism financing (CTF) requirements to reduce the likelihood that transactions can be used for money laundering or for financing terrorism. The current global approach to combatting financial crime is predicated on an assumption of end-to-end visibility of ownership and control of funds.

Payments systems operating outside the regulated framework are not required to make these investments or to meet these standards and operational requirements. In its current form the *Anti-Money Laundering and Counter Terrorism Financing Act 2006* does not properly capture digital currencies because of a technical/legal deficiency. As such some digital currencies are at greater risk of being used for criminal activity because traceability cannot be ensured and balances can be transferred anonymously.

It is recommended that consideration be given to whether all digital currency payment mechanisms should be brought into the AUSTRAC AML/CTF regime. This would require digital currencies to be

² United States Government Accountability Office, Report to the Committee on Homeland Security and Governmental Affairs, U.S. Senate, *Virtual Currencies, Emerging Regulatory, Law Enforcement, and Consumer Protection Challenges* published May 2014 and released publicly June 2014.

³ European Banking Authority *Opinion on 'virtual currencies'* 4 July 2014.

⁴ HM Treasury media release, *Plan to make Britain global centre of financial innovation set out by government*, 6 August 2014

included in the statutory review that the Attorney-General is currently undertaking of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006*.

Some regulatory actions have been taken in other jurisdictions.

In the USA regulatory steps include:

- The issuing of guidance in March 2013 by the Department of the Treasury's Financial Crimes Enforcement Network (**FinCEN**) clarifying which participants in virtual currency systems are subject to anti-money laundering requirements and which virtual currency exchanges are required to register with FinCEN.
- Financial regulators have taken actions regarding anti-money laundering compliance and investor protection.
- Law enforcement agencies have taken actions against parties alleged to have used virtual currencies to facilitate money laundering or other crimes.
- Federal agencies have begun to collaborate on virtual currency issues but primarily on money laundering and other law enforcement matters.

The Canadian Government has introduced legislation to Parliament that allows the Government to police online casinos and requires dealers of virtual currencies to report suspicious transactions, or those over \$10,000, to an appropriate government authority.

Taxation risk

To avoid erosion of the tax base, payments using digital currencies should be subject to the same taxation regime which applies to existing regulated payments channels.

There has been some progress on addressing this risk in Australia. In August 2014 the Australian Taxation Office (**ATO**) released a guidance paper on the taxation treatment of Bitcoin and other cryptocurrencies for the 2013-14 year. The ATO view is that Bitcoin is neither money nor a foreign currency. Under the guidance paper and rulings, Bitcoin transactions are treated like barter transactions with similar taxation consequences. Generally, there will be no income tax or GST implications for individuals if they are not in business or carrying on an enterprise and they pay for goods or services in Bitcoin. Businesses will need to record the value of Bitcoin transactions as a part of their ordinary income. They must also charge GST when they supply Bitcoin and may be subject to GST when receiving Bitcoin in return for goods and services.

Other risks

Consumer risks

There are no legal or regulatory safeguards for consumers when using digital currencies as a means of payment, beyond protections applicable to all goods and services.

There are no guarantees for consumers that payments made with digital currencies will be "made good" in that the currency will be accepted as a means of exchange and they will receive in return the goods and services purchased.

There are no guarantees that receivers of digital currency will be able to convert it into legal tender or at what rate that conversion may be made.

It is unclear if consumers or investors would have any claims on the creators of the digital currency if electronic stores of value were exposed to loss through the hacking of IT systems, the dilution of value through increased supply of the currency, or the insolvency of the issuer.

It is also unclear whether consumers and investors are aware of the differences between the consumer protections afforded under payment and banking systems, and digital currencies.

These risks should be addressed through an appropriate consumer and investor protection regime focussing on conduct and disclosure standards applicable to issuers of digital currencies.

Conclusion

Innovation through technological change is to be welcomed as a key driver of continued advances in economic growth and prosperity.

The public policy challenge is to create a regulatory environment under which the benefits of innovation can be maximised while ensuring protection of consumers and preserving the integrity of the financial system and of the tax base.

The banking industry will continue to monitor developments in this area and will maintain an ongoing dialogue with regulators on the risks and likely responses.

Yours sincerely,

Tony Pearson