The Capital Meets Policy Dialogue™

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LESSONS FROM THE "CAPITAL MEETS POLICY DIALOGUE, EUROPE CHAPTER"

DOUGLAS J. ELLIOTT
Oliver Wyman, LLP

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The Europe Chapter "Capital Meets Policy Dialogue" at the Point Zero Forum in June of this year yielded important insights from business leaders, regulators, investors, and others. The speakers and panelists brought a wide range of views about the implications of digital assets and of Generative AI for finance, its regulation, and the larger economy.

Three themes struck me most as I listened to the discussions. First, we are still working our way through very fundamental structural decisions about regulation and policy in these areas. This is partly due to the early stage of development and partly because there is such a wide gulf in understanding between the technological entrepreneurs and the regulators and policymakers.

Second, the entrepreneurs in this area must become substantially more realistic about regulatory issues. At the same time, there are also some unrealistic viewpoints in the official sector that need to disappear. Third, communications will be very important in bridging the gaps in understanding to ensure a high level of innovation that is produced safely. Let me expand on each of these themes.

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We are still debating the basics of regulation for digital assets and, in even more rudimentary fashion, for AI. Navin Suri (Advisor to the Board of Directors, Elevandi) and Rafat Kapadia (Head of Investments, Elevandi), and then Navin's panel, surfaced a number of core regulatory questions. All of them are issues that have been, of necessity, tackled in other regulatory fields and we should look to those previous learnings, rather than falling into the trap of designing bespoke regulatory structures because of the novelty of the technology. This is not to suggest that we can simply pick up existing regulatory structures and apply them in a cookie cutter fashion, but rather to emphasize that the categories of issues we are wrestling with are not novel. I will illustrate with five sub-themes.

One, there was a great deal of discussion about how regulation can handle the speed of development we see in digital assets and Generative AI. The truth is that regulation and related policy will always run behind developments out in the world. Changes take time to manifest themselves, then there may be some delays before regulators focus on them, they then take some time to really understand those changes and to formulate responses, stakeholders are then given time to assimilate and respond to regulatory proposals and, finally, time is needed for businesses to implement responses to the new regulations. There may also be lobbying or legal actions that slow responses down further. The financial sector has created any number of products, such as money market funds or credit derivatives, that developed for years before regulators had formed their responses. We've seen developments in the ground transportation industry that have led Sir Jon Cunliffe and others to refer to a fear of being "uberized" by allowing the rapid growth of an unregulated or lightly regulated sector that becomes too strongly established to control using existing regulatory structures.

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There are many tools policymakers can use in response to this fact of life, including:

- Legislating and regulating at the level of broad principles so changes in specific products and market structures matter less
- Providing room for supervisors to apply these laws and principles relatively quickly to specific circumstances
- Communicating policy and regulatory decisions clearly to allow businesses and developers to adapt and avoid some potential conflicts with public policy
- Encouraging dialogue between the private sector and regulators in order to better understand what is coming and what it will mean
- Making use of industry self-regulation and standards without abdicating regulatory responsibilities.

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Two, there was a great deal of discussion of how to ensure the benefits of innovation are captured while maintaining acceptable levels of risk. This is virtually the definition of what good regulation is about, so I will not attempt to lay out all the ways to try to accomplish this. My point is rather that there is a great deal to be learned from past regulatory experience and we shouldn't waste those lessons by acting as if digital assets and Generative AI were the first areas that ever needed regulation.

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Three, we clearly need both regulators and entrepreneurs to be flexible. There is simply far too much uncertainty to proceed with plans that are dependent on a particular potential future to occur. Panelists presented some different views of the future and we don't know who will come closest to being right, although we can be certain they will all be wrong to some extent. Expanding on this idea, I recently co-authored a paper with my Oliver Wyman colleagues

Our premise is that we must collectively live with the massive uncertainty and therefore we laid out the key factors that would determine future developments and provided four illustrative futures in order to explore how they might happen and what they would mean. We explored futures in which: (1) TradFi wins and the main digital money is tokenized deposits; (2) crypto-natives win and stablecoins dominate; (3) central banks over-achieve on their objectives and CBDCs dominate; and (4) the revolutionaries win and DeFi dominates, supported by a range of digital monies.

Four, virtually all of the panelists and speakers called for deeper and better interactions between the public and private sector. As I've already noted, this is especially important in these nascent technological areas where there is still so much to decide and where change is particularly rapid. There do need to be guardrails to avoid excessive closeness between officials and those they oversee and to minimize other causes of overly lenient regulation. However, there is substantially more room for

there is substantially more room for communication and cooperation than we have availed ourselves of so far.

Fifth, regulatory structures do need to be soundly designed in order to avoid regulatory arbitrage or a "race to the bottom". Again, this is a concern in virtually every area of regulation and not remotely unique to digital assets or Generative AI. Many of the regulatory tools available to deal with the speed of innovation will also serve to reduce regulatory arbitrage by avoiding locking regulators into overly specific structures with overly specific powers, leaving holes to exploit.

One of the obstacles to dealing effectively with these five challenges to good regulation is the wide gap in understanding between many entrepreneurs and the regulators and policymakers who will determine their fates to a large extent. So many of the

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entrepreneurs in this area come out of tech backgrounds that have limited their previous interactions with regulators, as opposed to those coming from the financial sector, for whom regulation has always been an important fact of life. In addition, a substantial segment of the digital asset community was drawn to this area in part because of their strong libertarian values, which are virtually the polar opposite of the values and views of regulators. The burden of accepting reality is heaviest on the entrepreneurs, since policymakers generally hold the trump cards, so the future reality may come closer to their wishes. However, regulators and other policymakers sometimes cling to their own versions of unreality and they need to let go of these misconceptions.

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I wrote a paper called, "Cryptoassets: Tulips or Dot-Coms", based on my extensive discussions with policymakers globally about unbacked cryptoassets such as Bitcoin. I found that policymakers divided into four broad camps and, as you'll see, not all of them are realistic ones. At one end of the spectrum, perhaps 20% of those policymakers believe that cryptoassets essentially represent the latest Tulip Bubble. The underlying assets are viewed as valueless, but propped up temporarily by speculative forces. This group believes that they will go away on their own and that regulation is a bad idea, as it would lend credibility to the sector without providing the necessary safety. The next group, probably 30% of the senior policymakers with whom I speak, wish cryptoassets would go away, but reluctantly have accepted that they are here to stay. Their focus is on keeping cryptoassets away from anything they care about, such as

the banking system. The third group, probably also about 30%, isn't fond of cryptoassets either. However, they see their growth as inevitable and that they will increasingly be intermeshed with the financial system. As a result, they focus on securing appropriate legislation, regulation, and supervision to keep the financial system safe while reaping whatever innovative benefits are truly available. The final group, maybe 20%, see cryptoassets as like the Dot-Coms in the late 1990's. They recognize that cryptoasset markets, like those for the Dot-Coms, have been rife with speculation, naïveté by some investors, poor business models, and even outright fraud. However, they also recognize that the Dot-Coms eventually created huge economic gains for society and they believe cryptoassets will be an important part of a digital assets revolution with high potential for economic gains as well. Therefore, this group focuses on avoiding excessive burdens for innovation, while still constructing appropriate guardrails to protect the public and the financial system.

The implications of this survey of views are that (a) there is a fair amount of unrealistic thinking, such as the belief that cryptoassets will disappear and (b) that it is very difficult to formulate sound and consistent policy with this wide a range of views.

Which brings me to the final overall theme that I drew from the morning's discussions – communications between the public and private sectors must be widened and improved. First, we need to squeeze out at least the most unrealistic views from both sides in order to concentrate on the real issues and possibilities for improvement. Second, sound development of both the digital asset and Generative AI sectors requires work from regulators and from those they will regulate. There is much still to build in these ecosystems and it will require cooperation from all sides to create sound and lasting foundations.

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Let me conclude by thanking the organizers of the Point Zero Forum for bringing together these excellent speakers and panelists and for allowing me the opportunity to close the session with my synthesis of the key issues that were raised, which I have attempted to capture in this paper.