

Bitcoin – Infiltrating the Financial System Bit by Bit: What Does the Rise of Cryptocurrencies Mean for Financial Crime?

by Khalid Al Hamrani - k.hamrani@tamimi.com - Dubai International Financial Centre

September 2017

The world's repertoire for money management is undergoing a period of radical overhaul with the recent advancements in financial technology. Nowhere is this more true than with the creation of cryptocurrencies like Bitcoin, which has introduced an anarchic system for accruing, storing and transferring funds.

Bitcoin came to fruition only relatively recently in 2009. Due to its novel and largely unregulated nature, governments are still grappling with the legal and fiscal implications tied to virtual currencies and are faced with a difficult choice; to develop effective safeguards against the new threats involved in dealing with online currencies, or to restrict their development and use within manageable confines? Few countries have declared a definitive legal approach to integrating Bitcoin and other cryptocurrencies to their regulatory systems due to a pervading uncertainty about the balance between the potential benefits provided and any risks to the integrity of their financial systems. Likewise, individuals determined to dip their toes into the virtual water should also be aware of the risks and volatility involved when dealing with cryptocurrencies.

How Bitcoins Work and Where the Complications Arise

Bitcoin is what is known as a cryptocurrency, a medium of exchange that is created and held on a digital payment network; in other words, it is virtual cash that is completely intangible and stored online. Like a regular currency, it can be used to buy things electronically, functioning in a comparable way to conventional denominations of dollars, euros, or yen, which are also traded digitally. However, one of Bitcoin's most important characteristics and a distinguishing factor, is that it is decentralised; no single institution controls the Bitcoin network, monitors or settles transactions, or holds Bitcoins belonging to other people. This has evident appeal to many of those that protest the notion of banks being able to control or restrict the flow of their money but it does remove the protection granted to funds that are overseen in a conventional banking system. Since Bitcoin is not physically printed under strict control of a Central Bank, unlike physical currencies its value cannot be manipulated by financial authorities. The value is fixed demand, so Bitcoins accrue worth as they become more widely used and sought. In this way, Bitcoins function more like a commodity than a conventional currency, and stability in value is sacrificed for security against manipulation.

There are three major points of departure in how cryptocurrencies function that differentiate it from government-backed physical currencies. Firstly, it operates in a completely decentralised system, devoid of any central authority. Units are held by individuals owners and usually transferred directly peer-to-peer without requiring the services of a middle man. Secondly, ownership over Bitcoins and records of transfers are completely anonymous. Users can hold multiple Bitcoin addresses that are not linked to personal information able to identify related parties. Despite this element of concealment, the software itself remains completely transparent as the details of every single transaction are stored as code in the network in an enormous virtual version of a general ledger known as the Blockchain. Finally, Bitcoin transactions are completely non-repudiable, meaning that that once they have been sent it is impossible to reverse the transaction to recover them unless the

recipient agrees to return them in a new transaction.

Though these features have been lauded for streamlining procedures and increasing autonomy in matters of financial management, there are a number of associated risks that significantly mitigate the desirability of the Bitcoin system. Granting complete control over transactions to every individual gives little consideration to how money needs to be safeguarded, especially given the anonymity and irreversibility of each transaction. Moreover, Bitcoins do not benefit from any of the security measures that are given to regular currencies and thus they create a market ripe for exploitation.

In the absence of regulation, many states remain perturbed that Bitcoin's unique characteristics will facilitate the commission of financial crimes, particularly money laundering and counter terrorist financing. Fears are predominantly based on the apparent appeal of borderless and concealed transactions to criminal cohorts, rather than an accurate analysis of the threat landscape. However, there are some early indications that abuse of cryptocurrencies is a mounting probability, rather than an unlikely possibility. Cases involving instances of clients being blackmailed with stolen sensitive information and ransoms demanded in the form of Bitcoin are becoming increasingly frequent, and lack of applicable law makes prosecution a complicated issue.

In light of this, it is easy to see the importance of governments taking a proactive approach to addressing Bitcoin. Whether it is through applying existing laws to cryptocurrencies or introducing new legislation to regulate the virtual market, keeping people in the dark about the official standing of Bitcoins will leave governments woefully ill-equipped to protect their economies from the inherent risks of dealing with uncontrolled and unverified currencies.

Jurisdictional Responses in the Middle East

At the national level, the UAE Central Bank has offered some initial indication as to the government's position regarding the use of Bitcoin in its jurisdiction. In regulations released on January 1, 2017, the Central Bank indicated that they do not outlaw virtual currencies such as Bitcoin and the same are not regulated by any of the existing controls. However, the Governor of the UAE Central Bank has informed the media that virtual currencies are currently under review by the Central Bank and new regulations will be issued as appropriate. This indicates that the UAE Central Bank has not yet formed a definite opinion on the safety of dealing with Bitcoin or its potential impact of the UAE's economic integrity. Whilst its use is not illegal at present, individuals accept the burden of all risks without any form of financial protection. Any change in the UAE's position on this matter will likely involve imposing stricter controls on its use.

At present, this position resembles a more relaxed approach than those taken in other regional jurisdictions. In the Kingdom of Saudi Arabia, for example, reports state that the Saudi Arabia Monetary Authority (SAMA) has actively discouraged the use of Bitcoin as an unverified currency due to the inherent dangers involved in dealing with an uncontrolled entity. Though this position may be revised in the future once best-practice for regulating cryptocurrencies has been established, for now it is indicative of the natural wariness certain governments feel over de-centralised and anonymous financial activity.

The Central Bank of Jordan has indicated a similar position, reiterating that Bitcoin is not considered legal tender and carries a high risk for investors for both devaluation and financial crime. It also emphasised that Bitcoins are not guaranteed by underlying material assets, and there is no bank in the world that is obliged to exchange virtual units for real currency. The Jordanian Central Bank has issued circulars to prohibit all national financial institutions from dealing with virtual currencies. As more neighbouring powers release their own guidelines for Bitcoin's use, it will be possible to discern whether the regional trend favours a risk averse approach or more open minded caution.

Beyond the Middle East, there are certain countries where dealing in Bitcoin has not only been permitted, but has developed to become a more commonplace occurrence. On the 1st January 2015 with the implementation of Bill AB 129, California became the first American state to fully legalise the use of digital currencies as a form of viable payment. Likewise in Germany, the official government position is one of open acceptance rather than restriction. In December 2013, the German Federal Financial Supervisory Authority (BaFin) classified Bitcoin as a recognised unit of account for private means of payment and does not subject its use as a substitute currency to regulation. Trading in Bitcoin is permitted but requires a licence administered by BaFin. Although BaFin has also been careful to warn Bitcoin users of the accompanying risks, in adopting such an open approach, Germany's economy is providing valuable lessons to other jurisdictions that are unsure of how to address the growing issue of Bitcoin usage. Benefits and risks identified through Germany's experience will provide a more empirical indication of how cryptocurrencies interact with illicit activity and economic security.

In conclusion, Bitcoin's infancy places it in a grey area concerning risks and regulation. As with all innovative technology, early acceptance is tempered by caution until the intricacies of its functionality are better understood. Its outstanding features may entice some individuals to jump ship from conventional banking but doing so without an appreciation of the associated dangers is ill-advised. These same features that attract legitimate users also contain strong appeal to less savoury characters, and Bitcoin's unregulated nature provides plenty of opportunities for exploitation at the hands of criminals. Looking ahead, Bitcoin users will also need to be aware of the shaky legal terrain beneath their feet, which is set for seismic shifts once jurisdictions clarify their approach to regulation. For now, the only protection to be found against risks is in arming oneself with awareness and exercising a healthy degree of discretion before venturing into the dark world of cryptocurrencies.