DECENTRALISED FINANCE: WHAT IS IT AND HOW IS IT REGULATED IN SOUTH AFRICA?

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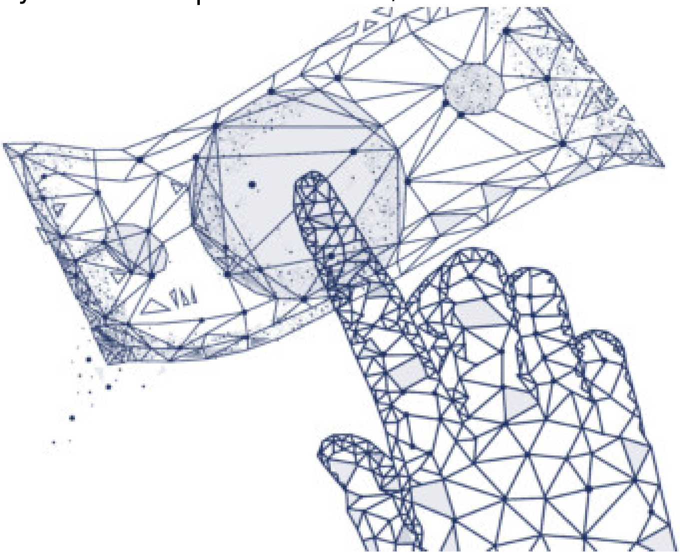

WHAT IS DECENTRALISED FINANCE?

Decentralised Finance (DeFi for short) is a financial system built on public blockchains such as BitCoin and Ethereum. Blockchains refer to a list of data records that work as a decentralised digital lender. The data in a specific blockchain is organised into blocks, which is chronologically arranged and secured by cryptography. The oldest and safest blockchain network is BitCoin, which is now one of the most utilised cryptocurrencies.

Decentralised Finance also refers to a movement that that aims to disrupt traditional financial lending systems and to create an open-source, permission-less and transparent financial service system. The centralised nature of the global financial system means that wealth is amassed among wealthy that have full access to financial systems. This has created inequalities whereby many people do not have access to basic financial services. DeFi offers individuals and organisations broader access to financial applications without the need for a trusted intermediary. Rapid technological advancements have allowed for this new decentralised system to emerge.

TRADITIONAL FINANCE SYSTEMS V DECENTRALISED FINANCE

There are a number of features inherent in a decentralised finance system that differentiates it from traditional finance systems like banks:

1. DeFi applications do not require intermediaries or arbitrators. The code specifies the resolution of every possible dispute, and the user always maintains control over their funds. Traditional finance requires banks to act as intermediaries, and courts to provide arbitration.
2. Permission-less participation – This means that no credit score or prior approval is required in order to access financial products. Users can access these services no matter their wealth, status, or location. This is especially advantageous to users living in developing countries, or

countries with hyperinflation. Instead of seeing their savings lose value, they can actually earn money on them or convert and transfer them when needed. DeFi also makes cross-border payments more affordable. It is generally expensive to send money across borders, however, through DeFi remittance fees are lowered.
3. Trust-less – This means that users can take charge of their assets and have complete autonomy about what to do with it. A central party is not required to ensure that transactions are valid. In a traditional system, people’s wealth and information are in the hands of institutions who are trusted to secure it. Through DeFi, a user’s funds cannot be stolen without their private key. DeFi also ensures that a user’s wealth is protected from hyperinflation and government manipulation and control.
4. Transparent – All transactions on the network are publicly auditable. Every transaction is broadcasted and verified by other users on the network.
5. Programmability – Contracts between users are programmable which enables the creation of new financial instruments and digital assets.
6. Tamper-proof – Data on a blockchain network is safe and secure. Blockchains cannot be shut off by central institutions.

THE REGULATION OF DEFI IN SOUTH AFRICA

There is currently no clear set of regulations in South Africa to deal with cryptocurrencies and blockchains. However, a number of steps have been taken to understand the growing role of financial technology (fintech) in South Africa. In 2016, the Intergovernmental Fintech Working Group (IFWG) was created to develop a common understanding between among regulators and policymakers of fintech developments, and to understand the regulatory implications of fintech to the economy and the financial sector. The IFWG comprises of members from the National Treasury, the South African Reserve Bank, the South African Revenue Services, the Financial Sector Conduct Authority, and the Financial Intelligence Centre.

In 2018, a joint working group, the Crypto Assets Regulatory Working Group (CARWG) was created under the IFWG, represented by members of the IFWG and SARS. The aim of CARWG was to review the position of cryptocurrencies and to consider the public policy concerns raised, to inform the regulation of these assets. CARWG took into consideration international policies and guidance from other jurisdiction to develop a policy for South Africa. In 2019, CARWG and IFWG released a joint consultation paper entitled the “Consultation Paper on Policy Proposals for Crypto Assets” for public comment. The paper does not intend banning on the purchase, sale or holding of crypto assets, or the use of crypto assets for payments, it appears that fairly robust regulations are heading our way.

Some of the regulations proposed by CARWG and IFWG is that crypto asset service providers would have to register to provide crypto related services. This will serve as the basis for formal authorisation and designation as a licensed service provider for crypto assets services operating in South Africa. The working groups will then assess whether crypto asset activities fit into the existing financial regulatory frameworks, or whether existing laws will have to be amended to accommodate crypto activity. In the interim, it was recommended that service providers be required to comply with anti-money laundering and combating the financing of terrorism provisions in the Financial Intelligence Centre Act, 2001, and regulations made thereunder (FICA).

The current lack of regulation around blockchain and cryptocurrencies globally is concerning. Given the borderless nature of blockchain technology, the scope of applicable laws is potentially global. For any particular transaction, regulators need to take into consideration data privacy concerns, intellectual property rights, global dispute resolution, consumer protection laws, securities laws, anti-money laundering laws and income tax obligations.   However, non-regulation of crypto assets invites money laundering, terrorism financing, monetary instability, and tax evasion. Crypto-asset service providers should be held as accountable as any other financial institution.   Therefore, countries globally and developing countries in particular, need to embrace a robust regulatory approach taking into consideration the continuously advancing fintech landscape.

If you have a question