THE FUTURE OF DIGITAL ASSETS IN THE BAHAMAS

BACKGROUND

The Government of The Bahamas recently issued a policy white paper on digital assets entitled "**The Future of Digital Assets in The Bahamas**". In part the white paper noted that the vision is, ***"to transform The Bahamas into the leading digital asset hub in the Caribbean and a global leader in the progressive regulation of businesses in this profoundly innovative space. By this we mean that we will substantially grow the sector by 2025, while ensuring that only well-run, trustworthy, and thriving digital asset businesses, which are able to maintain high standards and sustain the good reputation of The Bahamas, are allowed to operate from the country"***. A clear and unequivocal position of what and how the country wishes to participate, and to be seen, in this emerging and exciting space of digital assets.

Many are still uncertain about this new paradigm of digital/virtual assets, non-fungible assets and currencies. Our position at **NextLevelSolutions** is that while underdeveloped at this stage the use cases of the technology in many instances are encouraging with the ability to successfully create value. The emergence of stablecoins; the disappearance of some levels of regulatory fuzziness; and the roll back from total anonymity, suggest that these very much have the ability to integrate into traditional financial systems and are therefore here to stay. This document provides brief recap and commentary on the white paper, undergirded by contemplations of how do we capitalize on the new evolving technologies and how to strategize for the creation of real national long-term value.

The published IMF Article IV Consultation Report on The Bahamas, provides a "corroborating" glimpse of how influential international agencies, are generally responding to the digital assets space when it stated, *"A large crypto asset trading platform has recently established its headquarters in the Bahamas. Given the potential significant risks from this sector, the authorities should establish and implement a robust supervisory framework to regulate registration, ensure prudential supervision, and AML/CFT compliance".* Regulation, supervision, and compliance. This formula delineated in this statement is well captured in the stated intentions documented in the digital assets white paper. A response such as this, while not endorsing, is a clear nod to the fact that it is taken seriously.

SUPPORT

NextLevelSolutions generally supports the propositions in the white paper and the framework. The insights and intentions are clear. The country's proposed "differentiated" approach, designed to create competitive advantage, especially as it relates to proportionality in regulations, appears sound, responsive and respectful of the developing environment. The paper does have a number of broad statements for which general refinements will be required for better communication of national benefit. While the focus is on digital assets this represents, in a significant way, an economic policy position. To underline this we note from the IMF document cited above "*The authorities would like to establish The Bahamas as a leader in digital assets and crypto currencies. They are pleased to have put in place a designated legal framework for the digital asset space (the 2020 Bahamas' Digital Assets and Registered Exchanges Bill, DARE) and are working to facilitate the granting of approvals and licenses in a fair and transparent manner".* Under "Long-term, Inclusive Growth", *"authorities view economic diversification, digitalization, and innovation as means of achieving resilient growth. To this end, they are working to further diversify into the digital assets industry…They have also presented a White Paper to parliament which explores opportunities, in the digital asset landscape".* Consequently, early pronouncements will be needed to demonstrate how value will accrue through national fiscal arrangements. The announced selection of the Policy Advisory Committee appears to carry a sufficiently balanced set of competencies and experiences. Leveraging that balance, great care should be taken in ensuring that the "big economic picture" remains the "true north" for all deliberations and intended outcomes.

RISK OR OPPORTUNITIES

The most direct observation is that digital assets and the underlying technologies has the ability to revolutionize payment systems, intermediation and the provision of financial service across the board. Decentralized financing (DeFi) is taking hold in the global space with the use of smart contracts. The FATF's most recent look at virtual assets and virtual assets service providers (VA/VASP), contemplating the risk to the financial system, gives a clear appreciation of the future value of the technologies. The accepted position is that virtual assets are making major incursions into the traditional system and there are concerns for financial stability. Such conclusions are not drawn when impact is not considered significant. *The FATF considers VA inherently risky but hasten to note that they should be regulated and not automatically excluded*. Stablecoins pose the greatest chance of integration. Consequently regulators, AML frameworks and risk management practitioners must all be readied to support this national push. The expectation is for greater integration, over time, not less.

At NextLevelSolutions we believe that the focus should be on the technology while seeking to benefit from what is currently evolving. The technology in the interim will be disruptive in different ways to financial services and must therefore be carefully managed. The financial values that are being observed today may very well fall away but we must be mindful that it could take a system with it. Regulations, risk management, compliance and strategic thinking become paramount as this evolves.

The country is diving deeply into the digital assets game. Now what? Will The Bahamas become a factor in the strategies of digital asset businesses or will digital asset form an important part of its economic strategy? The difference is not at all subtle and fundamentally important. Where do you fit in along value chain path? Will value extraction only come through traditional products and services which are themselves regulated? Is there potential detriment of an undermined financial system and financial services offerings? How do we align our efforts and thinking to be able to actively participate in the space? There are important questions to be contemplated as we study this white paper.

POLICY OBJECTIVES

The following are the nine policy objective delineated in the white paper. Here we consider each with brief commentary or highlights and in instances drawing attention to matters which we believe will need further and early clarification. Additional we note approaches which may be useful having regard for the national competencies and critical understanding in areas which are likely to be seen as pressure points for external "attack".

WHITE PAPER – FUTURE OF DIITAL ASSETS IN THE BAHAMAS	
POLICY OBJECTIVES	COMMENTARY
1. "To explore new opportunities in a rapidly and continuously evolving digital asset landscape, including developments in decentralised finance (DeFi), non-fungible tokens (NFTs), stablecoins and asset-referenced tokens."	Clearly stated. Attention should be focused on the potential for parallel development of new systems and services as a result of exposures to underlying technology used in the digital space. Rapid changes have taken place and are expected in this arena. The disruptive opportunities it presents, especially for financial services, should be embraced and incorporated in all forward looking policy discussions, not just those applicable to financial sectors.
2. "To improve the attractiveness of The Bahamas as a well-regulated jurisdiction where well-run	The DARE Act. has given The Bahamas a great head start in this regard. The digital asset space

	digital asset businesses, of any size, can operate, grow, and prosper".	comes with all variety of bad actors and therefore protection of jurisdictional reputation and continued fulfilments of obligations is critical. In order not to stymie innovation the space may demand approaches which could be seen as being counterintuitive. The regulatory balance will therefore be crucial in providing effective facilitation while complying with international regulatory obligation, adopting, adapting and adhering to best practices.
3.	"where necessary, to clarify and expand the scope of the current legislative framework, generally, and the DARE Act, in particular, to continue to safely regulate digital assets and digital asset businesses"	It is anticipated that in the near term, as the technology and practices evolve, as new guidance emerges, as best practices crystalize, the local regulatory frame works will become more of a living mechanism being responsive to the dynamism of the environment. This clear commitment to do so is fundamental to not only growth but protection of existing national value proposition.
4.	"To encourage innovation in the Fintech space and identify emerging technologies that would help maintain the Bahamas' competitive advantage".	This could be the area of greatest value for the "domestic" benefits. Greater entrepreneurial energy is needed in this area but that demands facilitation, regulatory and otherwise. Acknowledging that the digital assets space may be skewed to external players, policy makers have the opportunity to encourage greater domestic participation in and bring greater local value through Fintechs and other digitally oriented concerns which will represent the future ecosystem for financial services. This holds significant value for family islands and the ability to inject commercial energy into geographical centers where cost, size and scale are major inhibitors to provision of financial services.
5.	To explore linkages between the Bahamas' existing financial services toolkit (i.e. corporate and fiduciary services) to facilitate continued innovation in the international financial services sector.	Given the many current challenges digital assets business have in directly accessing the traditional financial system the linkages are many and easily identified. The proximity to finances and the potential wealth to be derived makes connection with a wide variety of local service offerings a natural extension. Linkages through/with traditional service providers such as accountants, risk and compliance should be factored into the mix. Lack of skillset and domestic competencies could eventually hurt the jurisdiction. Strategies for creating critical mass of professional exposure to the space will be fundamental to

		stated long tern sustainability. Such strategies need deeper articulation beyond ideas of training noted in the white paper.
6.	"To develop the necessary skills and expertise to fill jobs created in The Bahamian digital asset sector".	See above. The timelines being contemplated are not yet clear. Given the fast moving pace of this space and the stated reference to center of excellence, there would need to be policy initiatives to create in the shortest possible time the widest potential exposures of domestic talent. The usual route to skills development, left to the discretions of employers alone might not be sufficient to drive the urgent impetus needed. Potentially, as a condition of approval or registrations, a comprehensive training and development plan for local talent, which aligns with some national guidance, should be agreed to, being careful not to create significant extra cost on regulated entities. Mechanisms for ensuring real adherence vs window dressing should be considered upfront.
7.	to work with the Central Bank of The Bahamas to ensure that polices are adjusted and clarified to enable Bahamians to access digital assets in Bahamian Dollars (B$).	This stated objective might not be as straightforward as it initially appears and could represent the main point of contention for the government in seeking to demonstrate that there is value in the digital space for the average Bahamian, as opposed to it being largely an offshore focused play, which generally excludes most citizen and residents.
8.	to build capacity and expand the resources of the SCB in order to support and enhance its role as the pre-eminent digital asset regulator and to enable it to become a global centre of excellence in the pragmatic, risk-adjusted regulation of digital assets and digital asset businesses.	Given stated broader goals this is an important objective. The extent to which success is realised will be a function of available talent beyond that which is needed by the regulator. A regulator as a center of excellence is unlikely if the wider community does not display at least characteristics thereof. Practitioners and professionals in the regulated entities must have skillset moving in tandem with that of regulators. If this fails, the level of innovation, learning, and development anticipated, due to ongoing industry and regulator interaction, is not likely to emerge and therefore leaving the jurisdiction vulnerable as a result of a lack of indigenous, local talent.

9.	And to provide sustainable funding for our digital asset policies, initiatives, and programmes.	Funding is clearly important. There must be clear means of moving plans and strategies forward. However, within context of the broadest policy objective, economic recovery, there needs to be stronger linkage demonstrated as it relates to impact on government revenue.

POTENTIAL IMPEDIMENTS

Following pioneering moves with the DARE Act, the current developments hold great significance for the continued vibrancy of the local financial services sector (offshore) with high spillover value and effect for domestic segments of the economy. We consider this a very progressive and useful policy position. The stated intention of The Bahamas becoming a center of excellence in the region and world is, in our opinion, very fascinating and highly strategic. The position is, however, not without important challenges which should not be ignored if the country is to maximize its potential in this arena.

The focus this position draws to local fintech (now mainly in the form of MSBs) we believe should lead to more timely maturation in that segment, going well beyond payment services, eventually making incursions into the traditional banking sector. *This points to the potential complexities, intended or otherwise, that this policy will imposed and consequently a need for broad thinking to include its potentially productive but disruptive impact and the opportunities for parallel (crypto vs use case technology) innovation in the digital space*. The consistency with which the document promises policy adjustments via the Central Bank and maintaining a proportional approach is clearly necessary thinking. We believe that some effort will be required to demonstrate balanced benefit to the local populace.

Primarily the limitation on Bahamians, challenges with banking and correspondent relationships are core matters to be addressed and solved. The former is more complex and nuanced than it may appear from cursory review and therefore will require clear exposition by the government how and to what extent will the average Bahamian be able to benefit from the execution of this policy position. The ability to purchase crypto in B$ is a fascinating idea but has serious inherent friction with existing foreign exchange control arrangements. Recent response by the Governor of the Central Bank to "move cautiously" is indicative of the fact that more time and thinking is needed in this regard.

The nature of digital assets (Cryptocurrencies), at this point, makes them essentially foreign imports which will create demands against reserves. The volatility of these assets represents a very high risk of limited or no flow back of capital after purchase and therefore, subject to quantum, significant adverse implication for the country's reserves. *The government will have to set out more clearly, as this develops, how it will facilitate the "average person" or indicate that the benefits of the policy is more macro and externally looking and therefore efforts are focused on facilitation of corporates* and service providers rather than the average individual. This is a potential point of tension the policy position.

POTENTIAL EXTERNAL PRESSURES

It should be anticipated, consistent with past attacks on financial services sector, that international efforts to control the crypto space will emerge. It is inevitable, should be anticipated and strategized for. AML/CFT represents the most likely pressure point. It should be accepted that they are coming, especially the EU. Their modus operandi is well known and consistent and they will be looking for cracks to exploit as might be manifested by weak AML regimes, light touch regulatory regimes, lack of enforcement, and of course we anticipate that claims of taxation abuse will feature and these arguments around given on going debates about when taxable events with cryptocurrencies crystalizes and where.

The policy paper in many ways anticipates such action or at least is careful enough to realise that there will be those possibilities when it speaks to proportionality but respecting international obligations, addressing FATF guidance note on VA etc. The matter will turn on the adjustments made to The Bahamas' AML regime in response to new exposure faced. Extending the risk-based approach to take into account distinctions imposed by digital assets; ensuring effective risk assessment and proper risk profiling (re-profiling) for organizations engage with digital assets; and proper assessment of risk capacity, aligning to existing capital adequacy and other risk buffer measures would represent

prudent considerations. The recent removal from of The Bahamas from the AML Grey List puts the country in good stead, and experience with the Dare Act gives a clear competitive advantage for dealing with preceding issues. With active collaboration between regulators and industry practitioners, The Bahamas should be fine. This however will require deliberate actions.

MAJOR CHALLENGE

"Globally, digital asset businesses find it challenging to open bank accounts and maintain banking relationships. While governments cannot dictate banks' commercial decisions, we will encourage banks licensed in The Bahamas to incorporate a calculated and robust risk-based approach to onboarding and monitoring digital asset businesses, as an alternative to following a pro forma de-risking policy by avoiding entities operating in the digital asset space".

Financial institutions and service providers will need to recalibrate their internal risk management systems to take into account the new exposures to be imposed by digital assets. The adjustments required are not necessarily revolutionary in nature but will require careful and studied action to minimize both institutional and jurisdictional risk. The FATF indicates that while digital assets are risky they should be regulated and not automatically excluded. This principle is clearly extendable to service providers but comes with clear tensions for correspondent banking and maybe other settled relationships.

In the digital asset space there is a "cold war" with the traditional financial sectors driven mainly by views of extreme decentralizations and the response of large multinational banks, who are the main providers of correspondent banking. Following active de-risking efforts in the region in recent years, this creates the need for a very delicate balance. For The Bahamas there are existing relationships between local institutions and correspondents which are somewhat tenuous and therefore calls into question the level of participation. The current state of affairs creates opportunities for service providers to facilitate banking but exposes potential risks as it relates to "downstream correspondent banking" or "nesting". *The authorities will have to walk a fine line in this process having regard for the risk appetite and capacity of local banks.*

"We will also have dialogue and an appropriate approach with international correspondent banking institutions to ensure healthy relationships are maintained for our Bahamian licensed institutions so a framework to ensure they can provide transactional services to clients that deal in digital assets".

The commitment to support efforts in this regard is highly prudent. Any efforts possible should be exerted to facilitate the development of the policy intent. Such an effort must however be fully respectful of the realities. Government and regulators will consistently want to be seen as supporting efforts which secure the stability of global payments systems. Such intervention, while with all good intentions, could be misconstrued and may be of very limited effect even if some success are realised. As the digital/virtual assets make deeper incursions into the traditional systems it should be anticipated that there will be some increased tensions and actions emanating from international bodies.

THE ECONOMIC IMPACT

"The growth of the digital asset sector is seen as a critically important part of rebuilding an economy that has been badly damaged by Hurricane Dorian and the effects of the COVID-19 pandemic".

This is a fundamentally important statement having regard for a loss of $2B in GDP, erosion of government revenue and importantly the recognition that recovery demands higher levels of revenue, in the regions of 25% of GDP, moving from the prevailing average of 16 -19%.

While it may be unreasonable to expect this in the initial version of the white paper, there is no indication as to how the new digital assets space will operate differently with the fiscal arrangements of the country than what currently prevails in the offshore segment. Except for the mention of a "development and training levy" there are no other suggestion of any new revenue mechanism for government. This we believe will require further clarity.

The stated expectation of digital assets providing the impetus for driving the recovery of the economy demands a more clinical assessment of the policy impact. This is assessment should not just at the gross investment level but also how transfer of value will occur for country, beyond job placements or opportunities for service providers. The assessment should contemplate matters such as local investment facilitation, tax revenue, leveraging and adaption of technology, capacity expansion directly financed/facilitated by new investments. The reality is that the digital asset space is more aligned with the offshore arena and therefore investments does not automatically translate to increased taxes/revenues. The government will need to, in its promised update, outline more clearly what the macro impact of the policy position in this regard is likely to be.

BROAD POLICY COMMITMENTS

Understandably the positions stated are broad and are therefore refinements are expected. Throughout the documents there are a number of commitments made which are useful in understanding how the implementation of this policy position is likely to unfold. The following excerpts from the white paper with our appended comments and perspectives on them.

WHITE PAPER – FUTURE OF DIITAL ASSETS IN THE BAHAMAS	
POLICY COMMITMNET	COMMENTARY
1. "The Government's approach to digital assets builds on examples of successes in other countries"	The general observation is that many jurisdictions have applied relatively extreme approach to regulating the digital assets space. At one extreme they are banned or excluded. At the other there are restrictive elements which comes into play post initial regulation. The approach of learning from these examples and applying the best and most proportionate methodologies is not only prudent but very strategic. The following statement provides insight and reiterates the policy intent: *"Prudent policymaking depends on considering all factors, including the impact on other policies, legal and regulatory requirements and making appropriate evidence-based risk adjusted decisions*."
2. "We have sought to formulate a balanced policy that safely encourages innovation and fosters opportunity while adhering to best practices and rigorous standards along with meeting our international obligations".	Obligations in areas such as AML/CTF, financial system stability, tax cooperation, will loom large and exert pressure on the country's effort. It is prudent to acknowledge and accept that these exist and work strategically to address them. The robustness of the regulatory framework will be paramount but moves by other jurisdictions (including supranational organizations) which are largely self-serving and potentially disruptive to the proposed plans of the country should be anticipated. " When fulfilling our digital asset policies, we will strike a proportionate, risk-adjusted balance that considers all policy objectives and outcomes, holistically"

3.	Will ensure that The Bahamas remains at the forefront of nations seeking to provide a well-regulated safe space for digital asset businesses.	This is a reiteration of a desire to secure global leadership in the space. Strategically, this is the positive approach to take. Functionally it will demand strategies, plans and programs that go well beyond the usual corporate centric approaches of training and knowledge exchange. In order for the country to become a dominant player it must very quickly become "the jurisdiction to be in".
4.	"*FATF Interpretive Note and Guidance on a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers*. The Guidance was substantially updated in October 2021. The DARE Act and FCSP Act implement FATF requirements relating to virtual assets. We will review the latest Guidance and implement any necessary changes to our anti-money laundering and countering thereat financing regime"	The approaches in the area of AML/CFT does not change drastically but must adjust to take account of new exposures and typologies. The major takeaway here is that which the FATF is highly concerned it encourages national authorities to regulate and not exclude as a default action. The approach by the FATF should also be instructive for understanding the need to get involve. There is imminent risk to the existing financial system if left alone. Regardless of participation therefore regulatory adjustment is an imperative.
5.	"Frameworks relating to digital assets are kept up-to-date and fully aligned with sound and accepted international standards, including FATF's recommendations"	See above. Regulatory emphasis will be on this area with keen attention on risk-based approach. Internal risk practitioners will be required to skillfully adapt and respond to rapid changes, shifting risk appetites, adjusting risk tolerance and better understanding and aligning risk capacity in providing assurance of safety and soundness, effective risk management and governance.
6.	The DARE Act takes a pragmatic and proportionate approach to the regulation of digital asset businesses. It delivers an expansive regime while ensuring that the highest standards are applied and maintained by those businesses.	This statement underlines the much repeated stance: *"Assessing the impact on other policy objectives and outcomes will be a prerequisite for our policy and regulatory decisions ensuring that all factors are taken into account before decisions are made and action taken*"

CONCLUSION

The white paper delineates a clear policy intent of how the country will play in the digital assets space. The policy is progressive, timely and with effective execution should deliver value for the country. As is the case with matters in this sphere, the first public statement is usually subject to future refinements. This is anticipated. However, what we sought to do here is share our early views on elements which we consider important, points where greater clarity would be useful early and to highlight potential tension points of the policy position.

The arena of DeFi, NFTs, stablecoins, smart contract etc. is highly risky but represents real economic opportunities for the country. Despite the fact that there is certainly value, the benefits must be aligned and clearly demonstrated. Overarchingly, this is an economic policy and given the subject matter (digital assets) there is the risk of treating it otherwise. Great discipline must be employed in this regard. As an economic policy there should be demonstrable government revenue streams with the ability to expand both GDP and positive revenue to GDP shift.

At **NextLevelSolutions** we have a keen interest in the development of the digital asset space. We are especially focused on how the regulatory environment will unfold impacting areas of governance, risk management, compliance and business strategies. To better understand the arena; the risk exposures and risk management implications; and to position ourselves to serve clients, we recently created a system of support and facilitation through an affiliated entity, **PCB Digital Solutions. PCB Digital Solutions** represents a group of individuals, located in the USA and The Bahamas, with strong interest in the digital assets/cryptocurrency space, with real life investment experiences; competence in training, coaching and research. As an interested party we will be following the development and will share our thoughts and views as things evolve. Should you have questions or wish to discuss any aspect of this document then feel free to reach us at the contacts below.

About NextLevelSolutions: A business consultancy firm focused primarily on delivering solutions in the areas of Enterprise Risk Management, Corporate Governance, Compliance, Strategic Planning, Accounting and Finance and Training.

About the Author: Hubert Edwards is the Principal and Lead Consultant at NextLevelSolutions. A former Senior Bank Executive; Senior Audit and Regulatory Consulting Manager with a leading "Big Four" public accounting firm; and Senior Bank Examiner with the Central Bank of The Bahamas. He is fellow of the Association of Certified Chartered Accountants (ACCA); member of the Bahamas Institute of Chartered Accountants; holds a MBA in Finance with distinction - University of Manchester; a LLB with First Class Honours - Huddersfield University; and a Certified Anti-Money Laundering Specialist (CAMS).