

Virtual Currency and Debt



With the rise of virtual currencies or ‘cryptocurrencies’ as they are more commonly known,

Aadal Shafiq aims to provide an overview of what cryptocurrency is and what an individual in debt may need to consider if they own any.

“So, do you have any savings or assets such as a property?”

“No, I don’t have any assets, but I do have some cryptocurrency. Does that count?”

Yes, cryptocurrency might well be an ‘asset’ that your client tells you about in addition to other assets such as a property or a lump sum. But what is cryptocurrency and how might it affect clients in debt?

CRYPTOCURRENCY

Cryptocurrency is a form of virtual currency that can be used to make payments and investments. In the vast majority of cases, individuals own cryptocurrencies as a personal investment where the value of each unit of a cryptocurrency increases and decreases depending on the market value.

Transactions are made on what is known as the ‘blockchain’, which is a digital ledger. Each ‘node’ on that ledger represents a transaction and forms a chain of transactions only seen by those with access to the blockchain. This technology enables parties to make transactions within a certain cryptocurrency with one another based on mutual trust (a peer-to-peer network). Individuals

can access their cryptocurrency holdings online using a password, which is usually a string of numbers.

At the time of writing, the total market value of cryptocurrencies was in excess of £110 billion with around 1370 different cryptocurrencies in operation¹. Some of the more popular cryptocurrencies you may have heard of include Bitcoin, Ethereum and Litecoin. It is believed that blockchain technology came into existence in 2008 as a way to exist outside of the banks and financial institutions. The founder of blockchain technology – Satoshi Nakamoto’s original paper explores some of the attractions of virtual currencies².

Benefits of using blockchain technology with cryptocurrencies include:

- peer-to-peer network with no central bank having control;
- transactions are carried out quickly due to not requiring a ‘middleman’;
- those that have access to the blockchain can view the entire chain providing transparency;
- It is easily accessible to the public.

RISKS OF INVESTING IN CRYPTOCURRENCY

With benefits of buying and selling cryptocurrency come potential risks. The European Union has defined ‘virtual currencies’ in EU Directive (EU) 2018/843³ as “not necessarily attached to a legally established currency and does not possess a legal status of currency or money”, as cryptocurrencies

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seem to resemble a store of value more closely than a medium of exchange.

The FCA has said virtual currencies should be seen as a “high risk, speculative investment” and not as a fiat currency due to their volatile nature⁴. Since cryptocurrency is not guaranteed by government or a central bank its value is based purely on its popularity, which causes the price (or exchange rate) of the cryptocurrency to vary unpredictably.

Since December 2017, the total market value of cryptocurrencies was in excess of \$600 billion with around 1800 cryptocurrencies in operation at the time and have therefore, lost approximately 70% of their value compared to the market value in December 2018. This is a prime example of the cryptocurrency market being volatile. It is an industry built on large gains, made quickly due to very little effort made.

1. <https://coinmarketcap.com/>

2. <https://bitcoin.org/bitcoin.pdf>

3. <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32018L0843>

4. www.fca.org.uk/news/news-stories/consumer-warning-about-risks-investing-cryptocurrency-cfds

An additional risk of dealing with cryptocurrency is the possibility of being hacked or scammed. Due to the nature of the buyer/seller not being seen on the blockchain, this has led to criminal activity including money laundering. As it stands, cryptocurrency falls outside Part 5 of the Proceeds of Crime Act 2002. There is also the possibility of individuals losing their passwords to access their cryptocurrency holdings, meaning access is lost forever.

CRYPTOCURRENCY REGULATION

Section 19 of the Financial Services and Markets Act 2000⁵ (FSMA) provides that no one may carry on a regulated activity unless they are either an authorised person or exempt (the ‘general prohibition’). The FSMA (Regulated Activities) Order 2001 (SI 2001/544) (the ‘RAO’) sets out what constitutes regulated activities under FSMA. In general, cryptocurrency is not mentioned in the list of investments. Therefore, if cryptocurrency is not seen as an ‘investment’ dealing with cryptocurrencies will most likely not constitute a regulated activity and as a result, will fall outside the general prohibition. The FCA has stated that they do not regulate cryptocurrencies by themselves, but they have accepted that where cryptocurrencies form part of a firm’s other regulated services or products (such as

cryptocurrency ‘derivatives’), those cryptocurrencies are subject to regulation⁶. However, this currently applies in limited circumstances.

This means that consumers will have little or no protection should something go wrong with cryptocurrency transactions such as falling victim to a scam or their blockchain being hacked with high profile cases reported in the media⁷.

So, although largely unregulated, there has been recognition that cryptocurrency needs to be regulated to a degree with work being done to understand how this form of virtual currency works and the implications on various financial markets in the UK. For instance, HMRC recognised cryptocurrency as a “new and evolving area” as far back as 2014⁸.

In March 2018, the Chancellor of the Exchequer launched the “Cryptoassets Taskforce” comprising the Treasury, FCA, and the Bank of England. The Taskforce held their first meeting on 21st May 2018 where the Taskforce discussed exploring the effect of cryptocurrency, the potential benefits and challenges of cryptocurrency, and assessing whether regulation is needed⁹.

In June 2018, the FCA also issued a ‘Dear CEO’ letter to Britain’s banks highlighting the potential risks in dealing with cryptocurrencies¹⁰.

In September 2018, the UK Parliament Treasury Committee reported the findings from their inquiry into digital currencies and distributed ledger technology. They concluded that regulation of cryptocurrencies is required for anti-money laundering purposes and consumer protection.

In October 2018, the Taskforce published their final report outlining the risks and opportunities cryptocurrencies present and setting out a new path for the regulation of cryptocurrency in the UK¹¹. The key highlights from the report are: to mitigate the risks to consumers (who could face large losses) and to prevent use of cryptocurrency for illegal activity. The FCA agreed to provide guidance on additional Perimeter Guidance (PERG) specifically for cryptocurrency by the end of 2018, and consulting in early 2019 on whether PERG needs to be extended to include unregulated cryptocurrencies that have characteristics that are similar to regulated specified investments. It is also interesting that the Taskforce have coined the phrase ‘cryptoassets’ to describe cryptocurrencies due to their lack of standard currency characteristics.



5. www.legislation.gov.uk/ukpga/2000/8/section/19
6. www.fca.org.uk/scamsmart/cryptocurrency-investment-scams
7. Mt Gox hacking case, *Terpin v AT&T*, US Federal Trade Commission blackmailing scam
8. www.gov.uk/government/publications/revenue-and-customs-brief-9-2014-bitcoin-and-other-cryptocurrencies/revenue-and-customs-brief-9-2014-bitcoin-and-other-cryptocurrencies
9. www.gov.uk/government/news/cryptoassets-taskforce-meets-for-the-first-time
10. www.fca.org.uk/publication/correspondence/dear-ceo-letter-cryptoassets-financial-crime.pdf
11. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf

In addition to regulation, the HMRC published their policy paper on 19th December 2018 confirming that the buying and selling of cryptoassets will be seen as an investment rather than a standard currency for tax purposes.

Therefore, if we view cryptocurrency as a 'cryptoasset' rather than a conventional currency, as the Cryptoassets Taskforce prefers, you may still be able to give debt advice to someone who may own cryptocurrency. In all the scenarios below, it is advisable for the client to seek independent financial advice and to contact the FCA Consumer Helpline 0800 111 6768 on how to deal with their cryptocurrency before committing to a particular debt option.

FULL AND FINAL SETTLEMENT OFFER

The client could sell their cryptocurrency holdings and potentially have a substantial lump sum to offer to their creditors in full and final settlement of their debts. Page 252 of the CPAG Debt Advice Handbook 12th Edition confirms that the lump sum payment should not be paid until the creditor has agreed in writing to accept it in full and final settlement of all the money owed. Keep a copy on the client's file.

See the National Debtline fact sheet 'Full and Final Settlement Offers'¹² for all the implications of making such offers to those creditors including changes to the client's credit file.

INDIVIDUAL VOLUNTARY ARRANGEMENT (IVA)

In an IVA, the client's cryptocurrency would be seen as an asset like any other in that it would be disclosed to creditors, and they would take a view as to whether it should be converted into pound sterling and paid into the IVA.

An Insolvency Practitioner (IP) from



a reputable firm has taken the view that if the cryptocurrency was discovered by the IP during the life of the IVA and it was held at the time of the IVA approval, it would be treated as an undisclosed asset, and the IVA would then fail or the client may have to agree to pay some of the value into the IVA for the benefit of creditors.

Where the client sells their cryptocurrency during the term of the IVA or following the completion of the IVA, the asset would still be held on trust for the creditors, as was the outcome of *Green v Wright* [2017] EWCA Civ 111¹³. This case concerned an IVA agreement that had been completed, but the refund from a PPI mis-selling claim still had to be handed over to the IP as the PPI mis-selling took place prior to the IVA. However, if the IVA agreement states that the IVA terminates upon completion of the IVA, the client is able to keep the proceeds of the cryptocurrency.

BANKRUPTCY

Not very surprisingly, when valuing the client's estate, the Insolvency Act 1986 (IA 1986) and the Insolvency Service Technical Manual do not deal with cryptocurrency.

Fortunately, the Insolvency Service has provided preliminary guidance stating that cryptocurrencies will be treated as 'cash at bank'¹⁴ and not

as income for the purposes of an Income Payment Arrangement or Order under s310 of the Insolvency Act 1986 (IA 1986)¹⁵. The Official Receiver (OR) will also request a password from the client so they can access the cryptocurrency account.

BANKRUPTCY – 'RASH AND HAZARDOUS SPECULATION'

In the rapidly increasing and volatile nature of the cryptocurrency market, an individual may have succumbed to the hype and decided to use a lump sum of money or might have taken out credit to buy cryptocurrency and/or sell their cryptocurrency holdings. If a client then decides to go bankrupt, the OR may look at the conduct of the client under Schedule 4A(2) IA 1986 to determine whether a Bankruptcy Restrictions Undertaking (BRU) or Bankruptcy Restrictions Order (BRO) is appropriate or not.

It may be a combination of the different kinds of behaviour that is listed under Schedule 4A(2), but in particular, the OR/court may find that Schedule 4A(2)(j) of the IA 1986

12. www.nationaldebtline.org/EW/factsheets/PDFs/fullandfinalsettlementoffers.pdf

13. www.bailii.org/ew/cases/EWCA/Civ/2017/111.html

14. ISTM Chapter 31.5, paragraph 69

15. www.legislation.gov.uk/ukpga/1986/45/section/310

is most relevant, which states:

“(j) carrying on any gambling, rash and hazardous speculation or unreasonable extravagance which may have materially contributed to or increased the extent of the bankruptcy or which took place between presentation of the petition and commencement of the bankruptcy;...”

The effect of a BRU/BRO is to impose wide ranging restrictions on a bankrupt, which include the restrictions that a bankrupt is subject to prior to their discharge from bankruptcy. If a BRU/BRO is made against the client, the bankruptcy restrictions can last anywhere between two to fifteen years.

DEBT RELIEF ORDER (DRO)

If a client is considering a DRO, their total gross assets cannot exceed £1,000¹⁶. If the value of the cryptocurrency increases during the moratorium period, the client would have a duty to inform the OR of this change. There is then the possibility that the DRO may be revoked as they no longer meet the eligibility criteria. The client may decide to sell their cryptocurrency holdings before applying for a DRO to avoid the issue of an increase in value during the moratorium.

DRO – ‘RASH AND HAZARDOUS SPECULATION’

Similar to bankruptcy, the OR would look at the possibility of making a Debt Relief Restrictions Undertaking (DRRU) or Debt Relief Restrictions Order (DRRO) under Schedule 4ZB IA 1986¹⁷. The court would take into account the client’s conduct including if the speculation was rash and hazardous or if the OR received information stating that this behaviour was a major factor in their insolvency. The DRO Team have stated that investing in cryptocurrency alone may not be sufficient for this course of action and would be looked at on a case by case basis.

TRANSACTIONS AT AN UNDERVALUE

In both bankruptcy and a DRO, the client should ideally be able to provide evidence that the sale of their virtual currency on the date the financial transaction took place was at market value. This is to try and avoid the sale being seen as a transaction at an undervalue.

CONCLUSION

It is becoming increasingly difficult to find ways of maximising a client’s income to deal with debts. Although many of the clients that you see on a daily basis won’t have heard of cryptocurrency

(let alone actually own any), due to the ever-growing popularity of cryptocurrency, it is likely to become a more common feature of debt cases. It could be the difference between your client not qualifying for a DRO or being able to offer full and final settlement offers by selling the cryptocurrency they own.

The buzz around virtual currency seemed to have died down in 2018 because of the high risk involved, but with more companies and individuals using virtual currency as a form of financial transaction, and with regulation in the UK in some form becoming a reality in the near future, the value and importance of virtual currency could be on the rise once again in 2019. If you have a client that owns cryptocurrency, signpost them for independent financial advice before they decide what they do with it. In the first instance, you should also speak with your line manager on how best to progress the case and if still in doubt, contact the Shelter Specialist Debt Advice Service.

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16. Page 4 of the DRO Intermediary Guidance Notes Version 16

17. <http://www.legislation.gov.uk/ukpga/1986/45/schedule/4ZB>

