Beyond Traditional Banking: Evaluating the Role and Challenges of Blockchain and Cryptocurrency in Sri Lanka

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Abstract

'Banking is necessary, but banks aren't.' Bill Gates' controversial statement in 1994, that new inventive alternative financial banking systems are rendering banks obsolete, is now being realized. Cryptocurrency is now at the cutting edge of financial development, generating a lot of attention. It is a string of encrypted data used to represent a unit of money. It is thought that digital currencies will define the future of finance since they provide both possibilities and threats on the financial markets. Cryptocurrencies have the potential to help a country's economy while also facilitating illegal acts like terrorism and money laundering. As a result, there is a contradiction between regulation and user anonymity when it comes to the use of cryptocurrencies. Since 2009, cryptocurrency has grown in popularity as a speculative investment, and given the present economic condition, an increasing number of Sri Lankans are turning to digital trading platforms. Although purchasing virtual assets is not a legal investment, it is increasingly being used in Sri Lanka for investments and commercial activities. As the digital currency industry remains unregulated, it poses risks and dangers to traders when they run the risk of violating the law. The purpose of this investigation is to discuss Sri Lanka's present legal framework, highlight the gap in regulation of Cryptocurrency and recommend appropriate legislation proposals for the country. The Study emphasizes that banking is still necessary, but banks need to adapt and evolve to stay relevant in the digital age. Blockchain technology, the underlying technology behind cryptocurrencies, has the potential to revolutionize traditional banking systems. However, the study suggests that appropriate regulatory measures are necessary to manage the risks associated with cryptocurrencies and ensure ethical use of these technologies. The research design to be carried out by analysing existing literature subjective to qualitative analysis.

Keywords: Blockchain technology; Cryptocurrency; Reforms.

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Introduction

Bill Gates' famous quote, "Banking is required, banks are not," has taken years to fully comprehend. It's now becoming true what he said back in 1994. The banking sector is growing more quickly as a result of technological advancements, with an emphasis on efficiency, transparency, and improved customer experience. Banking practices are being disrupted by the current digital revolution, which is being driven by changing client wants, behaviors, and expectations. Customers increasingly demand a personalized, anytime, everywhere user experience, which means they want to be able to do their banking anywhere. (Asian Banking School, 2021) The future of finance is thought to be being formed by digital currencies, which present opportunities and threats on the financial markets. Cryptocurrency is currently at the forefront of financial development and generating great interest. A cryptocurrency is a digital, encrypted, and decentralized medium of exchange. Unlike the U.S. Dollar or the Euro, there is no central authority that manages and maintains the value of a cryptocurrency. (Ashford,2023)

Instead, these tasks are broadly distributed among a cryptocurrency's users via the internet. Cryptocurrencies can help a nation's economy, but they can also be used to assist illegal acts like terrorism and money laundering. There is conflict between regulation and user anonymity as a result of different perspectives on the use of cryptocurrencies. Despite being widely accepted in industrialized nations, many countries, including Sri Lanka, are hesitant about it and worried about the risks it poses to the current monetary systems. It is not governed by international law despite being widely used for the purchase of goods and services. In light of this, socioeconomic factors, the level of technology advancement in the nation, political realities, and legal precedents all have an impact on the blockchain revolution. (Sichinava, 2019)

Since past decade, cryptocurrency has grown in popularity as a speculative investment, and given the current economic climate, an increasing number of Sri Lankans are eager to use online trading platforms. Even though buying virtual assets is not a permitted investment, it is becoming more and more common in Sri Lanka for both investments and commercial dealings. The unregulated nature of the digital currency market exposes traders to risk and peril as they run the chance of breaking the law. This investigation's goals are to analyze Sri Lanka's current legal system, point out where there are regulatory gaps with cryptocurrencies, and suggest suitable legislation suggestions for the nation.

Therefore, Blockchain technology and cryptocurrency are relatively new concepts that have gained a lot of attention in recent years. The blockchain is a decentralized, digital ledger that records transactions across multiple computers. Cryptocurrency is a digital or virtual currency that uses cryptography for security. Both technologies have the potential to transform financial systems, and their impact on the Sri Lankan economy has yet to be fully explored. This study aims to investigate the impact of blockchain technology and cryptocurrency in Sri Lanka and identify necessary reforms to address the challenges posed by these technologies.

Research Problem

The emergence of blockchain technology and cryptocurrency has the potential to disrupt the traditional financial system in Sri Lanka. While some experts believe that these technologies

could lead to more efficient and transparent financial systems, others warn of the risks associated with cryptocurrency, such as money laundering and terrorism financing. The Sri Lankan government has not yet fully addressed the implications of these technologies, and there is a need to identify necessary reforms to mitigate risks and take advantage of the benefits.

Research Objectives

The primary objective of this study is to investigate the impact of blockchain technology and cryptocurrency on the Sri Lankan economy. The specific objectives are as follows:

1. To explore the current state of blockchain technology and cryptocurrency in Sri Lanka.
2. To identify the benefits and risks associated with blockchain technology and cryptocurrency in Sri Lanka.
3. To assess the potential impact of blockchain technology and cryptocurrency on the Sri Lankan financial system.
4. To identify necessary reforms to address the challenges posed by blockchain technology and cryptocurrency in Sri Lanka.

Research Questions

To achieve the research objectives, the following research questions will be addressed:

1. What is the current state of blockchain technology and cryptocurrency in Sri Lanka?
2. What are the benefits and risks associated with blockchain technology and cryptocurrency in Sri Lanka?
3. What is the potential impact of blockchain technology and cryptocurrency on the Sri Lankan financial system?
4. What necessary reforms are required to address the challenges posed by blockchain technology and cryptocurrency in Sri Lanka?

This study is expected to contribute to the literature on the impact of blockchain technology and cryptocurrency in emerging economies such as Sri Lanka. The study will provide insights into the current state of blockchain technology and cryptocurrency in Sri Lanka and identify the benefits and risks associated with these technologies. Moreover, the study will assess the potential impact of blockchain technology and cryptocurrency on the Sri Lankan financial system and identify necessary reforms to address the challenges posed by these technologies. The findings of this study could inform policymakers and regulators in Sri Lanka and other emerging economies as they navigate the opportunities and challenges presented by blockchain technology and cryptocurrency.

Litreature Review

As the field of blockchain technology and cryptocurrency is a relatively new area in Sri Lanka, there is a dearth of literature on the topic. Hence, the purpose of this literature review is to analyze both domestic and international literature and specifically focus on the impact of these technologies in Sri Lanka.

Daniel Drescher (2017) is not specifically focused on cryptocurrency in Sri Lanka. Rather, his book provides a general introduction to blockchain technology and its potential impact on various industries, including finance, supply chain management, and healthcare. Drescher delves into the fundamental principles of blockchain, providing a comprehensive understanding of its decentralized and distributed nature. The book likely covers key aspects of blockchain, such as consensus mechanisms, smart contracts, and the security features inherent in the technology. By examining these foundational elements, the literature review can establish a baseline understanding of blockchain technology, allowing for a contextualized evaluation of its potential impact on various sectors.

Moreover, Drescher's insights into the applications of blockchain across different industries can contribute to a broader understanding of the technology's versatility. While the book may not specifically address cryptocurrency in Sri Lanka, its exploration of blockchain's potential in finance could provide insights into how this technology might reshape financial ecosystems globally, including considerations that may be relevant to the Sri Lankan context.

Lewis (2018) contributes a comprehensive perspective on blockchain technology and cryptocurrency in his work, "The Basics of Bitcoins and Blockchains." This source delves into both the technical intricacies and the broader social and economic implications of these technologies. The coverage extends to key aspects such as the historical evolution of money, the role of intermediaries in financial transactions, and the potential of blockchain to address issues like fraud and corruption.

This foundational work by Lewis is particularly insightful for understanding the potential impact of blockchain technology and cryptocurrency on Sri Lanka's financial system. By exploring the historical context of money and the challenges in traditional financial transactions, the research can draw parallels and contrasts with Sri Lanka's existing financial landscape. Additionally, the exploration of blockchain's potential to address issues like fraud and corruption is pertinent to Sri Lanka's socio-economic context, offering valuable insights into potential benefits and challenges.

Moreover, Lewis's work lays the groundwork for identifying the regulatory and policy reforms necessary for the successful adoption of blockchain technology and cryptocurrency. By understanding the technical aspects and social implications, the research gains a nuanced understanding of the areas that require attention in the regulatory framework. This insight is crucial for crafting effective policies that facilitate the integration of these technologies into Sri Lanka's financial ecosystem. In addition, Lewis's work serves as a valuable resource for the literature review, providing a rich exploration of both the technical and socio-economic dimensions of blockchain technology and cryptocurrency. His insights contribute significantly to the understanding of potential impacts and necessary reforms in the context of Sri Lanka's financial system..

Furthermore, the literature review delves into the insights provided by Tapscott &Tapscott (2016), who present a comprehensive overview of blockchain technology and its far-reaching potential across diverse industries. Their work, titled "Blockchain Revolution: How the Technology behind Bitcoin Is Changing Money, Business, and the World," serves as a

foundational resource. The authors explore the transformative impact of blockchain in sectors such as finance, healthcare, and supply chain management. Specifically, Tapscott & Tapscott highlight the technology's capacity to enhance transparency, reduce operational costs, and improve overall efficiency within these industries.

In examining their work, it becomes evident that the authors not only outline the current state of blockchain technology but also project its future implications. The review emphasizes key themes such as the revolutionary nature of blockchain, its disruptive potential, and the multifaceted benefits it offers to various sectors. By referencing Tapscott & Tapscott's insights, the literature review aims to establish a solid foundation for understanding the fundamental concepts and potentials associated with blockchain technology as articulated by authoritative voices in the field. The critical analysis of this source contributes to a nuanced exploration of the broader landscape, laying the groundwork for a comprehensive understanding of the impact of blockchain on different industries.

In addition, Bogamuwa & Fernando (2022) examines the Sri Lankan perceptions on Cryptocurrency and Blockchain Technology and aimed to identify the factors that influence how residents of Colombo district perceive cryptocurrency and blockchain technology. They focus on establishing connections between independent variables and residents' perceptions, offering insights into the intricate relationships within the context of Sri Lanka. The research provides a nuanced exploration of the multifaceted dynamics shaping public opinion on Cryptocurrency and Blockchain Technology. By analyzing the effect of various independent factors on residents' perceptions, the study contributes valuable insights that could potentially inform the formulation of policies and strategies in the context of Sri Lanka's economic landscape.

Furthermore, Bogamuwa and Fernando's research, serves as a foundational element in understanding the current state of knowledge regarding Sri Lankan attitudes towards Cryptocurrency and Blockchain Technology. It contributes to the broader context of the study by providing a specific lens through which the complexities of public perception and its influencing factors are examined.

Bordo & Levin (2017) offer a summary of the potential of blockchain technology to disrupt the traditional financial system, along with the obstacles that may arise with its adoption.According to Bordo and Levin, the advantages of blockchain technology include enhanced operational efficiency, cost reduction, and improved transparency. The authors highlight how the decentralized nature of blockchain can streamline financial processes, potentially leading to increased efficiency. Moreover, the cost-cutting benefits are explored, shedding light on how blockchain implementation could result in more cost-effective financial transactions. The emphasis on transparency points to the potential for a more accountable and secure financial system.

However, the literature also discusses the challenges inherent in the adoption of blockchain technology. Bordo and Levin specifically address the hurdles associated with establishing regulatory frameworks. The authors acknowledge the need for strong regulations to govern blockchain applications, emphasizing the importance of striking a balance between innovation and regulatory oversight. Additionally, privacy concerns are recognized as a potential

obstacle, drawing attention to the importance of addressing and resolving these issues for the successful integration of blockchain in the financial landscape. The analysis provided by these authors contributes valuable perspectives to the broader discussion on the impact of blockchain in the financial sector. Despite the wealth of literature reviewed, significant research gaps emerge, pointing towards the imperative for further empirical investigations into the adoption and impact of blockchain technology and cryptocurrency within the Sri Lankan context. The existing body of literature underscores the necessity for more comprehensive studies that delve into the specific dynamics and challenges associated with the integration of these technologies in Sri Lanka. Moreover, a notable gap exists in the exploration of policy and regulatory reforms required to facilitate and encourage the adoption of blockchain and cryptocurrency. While some studies briefly touch upon these aspects, a more in-depth analysis is warranted to provide a thorough understanding of the legal and regulatory frameworks essential for the successful implementation of these technologies in the Sri Lankan economic landscape. Furthermore, the literature highlights the dearth of research examining the nuanced social and economic implications specific to Sri Lanka, indicating a need for studies that contextualize the impact of blockchain and cryptocurrency on local communities and the broader economy. Addressing these research gaps will contribute substantially to advancing knowledge in this field and inform policymakers, businesses, and scholars alike in shaping effective strategies and frameworks.

Methodology

The chosen research methodology employs a qualitative analysis approach, primarily grounded in a thorough examination of existing literature. A thorough review is undertaken, focusing on primary legal sources, which include Acts and ordinances, along with international conventions. This critical assessment forms the foundation for understanding the legal landscape under consideration. Additionally, the study incorporates secondary sources, encompassing journal articles, books, and policy papers, to provide a comprehensive perspective. The integration of these diverse sources is carefully considered to complement and enhance the research findings, ensuring a well-rounded and strong analysis.

Results and Discussion

In comparison to traditional currencies, Bitcoin is a digital, decentralized, partially anonymous currency, not backed by any government or other legal entity, and not redeemable for gold or other commodities. It relies on peer-to-peer networking and cryptography to maintain its integrity. (Grinberg, 2012) Bitcoins are extremely liquid, have low transaction costs, and may be used to make minor payments as compared to the vast majority of currencies or online payment providers, like PayPal. Blockchains enable direct payment transmission between two parties even without an intermediary. Cryptographic encryption secures and authenticates digital currency transactions by documenting coin ownership when consumers buy virtual assets.

Blockchains are distributed, tamper-proof ledgers that are used to publicly record transactions. This open-source framework prevents coins from being duplicated and eliminates the need for a central authority such as a bank to validate transactions. Bitcoin, created in 2009 by the pseudonymous software engineer Satoshi Nakamoto, is by far the most prominent cryptocurrency, and its total value has at times exceeded $1 trillion. But numerous others,

including Ethereum, the second-most popular, have proliferated in recent years and operate on the same general principles. (Siripurapu & Berman, 2023)

The Position of Sri Lanka in the Blockchain Industry

Sri Lanka has warned its citizens against using cryptocurrency, which it said is "largely unregulated". The Central Bank of Sri Lanka does not consider cryptocurrencies as legal tender in the country and reminded the country that it has not given license or other authorization to any entity to operate in the nation. (Singh, 2022) It declared that it had not allowed any initial coin offerings (ICO), mining operations, or exchanges for virtual currencies. Virtual currencies are regarded as "unregulated financial instruments" in the nation and do not have any regulatory control or usage protections. The Central Bank of Sri Lanka, (Central Bank of Sri Lanka,2022) it states as follows;

"As informed to the public previously by CBSL through press releases in 2018 and 2021, CBSL has not given any license or authorization to any entity or company to operate schemes involving VCs, including cryptocurrencies, and has not authorized any Initial Coin Offerings (ICO), mining operations or Virtual Currency Exchanges. Furthermore, as per the Directions No. 03 of 2021 under Foreign Exchange Act, No. 12 of 2017 issued by the Department of Foreign Exchange of CBSL, Electronic Fund Transfer Cards (EFTCs) such as debit cards and credit cards are not permitted to be used for payments related to virtual currency transactions. Therefore, VCs are considered as unregulated financial instruments and have no regulatory oversight or safeguards relating to their usage in Sri Lanka."

According to that, the public is therefore warned of the possible exposure to significant financial, operational, legal and security related risks as well as customer protection concerns posed to the users by investments in Virtual Currencies. The public is also warned not to fall prey to various types of Virtual Currency schemes offered through the Internet as well as other forms of media.

There is a possibility of currency substitution due to the deplorable state of the Sri Lankan economy. The political leader of the nation is working diligently to obtain assistance from the International Monetary Fund. The procedure takes a lot of time. According to several experts in the cryptocurrency sector state that the country of Sri Lanka now has a strong argument in favor of adopting cryptocurrencies due to the Sri Lankan Rupee has experienced a sharp depreciation since COVID-19 and is currently being drop even more by the current political unrest. The exploration of alternative investments has increased, and Cryptocurrency is one such investment.

Notably, the Sri Lankan government established a committee in 2021 to make recommendations for a regulatory framework to address the expansion of digital banking, blockchain technology, and cryptocurrency mining. According to a press release from the government, developing an integrated system of digital banking, blockchain technology, and cryptocurrency mining is essential for Sri Lanka to keep up with its neighbors in the area while boosting global trade. The committee will study the regulations and initiatives of other countries including Dubai, Malaysia, the Philippines, the European Union and Singapore, to recommend

suitable regulations in Sri Lanka. In terms of concerns, Sri Lanka will be exploring ways to reduce risks of crypto misuse in terror financing, money laundering, and other criminal activities.

According to a survey conducted in 2021 by the blockchain analysis firm Chainalysis, Central and Southeast Asia is one of the world's top regions for the adoption of cryptocurrencies. Sri Lanka, an island nation south of India, has lagged behind other Asian countries in embracing cryptocurrencies. (Chainalysis, 2021)

The Regulations of Crypto Assets in Other Jurisdictions

In the United States, crypto assets are in the spotlight of several federal agencies at once: the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CAEC), the Internal Revenue Service (IRS), the Office of the Comptroller of the Currency (OCC), the Financial Crimes Enforcement Network (FinCEN). Nevertheless, there is no agreed-upon definition of a cryptocurrency in the United States. From a legal perspective, the use of ambiguous categories like "digital assets" provides legislators and regulators more flexibility to control and monitor. The Securities and Exchange Commission, which oversees the issuance and sales of any digital asset, has the primary authority. According to US law, the term "security" includes "investment contracts," which are defined as financial investments made in any firm with a reasonable expectation of profiting from the managerial or entrepreneurial efforts of others by the US Supreme Court.

In China, the mining of digital assets is actively being fought against by the Chinese government, who have outlawed financial transactions involving cryptocurrencies. The People's Bank of China proclaimed all cryptocurrency transactions to be unlawful in September 2021. Such actions, in the opinion of the Chinese regulatory body, "seriously threaten the security of people's property." The People's Bank of China emphasizes that virtual currency business transactions are "illegal financial activity" and are not acceptable.

Furthermore, Japanese law defines “crypto assets” as payment methods that are not denominated in fiat currency and can be used by anyone. There are no restrictions on owning and investing in cryptocurrencies. In Japan, crypto asset exchange service providers are overseen by the Financial Services Agency (FSA). The FSA also cooperates with two self-regulatory organizations in the cryptocurrency industry: the Japan Virtual Currency Exchange Association (JVCEA) and the Japan Security Token Offering Association (JSTOA). JSTOA focuses on token issuance projects and crowdfunding events. The JVCEA is authorized to create rules applicable to cryptocurrency exchanges. Since 2021, crypto assets in Japan have been subject to an anti-money laundering regime and cryptocurrencies are subject to the “Act on Prevention of Transfer of Criminal Proceeds.” (Losev, 2022)

In the European Union, cryptocurrencies are recognized as legal assets and are subject to independent national regulation. Each nation taxes cryptocurrencies differently, with tax rates on income received ranging from 0% to 50%. The EU Court of Justice concluded in 2015 that transactions between fiat money and cryptocurrencies or virtual currencies should not be subject to VAT because they are services rather than goods. In 2021, the European Commission published a package of legislative proposals to regulate the transfers of funds and certain crypto

assets to safeguard EU citizens and the financial system from money laundering and terrorist financing.

The Significance of Cryptocurrency Regulation

A common misunderstanding is that regulation of cryptocurrencies is not necessary as long as they remain a niche industry because it is not beneficial to regulate something that has no obvious benefits and only makes up a small portion of transactions. In order to be regulated in the future, a technology must have either beneficial features, superior attributes, or a significant amount of potential. Whether or when cryptocurrencies eventually replace traditional currencies, regulation is necessary due to the hazards involved in not having regulation.

Due to the decentralized nature of cryptocurrencies, peer-to-peer international transactions are possible without the use of intermediaries. Furthermore, bitcoin owners are often pseudonymous unless they have undergone a KYC (know your customer or know your client) process with a regulated exchange. Watchdogs must therefore up to the technical challenge and adopt a proactive strategy for dealing with the complexity of this contemporary technology.

Market manipulation and price volatility are prevalent in the sphere of cryptocurrencies. The most well-known cryptocurrency in the world, Bitcoin, hit its peak in early 2021 before crashing and losing a large amount of its value. Due to the technical complexity and lack of authorized information regarding digital currencies, laws must be passed to safeguard investors and stop market manipulation.

The rapid development of bitcoin and the fact that legislation is not evolving in sync with cryptocurrency innovations are two other major regulatory concerns. Despite the fact that there are thousands of cryptocurrencies, the majority of investors only have a basic understanding of a few, such as Bitcoin, Ethereum, and Ripple. A regulatory authority overseeing cryptocurrencies is necessary to give an understanding of the performance of digital assets, as well as the possibilities and hazards involved, in order to protect users.

More concerns have been expressed about how purchasing cryptocurrencies can put people at risk of online fraud. Globally, hacking has increased in risk, and cyberattacks have become routine. A cyber-attack could result in losses for investors who have money invested in cryptocurrencies. Given the ease with which cryptocurrencies may be transferred across borders, its anonymity must be addressed in order to combat problems like money laundering and financial theft. Numerous major banking institutions are no longer able to work with cryptocurrency dealers due to a lack of regulation, thus lowering the standing of cryptocurrencies.

Any system that is unregulated inevitably has the potential to foster illegal activities, as is obvious. Therefore, just like a bank, a customer due diligence process is required when buying or selling bitcoins; this could help to keep track of investors' real names and confirm their provenance. Likewise, the bitcoin economy is booming, users are worried about the legal status of the currency, and prospective users and investors should be aware of the numerous risks connected to such a cutting-edge technology.

Conclusions and Implications

The Sri Lankan government cannot ignore the new blockchain since it is a fundamental technology with international relevance. Although the timing, manner, and rate of its growth are not yet established, the potential effects of widespread adoption are already being seen. Legislators, regulators, and judges must swiftly put in place a precise legal framework to govern the bitcoin business while they address the potential and difficulties brought on by this new technology. This is due to the requirement that cryptocurrency transactions be made without gaps in the future.

Businesses and individual investors in Sri Lanka have already started making sizeable capital investments in digital currencies, and this trend is expected to pick up speed when the reality of the development of commercial blockchain installations sets in. It is crucial to exercise caution when dealing with new products and innovative blockchain transactions that criminals are ready to take advantage of through a variety of channels. When regulations to regulate it are unstable or absent, regulators face a difficult problem in dealing with the hazards and opportunities posed by this new technology that is developing quickly.

Considering that the blockchain revolution, on which cryptocurrencies are founded, may represent the future of finance and technology, it is becoming increasingly important to identify the system's major stakeholders and components as this economy grows in size and complexity. However, the task has proven to be difficult because current laws governing the trading of fiat money are insufficient to monitor cryptocurrency activities. They are also insufficient to protect the financial system from important vulnerabilities like the financing of terrorism, money laundering, fraud, and the irreversibility of erroneous transactions.

A solid understanding of both the cryptocurrency's underlying blockchain technology and its potential to revolutionize the world's financial system is necessary for prudent regulation. It is essential that lawmakers craft specialized, custom regulatory frameworks that promote the acceptance of cryptocurrencies, foster the growth of crypto-based commerce, and include mechanisms to preserve financial stability, integrity, and security. There needs to be a better understanding of how regulations will affect innovation, competition, and the financial inclusion of digital currencies.

Sri Lanka is recommended to categorize cryptocurrencies as a form of payment, a security, or a good. The categorization of cryptocurrencies has an impact on how they are maintained, taxed, and what kinds of safety measures are necessary. In order to prevent tax problems or unfair taxing, it would be desirable if the government took on the duty for developing tax regulations and provided a uniform tax rate. It is also suggested to keep track of any virtual currency assets to avoid tax evasion.

Furthermore, identify which industries blockchain-based systems could benefit the country, then offer those system designs with appropriate technical and legal integration while continuously upgrading and amending the existing legal and regulatory framework to promote uptake and utilization. Due to the fact that virtual currencies are developing more swiftly than initially anticipated, Central Bank of Sri Lanka should consider incorporating them into its

payments and settlement infrastructure in the future in order to keep up with the global trend of creating more efficient and affordable payment systems.

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