Re: Comments in Response to the Second Consultation on the Prudential Treatment of Cryptoasset Exposures

The Global Financial Markets Association,[1] the Futures Industry Association, the Institute of International Finance, the International Swaps and Derivatives Association, the International Securities Lending Association, the Bank Policy Institute, the International Capital Markets Association, and the Financial Services Forum (collectively, the "Associations") appreciate the opportunity to respond to the Basel Committee on Banking Supervision's (the "Basel Committee") second consultative document on the "Prudential treatment of cryptoasset exposures" (the "Second Consultation").[2] The Associations welcome the Basel Committee's continued focus on designing a prudential framework for cryptoassets that is risk sensitive as demonstrated by the Second Consultation, including the creation of a Group 2a cryptoasset category, and the partial recognition of hedging for and the use of modified versions of the standardised capital approaches for that category.[3] Furthermore, we look forward to ongoing collaboration as these markets evolve.

The Associations support the design of a cryptoasset exposure framework that facilitates bringing these financial activities within the prudential framework where associated risks will be subject to robust capital and liquidity regulation, sound risk management and ongoing supervisory oversight. To that end, we encourage a suitably conservative but appropriately structured and designed regulatory framework and we believe our goal is very closely aligned with the objectives of the Basel Committee.

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[1] GFMA brings together three financial trade associations, including the Association for Financial Markets in Europe ("AFME"), the Asia Securities Industry & Financial Markets Association ("ASIFMA"), and the Securities Industry and Financial Markets Association ("SIFMA").

[2] *See* Appendix 5 for information regarding each of the Associations.

[3] The Second Consultation defines cryptoassets as private digital assets that depend primarily on cryptography and distributed ledger or similar technology. To determine the prudential classification, cryptoassets must be screened on an ongoing basis and classified into two broad groups: Group 1a cryptoassets consisting of tokenised traditional assets; Group 1b: Cryptoassets with effective stabilisation mechanisms; and Group 2a cryptoassets (unbacked cryptoasset, including tokenised traditional assets and stablecoins that fail to meet Group 1 conditions) that pass the Group 2a hedging recognition criteria, and Group 2b: all other cryptoassets that do not satisfy Group 1 or Group 2a conditions.

With these principles in mind, the Associations' comprehensive review of the Second Consultation has identified some features and calibrations that individually and collectively would meaningfully reduce banks' ability to—and in some cases effectively preclude banks from—utilising the benefits of distributed ledger technology ("DLT") to perform certain traditional banking, financial intermediation and other financial functions more efficiently. As a result, banks would be limited in their ability to respond to their customers' demand for access to cryptoasset products and services. That outcome is not in the best interests of customers, investors or the financial system more broadly. Indeed, the role of banks in the financial system and the scope of the financial sector within the purview of prudential regulators could be affected.[4]

Thus, our comments aim to improve the mutual understanding of current and emerging risks, the role of existing processes and frameworks for regulated entities to manage such risks, and to identify balanced solutions to help in the design of a capital framework that supports enhancing financial stability while avoiding overly restrictive limits to innovation. Getting this right is critical to meet customer demand and harness the benefits of DLT and similar technologies. For example, the speed by and transparency with which transactions can be recorded using DLT, combined with the ability to swap and record assets and cash simultaneously, (1) would help mitigate counterparty, liquidity and settlement risk, (2) allow transactions to settle, and funds and assets to reach their intended recipient, faster and (3) allow for efficiencies in collateral management.

Recent heightened volatility in cryptoasset markets has underscored the risks that emerge when a significant financial market develops outside a prudential risk management framework where excess leverage, inadequate liquidity, and lack of capital can materialise, regardless of the benefits of technology. Allowing appropriately risk-managed cryptoasset banking and other financial activities to take place within the regulatory perimeter should be a central goal of the final Basel Committee standards. A prudential framework that permits banks to support the growth of cryptoassets benefits supervisors by providing better insight into the evolution and growth of these activities (e.g., by requiring the reporting of cryptoasset exposures). At the same time, customers and investors will benefit from more transparent trusted alternatives and the protections of fully regulated institutions providing services.

Otherwise, un- and -lesser-regulated entities are likely to be predominant providers of cryptoasset-related services. The result would be an unlevel playing field and a lack of transparency in the buildup of leverage and risk in the financial system outside the regulatory perimeter. In that case, the absence of regulated financial institutions engaging in cryptoasset-related activities would be net worse than if banks were providing these

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[4] *See*, *e.g.*, Caitlin Long, *Banks Are About To Face The Same Tsunami That Hit Telecom Twenty Years Ago,* FORBES (Sep. 23, 2022), *available at* https://www.forbes.com/sites/caitlinlong/2022/09/23/banks-are-about-to-face-the-same-tsunami-that-hit-telecom-twenty-years-ago/?sh=3e1d483b7a7a (stating "I fear global bank regulators are about to make a decision that will unintentionally 'obsolete' the banks, by prohibiting a coming tech pivot. Making this mistake would guarantee that the tech industry continues going around the banks, right as internet-native payment technologies are starting to scale.").

services subject to an appropriately calibrated framework. Therefore, the Associations welcome the ongoing work by the Basel Committee and other global standard setters to align with "same risk, same activity, same treatment: a cryptoasset that provides equivalent economic functions and poses the same risks as a "traditional asset" should be subject to the same capital, liquidity and other requirements as the traditional asset."[5] As the Associations highlighted above, financial institutions can offer valuable expertise in setting market standards consistent with prudent risk management. In addition to the points noted above, bringing cryptoasset-related activities into the prudential regulatory perimeter would (1) garner the benefits of the operational risk management and operational resiliency of banks and (2) enhance customer protection due to the existing frameworks for claims against banks and their regulated affiliates, in the unlikely event of bankruptcy or insolvency.

The Associations stressed in our response (the "First Consultation Comments") to the First Consultation that banks have a long history of integrating new technologies into their product offerings and activities and working with supervisors to ensure the regulatory framework remains fit for purpose to support safety and soundness and financial stability. As reference, in Appendix 1, we provide relevant case studies that exemplify how the banking industry is effectively collaborating with supervisors while integrating cryptography and distributed ledger or similar technology into products and services to meet client demand and to deliver market efficiencies.

At this critical juncture in the development of cryptoasset markets, there are a range of issues we ask the Basel Committee to address. Among them, two could have a gating effect: (1) the design and calibration of the Group 2 exposure limit and (2) the proposed infrastructure risk add-on for Group 1 cryptoassets. If these issues are not addressed in whole, it may not be economically viable and rational to make the investments necessary to facilitate clients' needs on cryptoasset-related activities, which likely would result in a shift of activity in this space to the nonbank sector. The infrastructure risk add-on is particularly pronounced given the breadth of cryptoassets that the Second Consultation covers. That is, a wide range of tokenisation activities, including prudentially- and market-regulated traditional financial activities and assets, could be subject to the add-on, impacting cost structure of firms leveraging the benefits of DLT or similar technology. While a 2.5% risk-weighted asset ("RWA") increase may not sound material, the overall position of banks trying to lessen RWA constraints combined with significant build expense would make the decision to engage in DLT infrastructure unattractive. This result also could derail the market and associated regulatory innovation via the introduction of regulatory sandboxes in a few jurisdictions starting in Q1 2023, whereby banks would need to justify additional capital requirements that would result from participation. Therefore, to avoid an effective preclusion on banks participating and developing in these markets, we underscore our view that the Basel Committee should address these two issues.

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[5] BASEL COMMITTEE ON BANKING SUPERVISION; *Prudential treatment of cryptoasset exposures* (June 2021), *available at* https://www.bis.org/bcbs/publ/d519.pdf (hereinafter the "First Consultation") at 2.

To sum up, our overarching goal is to help in the design of a prudential framework that supports enhanced financial stability and avoids overly restrictive limits to innovation. Accordingly, the Associations have identified features of the Second Consultation that would impede banks from engaging in such activities. Specifically:

- **The Group 2 Cryptoassets Exposure Limit Is Prohibitive and Should Be Recalibrated and Calculated on a Net, Rather than Double-Gross, Basis (pp. 10-22):** The Second Consultation proposes to limit banks' exposures to Group 2 cryptoassets to 1% of the bank's Tier 1 capital, calculated on a "double-gross" basis by adding the long and short positions without any hedging recognition. The Associations believe the exposure limit construct components: (a) gross calculation methodology; (b) the extremely restrictive quantitative limit calibration; (c) the scope of cryptoasset exposures subject to the exposure limit and (d) the cliff-effect penalty resulting from an exposure limit breach, individually and collectively would effectively bar banks from participating in Group 2 cryptoassets. Importantly, the proposed methodology does not allow banks to manage limit utilisation to cryptoassets as the addition of a hedge instrument or a price increase of the underlying cryptoasset could make breaching the limit more likely by increasing the total exposure. Instead, the Associations propose that a modified exposure limit—calculated on a net basis, calibrated to 5% of Tier 1 capital and accompanied with disclosure to supervisors of gross positions, as well as a supervisory approach to any breach of the limit—would ensure adequate capitalisation and transparency while not undermining the economic viability for banks to serve clients' risk management needs with the digital and cryptoasset markets.

- **The Infrastructure Risk Add-On Is Unnecessary and Seeks to Address Risks that Are Already Addressed by the Existing Prudential Framework and Risk Management Systems (pp. 29-37):** The Second Consultation proposes an infrastructure risk add-on for all Group 1 cryptoasset exposures as well as a classification that goes beyond focusing on a bank's third-party risk management and operational resilience controls. This capital penalty and the current scope of the associated classification condition appear to be inconsistent with a technology risk-neutral approach in that the add-on penalises a particular technology and these measures are not necessary to protect the safety and soundness of banks; these risks are already addressed through existing operational risk and third-party risk management frameworks and programs[6]. Supervisory tools and controls are also available to address any such identified risks. Finally, this capital charge would act as a disincentive to banks given the significant—but necessary—investment in these technologies and systems required to appropriately service clients in these markets and could encourage the movement of cryptoasset activity outside the regulatory perimeter. The Associations recommend removing the infrastructure

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[6] BANK OF ENGLAND; *Existing or planned exposure to cryptoassets* (Mar. 24, 2022), *available at* https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2022/march/existing-or-planned-exposure-to-cryptoassets.pdf?la=en&hash=9C23154F16580082C3DD6437B4C3352591A0F946.

risk add-on to reflect a more nuanced picture of how technology infrastructure can be used.

- **Group 2a Cryptoassets Hedging Recognition Should Be Further Adjusted (pp. 22-29):** While the Associations appreciate that the Second Consultation recognises partial hedging for Group 2a cryptoassets, the Associations believe that it would be appropriate to make certain further adjustments to the risk factor structure and correlation parameter calibration for Group 2a cryptoassets to more accurately reflect the actual risk characteristics of such assets and give appropriate recognition to established risk management practices.

- **The Group 1 Asset Supervisory Classification Process Is Not Workable (pp. 37-38):** The Second Consultation envisions supervisors reviewing and pre-approving a bank's determination whether a cryptoasset qualifies as a Group 1 cryptoasset to avoid prudential treatment as Group 2. The Associations affirm the need for sustained, iterative dialogue between supervisors and banks on integrating DLT and related technologies into their activities and offerings. However, the Associations maintain that a more practical and less burdensome model for supervisory engagement would be for banks, rather than supervisors, to be responsible for making these determinations, subject to satisfying the specified, clear classification criteria. The Associations' suggested approach would, on the one hand, be more responsive to the potentially vast universe of cryptoassets than pre-approvals for each individual crytpoasset while, on the other hand, supporting global consistency in cryptoasset treatment.

- **The Scope of the Cryptoasset Exposure Framework Should Be Clarified to Ensure that It Does Not Have Unintended Consequences (pp. 38-40, 61-63):** The Basel Committee should clarify the scope as follows:

    - *Assets under Custody*: Because assets under custody only give rise to operational risk, only the operational risk requirements of the cryptoasset exposure framework should be applicable to assets under custody both in fiduciary and non-fiduciary arrangements, similar to the treatment for traditional assets under custody.

    - *Settlement and Recordkeeping Functions*: The use of DLT for settlement or recordkeeping purposes—for example, including internally developed, private, permissioned blockchain systems— should not by itself subject the related asset to the cryptoasset exposure framework because such activities generally do not create a new asset that is distinct from the underlying asset or increase the risk or liquidity profile of the underlying assets.

    - *Scope of Exposures Subject to Group 2b:* The Associations seek confirmation that the reference to "other entities" in the scope definition of Group 2b only relates to fund vehicles and not to corporations, such as equity investments in crypto exchanges.

- **The Scope of Classification Condition 1 Should Be Revised (pp. 41-48):** Digitally native cryptoassets should be eligible for treatment as Group 1 cryptoassets. Certain requirements for Group 1a cryptoassets are overly restrictive and should be revised to better accommodate innovation in tokenised arrangements. For Group 1 cryptoassets, classification condition 1 requires minor modifications to allow digital representations of traditional assets (such as bank-issued tokens) using cryptography, DLT or similar technology to record ownership and that pose the same level of credit and market risk as the traditional (non-tokenised) form of the asset to qualify. The Associations also welcome that the Second Consultation recognises that a stablecoin that is issued by a supervised and regulated entity should be deemed to meet classification condition 1 in lieu of the redemption risk and basis risk tests.

- **Permissionless Blockchains and Public Permissioned Blockchains Should Be Eligible for Group 1 Treatment (pp. 51-53):** Cryptoassets that are based on permissionless blockchains should be eligible to be included in Group 1, subject to the existence of certain controls. We believe that, given the risk mitigants available to banks in their engagement with this technology, permissionless blockchain should be eligible for Group 1 treatment to allow stablecoins to be used for payment. If cryptoassets based on permissionless blockchains are not eligible to be included in Group 1, those based on permissioned public blockchains should be eligible to be included in Group 1.

In addition to the main body of the letter, this letter also includes the following appendices:

- Appendix 1: Cryptoasset Case Studies and Use Cases
- Appendix 2: Proposed Rule Text for Interim Approach
- Appendix 3: Correlation Across Tenors for Bitcoin and Ether
- Appendix 4: Supporting Analysis for Exposure Limit Calibration
- Appendix 5: Background Information on the Associations
- Appendix 6: Index of Defined Terms

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