

Via Electronic Submission

September 10, 2021

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 – Basel, Switzerland

RE: Consultative Document - Prudential Treatment of Cryptoasset Exposures (June 2021)

Ladies and Gentlemen:

The American Bankers Association (ABA)¹ is pleased to respond to the consultative document (Consultation) dated June 2021, issued by the Basel Committee on Banking Supervision (BCBS) concerning prudential treatment of banks' cryptoasset exposures. The Consultation provides a useful starting point for analysis of the regulatory issues relevant to bank cryptoasset activities. ABA believes, however, that considerable further work is required to inform this policy debate, which should be framed by three key principles:

- Market participants and supervisors should acknowledge the need for and work to develop a broad, common understanding of key features of the many existing cryptoassets, as well as the principal risks they present, as the basis for prudential treatment of these assets.²
- As banks seek to serve customers who want exposure to cryptoassets, national regulatory and supervisory authorities must permit prudent innovation to accommodate those customer desires. Authorities should be careful to avoid preempting technological innovation by being overly prescriptive - technological evolution is rapid, and highly prescriptive regulation cannot be adjusted quickly enough to remain current. Inflexibility would constrict financial inclusion and other benefits of emerging technology.
- The overall stability of the global financial system will benefit from the transparency that will result by conducting a significant share of the cryptoasset market through supervised financial institutions, as opposed to being driven outside the banking system. Rational supervision and regulation that avoids overly prescriptive approaches will promote key

¹ The American Bankers Association is the voice of the nation's \$22.8 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard nearly \$19 trillion in deposits and extend \$11 trillion in loans.

² This document, unless otherwise specified, uses the definition of "cryptoasset" set out in the Consultation, drawing on earlier consultative documents: private digital assets that depend primarily on cryptography and distributed ledger or similar technology. See Consultation at 1, <https://www.bis.org/bcbs/publ/d519.pdf>.

public objectives of law enforcement, and suppression of terrorism finance and other security threats.

Numerous aspects of the Consultation bear directly on these principles. The balance of this discussion explores these aspects in more detail.

Summary of Recommendations

- The proposed definition of Group 1 cryptoassets creates operational problems and a potential “cliff effect” that could undermine financial stability. Below are several suggestions for mitigating or eliminating these risks.
- The proposed risk weight for Group 2 cryptoassets is unnecessarily high.
- Credit risk and market risk for Group 2 cryptoassets should be assessed separately as is currently done for other assets.
- Hedging and netting should be recognized and encouraged as risk mitigants.

The general principles that guided the Consultation fail to highlight adequately several key factors that could produce adverse results.

The Consultation’s three guiding principles (summarized) are:

- Same risk, same activity, same treatment;
- Simplicity; and
- Minimum standards (*i.e.*, national regulatory and supervisory authorities would be free to add additional and/or more conservative requirements).³

Though appealing at first impression, application of these principles in a regulatory and supervisory scheme requires careful judgment.

First, equivalent treatment that is “technology neutral” is a sensible approach only if it is based on a thorough understanding of the relevant technology and the related operational risks. Lack of a thorough understanding on the part of regulatory and supervisory agencies would mean difficulties in understanding whether the “same risk” is present, likely leading to overregulation. The recent intense focus on operational risks generally (*e.g.*, cybersecurity) makes concern about potential overregulation even greater.

Second, the principle of simplicity as discussed in the Consultation appears to conflict in important respects with the principle of “same treatment.” As discussed in detail below, the

³ See Consultation at 2.

Consultation's proposed capital treatment for cryptoassets conflates capital protections against credit risk with those that protect against market risk. Though such an approach would arguably be simpler in many ways (and, indeed, regulatory capital regimes from decades past could be described as doing the same), the approach was discarded in favor of more granular measures of risk, with which internationally active banks are now familiar and which they have operationalized. Particularly with respect to cryptoassets that exhibit significant market volatility, national regulatory and supervisory authorities should seek consistent treatment for cryptoassets and traditional assets presenting similar risks, bearing in mind the relevance of differing technological characteristics discussed above.

Third, though the principle of minimum standards properly acknowledges the legal and practical aspects of the relationship of BCBS to national regulatory and supervisory authorities, divergence in national standards applied to internationally active banks creates a significant risk of regulatory fragmentation. Not only could this approach result in unfair terms of competition among those banks, but it also risks skewing markets because of regulatory arbitrage. An original objective of BCBS's work was to place regulation of international banking activity on a reasonably consistent basis across jurisdictions,⁴ and that objective certainly is important to this rapidly evolving financial sector.

The proposed definition and treatment of Group 1 assets would raise practical and operational problems and create a potential cliff effect that could undermine financial stability.

For tokenised traditional assets (Group 1a) and cryptoassets with effective stabilization mechanisms (Group 1b), the Consultation proposes application of the same risk-based capital treatments that apply to the underlying traditional assets, as long as the cryptoassets meet specified structural conditions.⁵ The conditions generally require either (in the case of Group 1a assets) that cryptoassets be digital representations of traditional assets using cryptography, Distributed Ledger Technology (DLT) or similar technology, or (in the case of Group 1b assets) that the asset have a stabilization mechanism that is effective at all times in linking their value to underlying traditional assets or a pool of traditional assets. The arrangements establishing these structures must be legally enforceable, have robust operational risk management, and be transparent such that all transactions and participants are traceable. In addition, only regulated and supervised entities could execute redemptions, transfers, and transaction settlements.⁶ For Group 1b cryptoassets, the Consultation proposes that the daily difference between the value of the cryptoasset and the underlying traditional asset(s) must not exceed 10bp of the value of the underlying traditional asset more than three times over a one-year period.⁷

⁴ See History of the Basel Committee, available at <https://www.bis.org/bcbs/history.htm>.

⁵ Consultation at 3. Stabilization mechanisms that: (i) reference other cryptoassets as underlying assets, or (ii) use protocols to increase or decrease the supply of the cryptoasset are not considered to meet this condition. See Consultation at 4.

⁶ Consultation at 4-5.

⁷ Consultation at 4.

Thus, the risk-based capital treatment of Group 1 cryptoassets would depend entirely on compliance with all of these tests, and, because of the highly punitive proposed risk weight proposed for other cryptoassets, discussed below, the consequences of failing any part of the tests could be catastrophic from a compliance and economic standpoint. If legal aspects of a cryptoasset's stabilization mechanism were called into question, *e.g.*, by an adverse court ruling in litigation to which a given institution was not a party, the bank could be required to reclassify its investment upon very short notice and with no opportunity to contest the result. The undesirable choice between dealing with a suddenly recognized capital deficiency and liquidating a position in what is likely a highly uncertain environment (at least as concerns that specific asset) is unlikely to further either institutional safety and soundness or financial stability generally.

Another potentially harmful (and avoidable) “cliff effect” would occur when values diverge beyond the 10bp collar more than three times in a year. Though it may be easier to foresee the potential test failure in advance, a third breach of the collar means a potentially drastic change in capital structure, with the poor choices of solution noted above.

Both of these scenarios can be avoided if national regulatory and supervisory authorities adhere to the principles noted at the beginning of this letter. A thorough common understanding among regulators, supervisors, and regulated institutions of key cryptoasset features should help significantly to avoid unexpected reclassification of assets (*e.g.*, from Group 1 to Group 2) due to misunderstandings or disputes about legal structure and enforceability.⁸ In addition, if market volatility (including divergence between a stabilized cryptoasset and the underlying traditional asset) is addressed by more precisely targeted measures, with incrementally higher volatility requiring only incrementally higher capital commensurate with the risk that volatility presents, part of the cliff effect noted above could be avoided. The ability to address market volatility in a more targeted way depends on a more thorough common understanding of cryptoassets by regulators and regulated institutions.⁹

In addition, the proposed requirement that, for Group 1 cryptoassets, entities that execute redemptions, transfers, or settlements of the cryptoasset be regulated and supervised is likely to inhibit banks' dealings with some existing major cryptoasset market participants.¹⁰ Some degree

⁸ The Consultation does not reach the question of who decides whether a particular cryptoasset meets the conditions for Group 1 treatment. Though national regulatory and supervisory authorities would certainly have significant voices in such decisions, it is unlikely that regulatory processes alone would be sufficiently flexible and nimble to accommodate rapid market innovation. On the other hand, supervised banks might be discouraged from market participation if there is lingering uncertainty about classification, particularly if the “cliff effects” discussed in the text are not addressed. Both of these considerations have the potential to inhibit banks' service to customers and to create a bias in favor of unregulated, unsupervised market participants in cryptoasset transactions. The entire cryptoasset classification logic must be judged against these considerations.

⁹ Moreover, as discussed more generally below, a comprehensive capital treatment of cryptoasset market risk should follow existing, well-understood models, and the classification problems described above could more easily be appropriately addressed.

¹⁰ For example, a recent €100MM bond offering by the European Investment Bank was delivered to investors via the Ethereum blockchain. See <https://www.eib.org/en/press/all/2021-141-european-investment-bank-eib-issues-its->

of diligence to verify other structural and legal aspects of stabilization mechanisms, as well as monitoring of market data, are logically necessary, but these prudent requirements do not necessarily depend upon, or even benefit from, the regulated and supervised status of service providers involved in the transaction. As long as banks can satisfy supervisors that these other conditions are met, supervisors should be flexible regarding the status of other parties.

The proposed risk weight of 1,250% for Group 2 cryptoassets is punitively high, particularly in light of the “cliff effect” of a classification failure.

The Consultation proposes that any cryptoasset that fails any aspect of the Group 1 tests be treated as a Group 2 cryptoasset, which would carry a 1,250% risk weight.¹¹ This proposed risk weight amounts to a mandate to fund long positions in Group 2 cryptoassets 100% with capital, not permitting any leverage,¹² and to hold similar capital against the notional amount of short positions. The rationale for this punitive risk weight is that it is intended to address both credit risk and market risk,¹³ and it may be an attempted analogy to the capital treatment of intangible assets.¹⁴

This aspect of the proposal raises several concerns. First, as noted above, a change in classification from Group 1 to Group 2 would have drastic results if the proposed risk weight is used. Regardless of the cause of the classification shift, the dramatic increase in risk weight, especially if unanticipated, may force liquidation of the position. Moreover, as noted above, such liquidations would be likely to occur under adverse market conditions for that asset, when either the legal status of a stabilization arrangement is suddenly thrown into doubt, or market conditions have resulted in (or market participants anticipate) an increase in volatility. In the latter case, liquidation of positions ahead of an expectation that a cryptoasset is likely to breach the Group 1 volatility collar could create a self-fulfilling prophecy.

These risks of sudden, adverse regulatory consequences, in addition to the punitively high risk weight *per se*, would likely amount to an effective prohibition of Group 2 cryptoasset activity by many banks. The unfavorable economics of positions in acknowledged Group 2 cryptoassets, combined with the potential uncertainty inherent in the proposed classification of Group 1 cryptoassets, would seriously inhibit banks from accommodating their customers' desire for cryptoasset exposure, even if managed conservatively and prudently.

The 1,250% risk weight also assumes that all Group 2 cryptoassets present equivalent combined credit and market risks. Both regulated banks and national regulatory and supervisory authorities are unlikely to accept this implicit conclusion. At a minimum, assets that do not present a risk of

[first-ever-digital-bond-on-a-public-blockchain](#). The financial and legal terms of this security would clearly meet the requirements of Group 1a, but [certain steps in] its transfer and settlement were not through a regulated entity.

¹¹ Consultation at 13. This treatment would not, however, apply to any assets that have already been deducted from Common Equity Tier 1 (CET1) under applicable risk-based capital regimes.

¹² This calculation assumes a basic risk-based capital requirement of 8% of risk-weighted assets.

¹³ See Consultation at 14.

¹⁴ Note that intangible assets usually lack available market quotations. Even many highly volatile cryptoassets have readily available market quotations.

a particular party failing to perform an obligation (because the structure of the cryptoasset includes no such obligation) present essentially no credit risks compared to those that do, and this difference should be reflected in an appropriate difference in risk weight.¹⁵

Finally, banks involved in or contemplating cryptoasset market-making have noted that some assets, such as tokenized bonds, involve payment of fees and similar charges in Group 2 cryptoassets.¹⁶ For example, to send bonds that have been issued via the Ethereum blockchain network to investors, firms must pay transaction fees in Ether. Ether and other Group 2 assets held for such purposes should be subject to a significantly lower risk weight.

Given all of these concerns, BCBS should propose a risk weight for Group 2 cryptoassets no higher than 400%. This risk weight is currently applied to “speculative unlisted equity,” including private equity securities and similar assets that typically offer very limited liquidity or price transparency. Many Group 2 cryptoassets offer a significantly higher degree of liquidity and price transparency. The development of a cryptoasset capital regime would ideally be based on a range of risk weights subject to this 400% maximum. To account appropriately for credit exposure will require further empirical research, but a range of risk weights should be an integral part of setting capital requirements for cryptoasset exposure.

Credit risk and market risk for Group 2 cryptoassets should be assessed separately as is currently done for other assets, and hedging and netting should be recognized and encouraged as risk mitigants.

Over several decades, BCBS and national regulatory and supervisory authorities have developed highly detailed, carefully calibrated risk-based capital regimes for addressing both credit and market risk. These capital regimes are now applied across the universe of asset types and activities that involve bank balance sheet exposure. As noted above, the Consultation proposes to depart from this framework with respect to Group 2 cryptoassets, substituting a 1,250% risk weight for more carefully calibrated approaches. Both because it would apply concepts already familiar to bank risk managers, supervisors, and public markets, and also because it should more precisely capture risks, BCBS and national regulatory and supervisory authorities should maintain separate but integrated approaches to credit and market risk of cryptoassets.

In this regard, the Consultation proposes restrictions on netting Group 2 cryptoasset positions, including requiring capital against the greater of the gross long and short positions in a given cryptoasset, without netting.¹⁷ This treatment is particularly problematic in light of the further proposal that, since (unhedged) short positions can theoretically lead to infinite losses, national regulatory and supervisory authorities are encouraged to consider incremental capital under Pillar 1 to address this risk.¹⁸ To the extent a long position is partially offset by a short position,

¹⁵Assessing market risk separately, as discussed below, would facilitate clearer recognition of such structural distinctions.

¹⁶ See, e.g., <https://support.blockchain.com/hc/en-us/articles/360000939903-Transaction-fees>.

¹⁷ Consultation at 13.

¹⁸ Consultation at 13-14.

holding capital, particularly at such a high risk weight, against the gross long position is unwarranted. Assuming an appropriate range of risk weights below 1,250% can be established, calculating capital based on net long positions (after deduction of short positions in the same cryptoasset) should be adequate. Net short positions, which could still theoretically pose infinite risk, require further analysis, but, again, the existing framework for holding capital against credit and market risk should be the guide.¹⁹

Beyond netting long and short positions, similar logic supports the recognition and encouragement of hedging to address cryptoasset risks. Practical hedging products exist for numerous Group 2 cryptoassets,²⁰ and these generally present negligible basis risk. Given the extensive history and effort that has gone into hedge recognition for trading book assets generally, it is both unnecessary and potentially dangerous to ignore this aspect of risk management in cryptoasset activities. Participating banks are likely to implement them as part of their own risk management strategies, and regulatory and supervisory regimes should acknowledge their benefits.

Concerning the related issue of recognition of collateral, existing capital frameworks again point to an appropriate approach. Qualification as collateral necessarily entails having adequate liquidity, and that requirement (and other criteria, *e.g.*, requiring a perfected security interest) currently in place for acceptable financial collateral should apply to cryptoassets also. In addition, current rules already address assessment of value and volatility (providing for haircuts). Like other aspects of the existing framework, these features should be incorporated into the capital treatment of cryptoassets.

Moreover, the market risk considerations applicable to Group 2 assets are also inconsistent with the proposed risk weight. For example, as noted above, speculative unlisted equity investments carry a 400% risk weight, and there is normally no market quotation available for such assets. In contrast, many of the best-known Group 2 cryptoassets are regularly quoted, and volatility can be measured and tracked. Graduated capital requirements reflecting documented volatility and the availability of quotations would be preferable to a single, excessively conservative risk weight.

In a final analysis, for all the reasons outlined, BCBS and national regulatory and supervisory authorities should build on and follow existing accounting, hedging, netting, and legal documentation concepts in existing risk-based capital requirements. The propriety of this approach for exchange traded or centrally cleared assets is especially clear, but the same logic applies to other assets as well.

¹⁹ In fact, the Consultation notes that, in addressing capital requirements for short positions, “...the capital add-on would be calibrated...to calculate aggregate capital requirements under the [BCBS’s] revised market risk framework...and to use this amount if the result is higher than the requirement based on a 1250% risk weight.” Consultation at 15. This aspect of the proposed framework demonstrates the logic of using existing credit and market risk capital frameworks to address cryptoasset risks.

²⁰ Examples include: [CME bitcoin futures and options](#) and various ETPs/ETFs, such as [ABTC](#), [QBTC11](#), and [BTCC](#).

The Consultation leaves other risks for future evaluation, but appropriate capital treatment cannot be developed, and definitely cannot be finalized, in isolation from regulatory and supervisory approaches to those risks.

The Consultation correctly notes that national regulatory and supervisory authorities (and presumably BCBS) will have to address other risks related to cryptoasset holdings, including leverage capital and liquidity ratios and supplemental capital requirements to address large exposures. Moreover, it notes that cybersecurity/resiliency and other operational risks will be left to Pillar 1 supervision.²¹ Though the Consultation provides a very useful opening discussion of risk-based capital requirements for cryptoasset activity, a fully developed risk-based capital regime is impossible to achieve in a context isolated from these other requirements. As the policy discussions of which the Consultation is an important part progress, these topics require concurrent thoughtful examination.

Throughout the policy development process, BCBS and national regulatory and supervisory authorities should operate under the key principles noted at the beginning of this letter: working toward a broad market consensus concerning the key features and risks of cryptoassets; permitting prudent innovation so banks can accommodate customer needs; and avoiding overly prescriptive approaches that shift cryptoasset transactions into less transparent parts of the financial market, with negative consequences for law enforcement and security. Doing so will promote the public interest in competitive, convenient, and secure financial services.

Thank you for your consideration of the matters discussed. Should you have any questions, please do not hesitate to contact the undersigned at hbenton@aba.com.

Very truly yours,

/s/

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Vice President, Banking Policy

²¹ Consultation at 15-17.