American Bankers Association
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Basel Committee on Banking Supervision
Bank for International Settlements
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RE: Second Consultative Document - Prudential Treatment of Cryptoasset Exposures (June 2022)

The American Bankers Association (ABA)[1] is pleased to respond to the consultative document (Consultation) dated June 2022, issued by the Basel Committee on Banking Supervision (BCBS) concerning prudential treatment of banks' cryptoasset exposures. The Consultation follows on the BCBS's previous consultation (Prior Consultation), which provided a useful starting point for analysis of the regulatory issues relevant to bank cryptoasset activities. In ABA's response to the Prior Consultation,[2] we noted that further work was required to inform this policy debate. ABA believes that the Consultation represents progress, but numerous issues remain. As we noted in 2021, supervisory and regulatory approaches to cryptoassets 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.[3]

- As banks seek to serve customers who want exposure to cryptoassets, national regulatory and supervisory authorities must permit prudent innovation within the regulatory perimeter 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

[1] The American Bankers Association is the voice of the nation's $24 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard nearly $19.9 trillion in deposits and extend $11.4 trillion in loans.

[2] *See* https://www.aba.com/advocacy/policy-analysis/aba-letter-to-bcbs-re-crypto-consultation.

[3] 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* Prior Consultation at 1, https://www.bis.org/bcbs/publ/d519.pdf.

financial institutions, as opposed to being driven outside the banking system. Rational supervision and regulation that avoids overly prescriptive approaches will promote key public objectives of law enforcement, consumer and investor protection, and suppression of terrorism finance and other security threats.

Moreover, as BCBS has noted, a cryptoasset that provides equivalent economics and functions, and poses the same risks, as a "traditional asset" should be subject to the same regulatory requirements as the traditional asset. The prudential framework should apply the concept of "technology neutrality" and not be designed to support or to discourage the use of specific technologies related to cryptoassets. The overall prudential treatment should, however, account for any additional risks (*e.g.,* operational risk) arising from cryptoasset exposures relative to traditional assets.

The balance of this discussion will focus on the areas in which the Consultation provides updates since 2021.

Summary of Recommendations

- The proposed definitions of Group 1a and 1b cryptoassets and the proposed consequences for failure to qualify under those definitions remain problematic. They excessively punish "narrow passing" of the basis risk test, and they may inappropriately treat tokenized bank deposits. Below are several suggestions for mitigating or eliminating these concerns.

- The proposed 1250% risk weight for Group 2 cryptoassets remains unnecessarily high, particularly in conjunction with other proposed limitations.

- BCBS should eliminate the proposed Group 2 exposure limit.

- The proposed infrastructure risk add-on for Group 1 cryptoassets should be eliminated, as the risks it seeks to address are covered in other sections of the Consultation.

- BCBS should avoid conflating exposures to on-balance-sheet trading and portfolio assets with assets held in custody or safekeeping arrangements for others, which are covered by the existing operational risk framework. Otherwise, the result would be unprecedented change in the capital treatment of assets held in custody, the risks of which should be captured through the existing operational risk framework.

Recent failures of stablecoin structures and cryptoasset losses more generally highlight the need for comprehensive, rational regulatory protections, including a "level playing field" between regulated financial market participants and those that are currently unregulated.

Cryptoasset activities conducted by unregulated entities across multiple jurisdictions have produced significant market losses,[4] making clear that such entities can raise potentially serious financial stability concerns. Some of the losses were simple declines in the market values of Group 2 cryptoassets (*e.g.,* bitcoin and ether), but others resulted from structural, operational, or legal failures.

The critical lesson of these events is that thoughtful, comprehensive regulation is essential to the health of cryptoasset markets. The entities that experienced losses and those that executed or facilitated loss-making transactions were generally not subject to the regulatory and supervisory requirements applicable to banks, and analyses of recent market experiences reveal that they often took more risks than would have been permitted for a regulated entity. Failures resulted from excess leverage and lack of liquidity in many cases. Though regulation is necessary, it should not prevent banks from engaging prudently in cryptoasset markets.[5] Banks will take a more methodical approach, and supervisors will have insight into their activities and attendant risks.

The treatment of Group 1b cryptoassets is an improvement over the Prior Consultation, but further simplification is appropriate and necessary.

The proposed basis test for Group 1b cryptoassets is an improvement over the Prior Consultation and will significantly reduce the "cliff effect" risk that ABA and many others noted last year. If a bank is able to redeem stablecoins directly with the issuer, however, ABA believes that the 100% risk-weight add-on for "narrowly passing" the basis risk test should not apply. If a bank holding a Group 1b cryptoasset can demonstrate that reserves are sufficient to cover the peg, can be redeemed in five days, directly with issuer, the basis test is unnecessary. The basis risk is a greater concern if the holder must instead sell the stablecoin on an exchange, but if a bank can redeem its holding directly for the underlying asset, only the counterparty risk of the issuer is relevant (and counterparty risk capital requirements would apply in any case).

[4] *See, e.g.,* https://www.nytimes.com/2022/05/12/technology/cryptocurrencies-crash-bitcoin.html.

[5] As discussed below, though offering some improvements over the Prior Consultation, ABA is concerned that the cumulative impact of several points raised in the Consultation in connection with Group 2 cryptoassets - the proposed 1% gross exposure cap, the retained 1250% risk weight, the proposed operational risk add-on, and the conservative approach to hedging – will still likely amount to foreclosing participation for many banks.

BCBS should make clear that "tokenized deposits" issued by banks are Group 1a cryptoassets.

In its elaboration of Classification Conditions, BCBS notes that "bank-issued tokenised payment assets that are backed by the general assets of the bank and not by a pool of reserve assets may be referred to as "stablecoins."[6] The Consultation goes on to provide that despite use of that terminology, such assets "may" be treated as Group 1a cryptoassets, provided they meet the other applicable classification requirements. ABA believes that BCBS's intent is that tokenized bank deposits described *should* be treated as Group 1a cryptoassets if they meet the applicable classification requirements, which would appropriately result in regulatory treatment accorded to deposit holdings under the current Basel framework. ABA is concerned, however, that use of the term "may" could be interpreted as suggesting that BCBS would leave this decision to national regulatory authorities. Besides raising the risk of conflicting treatment in different jurisdictions, treating tokenized deposits the same as asset-backed stablecoins would be inconsistent with the overall rationale of the Classification Conditions, and BCBS can easily eliminate this potential confusion by rephrasing the language.

The revised proposed capital standards for Group 2 cryptoassets are still inconsistent with prudent, meaningful market participation by banks, but potential adjustments would provide a reasonable approach.

Eliminate the proposed Group 2 exposure limit.

ABA notes, first, that there is no rationale offered for the Consultation's proposed Group 2 exposure limit of 1% of Tier 1 capital. Moreover, the proposed limit applies to all Group 2 cryptoassets on gross exposures, with no netting or recognition of diversification benefits.[7] In addition, measuring on a gross basis removes the incentives for prudent risk management. Breaches of the limit would mean that, until compliance with the limit is restored, all Group 2a cryptoasset exposures (*i.e.,* not simply the amount in excess of the cap) would be subject to the capital requirements that apply to Group 2b cryptoasset exposures.[8]

ABA recommends that BCBS:

- Eliminate the 1% cap; and
- Allow for netting with the refinements to the netting calculation discussed below.

[6] Consultation at 9.
[7] Consultation at 6.
[8] Consultation at 30.

Refine the proposed netting treatment for Group 2a cryptoassets to align better with actual market characteristics.

It appears that, in efforts to refine its proposed netting treatment of Group 2a cryptoassets, BCBS has attempted to adapt practices and methodologies from commodities markets to cryptoasset exposures. Though many in academia, the official sector, and elsewhere have drawn parallels between cryptoassets and commodities, in this specific context, there are structural differences that BCBS should acknowledge, particularly with respect to term structure. Adjustments should be made to the commodities calculation to take these differences into consideration. Specifically, ABA recommends the following:

- Remove maturity buckets. The term structure for commodities is rooted in requirements for physical storage, delivery, and seasonality. It is therefore reasonable to have a maturity element to netting where perishable physical commodities are involved. In contrast, the term structure for cryptoassets is more akin to those in foreign exchange and equities markets, which are based on funding spreads. BCBS should therefore remove maturities as netting criteria.

- Add an exception to the proposed treatment of consolidated exposures involving different exchanges – if the reference price is identical, full netting should be allowed regardless of exchange.[9]

Reduce overall proposed risk weights for Group 2 cryptoassets.

As we noted in our response to the Prior Consultation, the proposed 1250% risk weight for Group 2 cryptoassets is overly punitive. This proposed risk weight amounts to a mandate to fund long positions in Group 2 cryptoassets 100% with capital, not permitting any leverage,[10] 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,[11] and it may be an attempted analogy to the capital treatment of intangible assets.[12]

This proposed treatment raises several concerns. First, as noted in our response to the Prior Consultation, a change in classification from Group 1 to Group 2 would have drastic results if the proposed risk weight is used. Even with the Consultation's more refined approach to maintaining Group 1 classification, the dramatic increase in risk weight may force liquidation of the position. Moreover, such liquidations would be likely to occur under adverse conditions in

[9] For example, over-the-counter "non-deliverable forward" contracts reference the same spot price as CME Futures.
[10] This calculation assumes a basic risk-based capital requirement of 8% of risk-weighted assets.
[11] *See* Prior Consultation at 14.
[12] Note that intangible assets usually lack available market quotations. Even many highly volatile cryptoassets have readily available market quotations.

the markets for that asset, such as when projections point to an increase in volatility. 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, even when "failure" is incremental rather than binary.

These risks of sudden, adverse regulatory consequences, which would still exist under the Consultation's proposed revisions, 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 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 1250% risk weight also assumes that all Group 2 cryptoassets present equivalent combined credit and market risks. Even taking into account recent cryptoasset market volatility, 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 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.[13]

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.[14] 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 cryptoassets held for such purposes should be subject to a significantly lower risk weight.

Given these concerns, BCBS should propose a risk weight for Group 2 assets that is more consistent with the current overall Basel framework. Lower risk weights already apply to 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. 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.

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).

[13] Assessing market risk separately, as discussed in ABA's response to the Prior Consultation, would facilitate clearer recognition of such structural distinctions.

[14] *See, e.g.,* https://support.blockchain.com/hc/en-us/articles/360000939903-Transaction-fees.

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 cryptoassets are also inconsistent with the proposed 1250% risk weight. For example, there is normally no market quotation available for speculative unlisted equity investments. 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 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.

The proposed definition of exposure is overly broad and violates the Prior Consultation's general principles.

The Consultation contemplates including exposures in the prudential framework even if they may give rise only to operational risk. Custody and safekeeping of assets, which have traditionally been off-balance sheet and not subject to risk-based capital requirements, leverage requirements, or liquidity requirements, appear to be in scope and subject to the proposed cryptoasset exposure framework. By including cryptoassets held in custody, this definition risks the creation of an untenable framework for custody of cryptoassets by regulated banking institutions. Given the scale and volume of custody banks' operations, including assets under custody in the proposed cryptoasset framework and subjecting such "exposures" to factors beyond operational risk would preclude banks from safeguarding cryptoassets, thus limiting custody services to nonbank custodians that are not subject to prudential regulation and supervision, including the existing Basel framework.

Furthermore, including "non-fiduciary custodial services, that may give rise only to operational risk" in the proposed SCO60.4 definition of exposure would violate the BCBS's guiding principle of "same risk, same activity, same treatment." Including assets held in custody in the proposed cryptoasset framework would contradict the Consultation's principle of providing the same treatment for the same activity because the custody of digital assets for customers presents wholly different risks from a regulated banking institution's use of digital assets for its own account.[15] In the US, the Uniform Commercial Code states that financial assets held by a

[15] This question is critical for the health of the broader financial markets. Bank-provided custody services are essential to the functioning of the markets, and in some cases required by law or regulation for investor protection: US Investment Company Act of 1940 requires mutual funds to ensure the proper segregation of fund assets, which is usually achieved through the use of custodians; and EU rules regarding the Undertakings for Collective Investments in Transferable Securities (UCITS) and Alternative Investment Funds (AIFs) requires the use of custody services; assets of each UCITS or AIF must be held at a single depositary or custodian. Custody banks are

securities intermediary (i.e. the custodian) are not the property of the securities intermediary.[16] Such financial assets are traditionally accounted for separately on the custodian's books and records, a custodian may not use or rehypothecate digital assets held in custody, and assets held in custody would not be subject to claims of the custodian's creditors in the event of bankruptcy.[17] The existing Basel operational risk framework addresses the risks posed by custody services, and BCBS should continue that approach.

BCBS capital treatment for cryptoassets should be appropriately sensitive to unresolved accounting issues in some jurisdictions.

Consistent with regulatory capital requirements generally, the Consultation proposes to base many of its capital requirement calculations on cryptoasset "balance sheet exposures." Normally this approach would raise no issues beyond those of the proposed capital requirements themselves, but accounting practice in some jurisdictions raises serious concerns for cryptoasset custody and safekeeping activities of regulated banks.[18] This accounting treatment differs markedly from standard accounting and regulatory reporting for assets held in custody or safekeeping generally, which are not reported on the bank's balance sheet as long as certain conditions are met.[19]

Again, BCBS should refine the capital requirements proposed in the Consultation to make clear that assets held in custody or safekeeping are not treated as assets subject to the capital requirements, apart from the currently applicable operational risk framework.[20]

able to provide such services on a cost-effective basis largely because of the economies of scale they can achieve, which the Consultation's proposed capital treatment would render impossible.

[16] *See* Uniform Commercial Code §28:8–503. Property interest of entitlement holder in financial asset held by securities intermediary (1994).

[17] *See* Federal Deposit Insurance Corporation Advisory Opinions 87-7 and 88-14; 12 CFR 51.8(b).

[18] For example, effective April 11, 2022, the US Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin 121 (SAB 121), regarding the accounting for entities that have obligations to safeguard crypto-assets held for their customers. SAB 121 requires balance sheet recognition of an asset "similar in nature to an indemnification asset," *i.e.,* dollar-for-dollar recognition of assets held in custody. *See* https://www.sec.gov/oca/staff-accounting-bulletin-121.

[19] For example, the US Call Report instructions for reporting banking organizations state that "[a]ll custody and safekeeping activities (i.e., the holding of securities, jewelry, coin collections, and other valuables in custody or in safekeeping for customers) are not to be reflected on any basis in the balance sheet of the Consolidated Report of Condition unless cash funds held by the banking organization in safekeeping for customers are commingled with the general assets of the reporting bank. In such cases, the commingled funds would be reported in the Consolidated Report of Condition as deposit liabilities of the bank." *See* Instructions for Preparation of Consolidated Reports of Condition and Income, FFIEC 031 and FFIEC 041 (Mar. 2022) at 12.

[20] As BCBS has noted with respect to intangible assets, accounting treatment should not determine capital treatment.

Innovation such as improved internal recordkeeping should not trigger additional capital requirements beyond those appropriately applied to address operational risk.

The Consultation's proposed infrastructure add-on for Group 1 cryptoassets risks inhibiting technological innovation in ordinary banking activities. It raises the possibility that using distributed ledger technology (DLT) for traditional banking activities could bring those activities within the scope of the BCBS cryptoasset framework.[21] Banking institutions and securities exchanges have recognized that DLT is a secure, and often superior, method of recordkeeping. The proposed cryptoasset framework should not create regulation that limits the design philosophy of banks' books and records systems in cases where a bank or exchange uses DLT infrastructure for recordkeeping. There is no change in the risk profile of the underlying asset recorded on DLT, and the infrastructure risk add-on would violate the BCBS's general principle of technology neutrality. New and evolving technologies that may give rise to operational risk should be captured under the existing Basel operational risk framework, as proposed SCO60.105 notes. The same is true with respect to Group 1b cryptoassets, so long as they meet the applicable classification conditions.

Accordingly, the proposed infrastructure add-on for Group 1 cryptoassets should be eliminated.

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ABA supports BCBS's work to develop a framework for the prudential treatment of cryptoasset exposures. We encourage BCBS standards to reflect the general principles of "same risk, same activity, same treatment" and simplicity, and build upon established safety and soundness tools from the existing Basel framework, since an overly conservative framework would inhibit or even preclude regulated and supervised banks from engaging responsibly in digital asset market innovation. Confining cryptoasset activities to unregulated entities would deprive customers and markets of the benefits from a stable regulatory environment.

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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[21] In some situations ABA is concerned that, without clarification, the simple employment of DLT could be viewed as effectively transforming traditional assets into Group 1a cryptoassets.