

Via Electronic Submission
March 28, 2024

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

RE: Consultative Document - Cryptoasset Standard Amendments (December 2023)

The American Bankers Association (ABA)¹ is pleased to respond to the consultative document (Consultation)² dated December 2023, issued by the Basel Committee on Banking Supervision (BCBS) concerning proposed amendments to its standard on banks' exposures to cryptoassets. The proposed changes flesh out the criteria on the composition of the reserve assets that back stablecoins and put in place a due diligence requirement to ensure that banks have an adequate understanding of their stabilization mechanisms.

ABA members are closely monitoring the evolution of standards and practices across cryptoasset markets, as they assess possible opportunities to enter stablecoin markets and the possible roles they may play. ABA members' consideration extend to opportunities as stablecoin issuers, as potential providers of custodial and other services to issuers and stablecoin investors, and as intermediaries for customers seeking exposure to stablecoins. In all these potential roles, ABA strongly supports the importance of clear, rigorous standards for the maintenance and management of reserves backing stablecoins and for clear disclosure and transparency concerning the details of stabilization mechanisms and other essential features of stablecoin assets.

Accordingly, we believe that BCBS is taking a useful step in seeking to clarify the details of stabilization mechanisms and the composition of reserve assets. As described further in this letter, we believe the proposed approach deserves significant further development. Moreover, we believe that some of the details set forth in the Consultation are likely to prove impractical and should be reconsidered.

KEY CONSIDERATIONS:

- BCBS should balance the promotion of stablecoin markets and the development of a safe and sound regulatory and supervisory framework.
- Implementation of a stablecoin reserve regime must include the bank custodian's ability to hold cash deposits in connection with stablecoin operations.

¹ The American Bankers Association is the voice of the nation's \$23.7 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2.1 million people, safeguard \$18.8 trillion in deposits and extend nearly \$12.5 trillion in loans.

² Basel Committee on Banking Supervision, *Consultative Document – Cryptoasset standard amendments* (December 2023), available at <https://www.bis.org/bcbs/publ/d567.pdf>.

- Maturity, price volatility, market depth/public float, and availability of price quotations are key considerations in setting parameters for reserve assets.
- If repurchase transactions using reserve assets are permitted, they should be subject to several limits to maintain the integrity of the stabilization mechanism.
- Audits of stabilization mechanisms should occur at least quarterly.
- Requirements for diligence and statistical testing of stabilization mechanisms must not be unreasonably burdensome and must permit reliance on disclosures by parties best positioned to convey the critical information.

Two Broad Objectives Must Be Balanced

The Consultation will ideally serve two purposes – promoting rational development of stablecoin markets and enhancing their evolution on a safe and sound basis – and will strike an appropriate balance between the two. ABA urges BCBS and its national counterpart regulators to preserve the opportunity for regulated banks to play appropriate roles in stablecoin markets, because doing so will both promote market development (as potential stablecoin transactors and holders have market access through intermediaries that are known, supervised, trusted, and well capitalized) and enhance safety and soundness. In particular, bank participation will increase transparency for central banks, financial market supervisors, and public officials into market conditions and activities, including the operation of stabilization mechanisms. The suggested changes in approach outlined below will make bank participation in stablecoin markets more practical and effective, and in so doing will serve both objectives.

Key Practical Concerns

- *Structure of the custodial function would satisfy the bankruptcy remoteness requirements discussed in the Consultation, but implementation of a stablecoin reserve regime must include the bank custodian's ability to hold cash deposits in connection with stablecoin operations.*

A key aspect of the Consultation is its proposed list of acceptable stablecoin reserve, composed of high-credit-quality assets, including:

- central bank reserves to the extent that the stablecoin issuer is eligible and central bank policies allow them to be drawn down in times of stress;
- marketable securities representing claims on or guaranteed by sovereigns and central banks with high credit quality; and
- deposits at high credit quality banks with safeguards, such as: a concentration limit applied at group level that include entities with close links; bankruptcy remoteness of the deposits from any party that issues, manages or is involved in the stablecoin operation; and the banks apply the Basel Framework (including the liquidity coverage ratio).³

³ Consultation at 2-3.

As the Consultation recognizes, maintenance of reserve assets supporting stablecoins requires an appropriate custodian to act on behalf of stablecoin holders. In a typical custodial arrangement, a custody bank generally holds securities (analogous to the noncash assets backing the outstanding stablecoins) in safekeeping, as well as related cash deposits. Assets that are securities (which would typically include sovereign credits, and could include claims on central banks, both noted in the Consultation's list of acceptable reserve assets) are usually held indirectly through one or more central securities depository or clearing utilities.⁴ Because clients (in this case stablecoin holders) retain the beneficial property interest in the assets credited to their accounts held by custody banks (and so long as the custodian complies with applicable legal and operational requirements), under applicable laws in the United States, these investments are not included within the property of the custody bank, including upon its insolvency, nor are they reflected on the custody bank's balance sheet. Thus, to the extent stablecoin reserve assets are held under US law or functionally equivalent legal arrangements typical for securities custody, they would satisfy the Consultation's bankruptcy remoteness requirement.

Although the term "cash" is used in connection with custodial arrangements, client cash is in fact a deposit that is treated as a bank liability to the custodian.⁵ Although a custody bank could deposit these funds at a separate institution, a custody bank will agree in almost all instances to hold cash deposits as banker. Like other deposits, such cash balances are reflected as a liability on the custody bank's balance sheet, and the custodial client has a claim against the custody bank coequal with the claims of the bank's other depositors. Deposits held by a custody bank for a custodial client, like other deposits, generally benefit from an applicable deposit insurance regime, as well as from the priority given in some jurisdictions to depositors over other general creditor claims in the event of a bank's insolvency.⁶

If stablecoins are to be redeemed for cash at their peg, some party to the arrangement (likely the custodian, but otherwise via a direction to the custodian) must initiate the conversion of reserve assets to cash in an amount sufficient to meet the redemption. If the custodian delivers the reserve assets – e.g., sells a sovereign claim – for cash, it will receive the cash for distribution to the stablecoin holders and will hold it pending such distribution. In addition, the custodian will receive cash periodically when claims mature, and it will hold it pending reinvestment in eligible reserve assets to the extent not needed to fund redemptions. That cash, which custodian banks treat as a general deposit, is a necessary byproduct of the operation of an investment fund (in this case the stablecoin reserve) and thus integral to the custodian's role, but it generally represents a small proportion of the total value of assets held in custody under the stabilization mechanism.

For all these reasons, BCBS must clarify that a bank custodian would be permitted to hold cash in connection with stablecoin reserve assets and operation of the stabilization mechanism.

⁴ An example of such an entity in the US is the Depository Trust Company (DTC).

⁵ A custody bank may be willing to hold other assets as well, but securities and cash are predominant.

⁶ See 12 U.S.C. 1821(d)(11).

- ***Key Considerations in Reserve Holding Structure: Maturity, Price Volatility, Market Depth/Public Float, and Availability of Price Quotations***

As the Consultation suggests, in addition to the credit quality illustrated by the three proposed categories of reserve assets, other financial considerations will also be of prime importance:

- Maturity,
- Price Volatility,
- Market Depth/Public Float, and
- Availability of Price Quotations

Each of these factors bears directly on the ease, speed, and certainty with which a reserve asset can be converted to cash to meet redemption demands from stablecoin holders. Confidence in prompt and certain redemption, in turn, is critical to the stability of value of the coins themselves.⁷

Maturity is directly relevant only for debt-like instruments that are repayable by their terms, i.e., that convert to cash at a time certain without further action by the holder or the custodian. This aspect may not play a major role in the overall liquidity planning aspect of the stabilization mechanism (that is, the mechanism may not rely heavily on term repayment of debt instruments as a source of cash for stablecoin operations). It nevertheless may provide a cash management option, however, if a specified (and likely limited) portion of the reserve assets is maintained in very short-term maturities that will provide predictable liquidity in the near term. If such reserve assets are readily available in a deep, liquid market and proceeds are not required to meet redemptions, they can usually be rolled over at maturity and the process repeated.

Depending on the other terms of the instrument, maturity is often closely related to duration, and duration has a strong influence on price volatility. To the extent the expected mechanism for realizing the proceeds of reserve assets is a sale, low price volatility is essential to avoid either an unexpected shortfall in proceeds realized or a requirement to maintain a relative larger margin of excess value. The first problem compromises the effectiveness of the stabilization mechanism itself, and the latter at least makes it more expensive, likely having a negative impact on the market acceptance of the stablecoin.

To avoid both negative outcomes, ABA recommends requiring a limited acceptable degree of price volatility in noncash reserve assets, such as a “collar” or redemption risk test that stresses the market values of reserve assets, as BCBS has previously considered.⁸ National regulatory

⁷ We note that convertibility is arguably irrelevant to “algorithmic” stablecoins, which in general maintain their value by managing the outstanding volume of stablecoins. Because the concept of “reserve assets” is not necessarily relevant to algorithmic stablecoins, and because their structures will present issues far beyond the scope of the Consultation, ABA does not express a position on any aspect of that type of cryptoasset.

⁸ See generally Basel Committee on Banking Supervision, *Prudential treatment of cryptoasset exposures* (December 2022), available at <https://www.bis.org/bcbs/publ/d545.pdf>.

authorities may consider additional or alternative approaches to managing volatility risk as appropriate.

Market depth also provides protection against price volatility. ABA invites BCBS to consider some type of limit on stablecoin reserve assets in proportion to the total market volume of such assets, to average trading volume, or to some similar publicly available data.⁹ Since liquidity of an asset can be defined in terms of the ability to increase (or decrease) the quantity sold in a given transaction or series of transactions without having a material impact on price, the size of the reserve asset pool relative to the market float of the asset class would provide a logical check on price volatility.

Finally, available price quotations would provide ability to demonstrate that the volatility and market depth standards were met on an ongoing basis. In addition, they would provide an indication of a clear execution path for monetizing reserve assets to provide cash for stablecoin operations, reducing operational risk accordingly.

The considerations discussed in this section have obvious application to the second type of reserve asset proposed in the Consultation – marketable securities representing claims on or guaranteed by sovereigns and central banks with high credit quality – and similar considerations would apply to any other high-quality debt claims that national regulatory authorities ultimately accept within the scope of reserve assets. The other recommended asset classes – central bank reserves and deposits in high-quality banks – would not present the same considerations, as they would be convertible to cash at par on demand. If term deposits in banks without a demand feature were included, they would presumably raise risks of the same type as other fixed-income instruments, and the considerations discussed above would apply to that extent.

Beyond the concerns detailed above, ABA acknowledges the need for traditional credit- and market-exposure management practices, such as position limits on obligations of a single obligor or related obligors (those whose credit standing or market value reflects some degree of interdependence). National regulatory authorities have longstanding requirements that should serve this purpose well (or at least provide clear and familiar direction to the development of specific standards for cryptoassets).

- ***If repurchase transactions using reserve assets are permitted, they should be subject to several limits to maintain the integrity of the stabilization mechanism.***

The Consultation raises a number of questions concerning possible use of repurchase and reverse repurchase transactions. ABA believes that, to the extent they can facilitate reserve asset management and support stablecoin operations (including helping to cover operational costs without undue risk), such transactions could provide valuable operational flexibility. Appropriate

⁹ We acknowledge that such a limit would indirectly produce a limit on the potential size of the stablecoin issuance itself, except to the extent that alternative acceptable reserve assets were used to increase the reserve asset pool as a whole.

risk controls can achieve this flexibility without compromising the fundamental stabilization mechanism.

First, the Consultation notes that, unless restricted, repo transactions (assets sold subject to an agreement to repurchase) can create leverage in the reserve asset pool.¹⁰ ABA recommends that a transaction to raise cash be limited to the purpose of funding current stablecoin operations (i.e., redemptions) and maintenance of current cash at the level required by the stabilization mechanism's terms, pending reliable receipt of free cash from some other verified source to return to the repo purchaser. Thus, a reverse repo transaction would be essentially a cash management tool, not a means of raising funds for investment or creating ongoing leverage in the reserve asset pool. These terms imply also the need for a limit to the term of the repo agreement, which national authorities could establish based on more broadly applicable market trading and settlement procedures. The terms of the stabilization mechanism could be specific on these points and compliance verified through the audit function, discussed in more detail below.

The Consultation also raises concerns about use of reverse repurchase transactions, i.e., when reserve assets are purchased for cash, subject to an agreement to resell. Even if the purchased assets themselves meet the requirements for reserve assets held free and clear, the resale obligation may impose constraints on the reserve mechanism manager's ability to monetize the assets in stress conditions. Furthermore, at maturity of the transaction, receipt of the cash proceeds is subject to credit risk posed by the repo seller. This risk may be mitigated to some extent by local laws that would limit the impact of the seller's insolvency on the reserve asset manager's ability to liquidate the repo assets, but the operational and market risks of having to do so as a contingency must be considered in specifying permissible repo agreement terms.

Finally, even if leverage is avoided in the repo context, ABA recommends that BCBS consider requiring repo transactions to include limits on counterparties' remedies for asset value changes. Such changes are admittedly unlikely if repo transaction terms are short and if eligible reserve asset collateral is of short duration. Nevertheless, if a repo purchaser is permitted to make margin calls on the manager of a reserve asset pool, then the stabilization mechanism will effectively have exposure to actions of a creditor class other than the stablecoin holders. If that creditor can in effect trigger a claim on assets in the reserve pool in excess the then value of the purchased assets, it could create shortfalls in the value of the reserve asset pool or challenge its bankruptcy remoteness. Even if it has no legally enforceable lien on reserve assets beyond those sold in the repurchase transaction, it may be able to trigger a forced liquidation of some or all the reserve assets at a time of market stress, such that their remaining value is insufficient to support redemption of the outstanding stablecoins. Limiting repurchase transactions to short maturities and stable-value assets should make the limitation of such remedies more feasible.

In light of these risks and related considerations, ABA recommends that permitted repo and reverse repo transactions be limited in maturity, asset types (as to both credit quality and marketability), transaction terms, and counterparty credit and liquidity profile; and that the legal

¹⁰ Consultation at 3.

framework applicable to remedies for counterparty nonperformance or insolvency be taken into account in setting such limits.

- ***Audits of stabilization mechanisms should occur at least quarterly.***

The Consultation requires an external audit at least annually to confirm disclosures of outstanding cryptoassets and the value and composition of reserve assets.¹¹ ABA believes that an external audit of the disclosures and compliance with the stabilization mechanism should be required at least quarterly. The Consultation also proposes a requirement for the disclosed reserve assets to be verified by an independent third party at least semi-annually. It is unclear exactly how the audit and the “verification” would differ, but the importance of the stabilization mechanism, and the need for very close tolerances in compliance with the terms discussed above, strongly indicate that more frequent confirmations will be important. These procedures will both promote market acceptance and strengthen supervisors’ ability to oversee entities playing key roles.

- ***Requirements for diligence and statistical testing of stabilization mechanisms must not be unreasonably burdensome and must permit reliance on disclosures by parties best positioned to convey the critical information.***

The Consultation proposes that banks manage risks of their exposure to stablecoins by performing initial and ongoing diligence to understand the stabilization mechanism of a cryptoasset and its effectiveness. Furthermore, banks would be required to conduct statistical or other tests demonstrating that the cryptoasset maintains a stable relationship in comparison to a reference asset and to make available to their supervisors upon request the results of such tests.¹² Such measures provide an important aspect of risk management, but they depend for their effectiveness on availability of the right elements of reliable information. Banks’ compliance with any such requirements must therefore assume permissible reliance on specified information content and its sources.¹³

For example, to understand a stabilization mechanism, banks would have to have disclosures provided by a party who would be accountable for their accuracy, completeness, and timely delivery. Though a standard along those lines may initially seem to resemble disclosures required

¹¹ Consultation at 4. The disclosures of value and composition themselves would be required daily and weekly, respectively.

¹² Proposal at 5.

¹³ Requirements for diligence and testing to manage banks’ “exposure” to a cryptoasset appear to be aimed at banks acting as cryptoasset holders for their own account, or possibly for the account of others. Such requirements as eventually proposed by national regulatory authorities should reflect general standards of safety and soundness risk management and, in the case of cryptoassets held for others, general standards applicable to asset management relationships and the specific terms of those relationships. Furthermore, as noted previously, as banks also contemplate potential roles as stablecoin issuers, the requirements discussed would have to be balanced reasonably to permit practical issuance in a market that functions efficiently and reliably.

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in securities markets (the relationship of which to cryptoassets is still hotly debated), there would be many paths to achieving an effective disclosure regime to support the diligence obligation.

Similarly, statistical testing would require ongoing reporting concerning outstanding stablecoin volume and value and composition of reserve assets (all supported by appropriately frequent audits, as noted above). Though bespoke arrangements would of course be possible, some degree of standardization would both promote market development and streamline the supervisory process. First, information on the three audit fields (outstanding stablecoins, reserve asset values, and reserve asset composition) would have to be provided to banks on a timely basis.

Importantly, banks would have to be able to rely on this information, for which two conditions would be essential: as noted above, the parties providing it would have to be accountable for accuracy, completeness, and timely provision; and supervisors would have to acknowledge banks' reliance on those information sources and refrain from criticizing banks for doing so. If those conditions are met, banks should be well positioned to manage the risk of their exposures to stablecoins.

ABA appreciates the opportunity to work with BCBS (and in the future with national regulatory authorities) toward the goal of safe, sound, and efficient stablecoin markets. If you have any questions concerning the matters discussed, please do not hesitate to contact the undersigned at hbenton@aba.com.

Very truly yours,

/s/

Hu A. Benton

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