13 March 2020

The Basel Committee on Banking Supervision issued a Discussion Paper in December 2019 on designing a prudential treatment for cryptoassets. I have the pleasure in responding to the questions raised at Chapter 4 of the Discussion Paper on behalf of Allen & Overy LLP, a global law firm with significant expertise in international banking and prudential regulation with strong interest in transformation of banking and capital markets through adoption of Distributed Ledger Technology.

Context

The evolving technology commonly known as 'distributed ledger' has the capacity to revolutionise financial markets. Whilst early applications of the technology to financial markets have not produced a scalable and credible substitute to existing financial infrastructure there are considerable efforts by both incumbent and new entrants to financial markets to break new grounds and incrementally introduce transformational commercialised solutions with the potential to achieve adoption, consensus and scale.

Like most technological developments that have emerged in the last few decades, distributed ledger technology is not currently well catered for from either a legal or a regulatory perspective. Both branches need to be contextually interpreted (sometime with considerable flexibility and creativity) in order for the technology to 'fit' into existing known legal and regulatory classifications. Insofar as regulation is concerned, this task is made more challenging given the characteristics of some cryptoassets in allowing anonymity and bypassing well established anti-crime measures.

Nonetheless, we believe that policy makers ought to be approaching the emerging distributed ledger transformation with an open mind not least to legitimise and distinguish 'good' applications from 'bad' or undesirable applications. To take a monochrome view would risk pushing large swaths of cryptoasset activities to the shadows. Indeed, we welcome a harmonised minimum standard and principles approach to these issues, which in turn would, importantly, facilitate achieving a global level playing field. A global response is imperative given that the very essence of the technology is intended to achieve de-centralised, global, scale.

We would strongly support the BIS approach to distinguishing between the various different categories of cryptoassets. These are, in broad terms: 1. Exchange cryptoassets – essentially cryptoassets that seek to act as money or money substitute; 2. Security cryptoassets – cryptoassets possessing characteristics of traditional securities like shares and bonds (including derivatives); 3. Utility cryptoassets – cryptoassets entitling the holder to benefits or concessions from one or a limited universe of service or product providers.

We see category 2 as the one holding the most potential for short to medium term transformation. Category 1 appears to be likely to get traction for now only in the inter-bank space or in the long term if and when central banks decide to issue cash in the form of cryptoassets themselves. The third category is the least common and that which in our view is least likely to cause a material transformation in financial markets.

With that in mind, we would recommend that category 2 is prioritised in terms of detail and incentives to ensure that activities in connection with such assets are not more onerous or capital/liquidity consumptive than the same assets taking the traditional registered, certificated or uncertificated form.

Q1. What features of crypto-assets should be considered in the context of developing any potential prudential regulatory definition? Please describe the features and their relevance for the prudential treatment of crypto-assets.

At base level and at the risk of stating the obvious the very description of a 'cryptoasset' implies that there is a legal recognition of there being an asset (a form of property). An asset can only mean a thing that is recognised in law. This question is of course much more nuanced than meets the eye given that some forms of cryptoassets are not created on inception with the intention of being recognised under any particular legal system. For example, Bitcoin is not expressly associated with any particular legal system – it is pure computer code shared amongst network participants wherever located. This question, in the prudential context, is linked with the accounting treatment of cryptoassets although we would suggest that it is the legal classification of the nature of the interest that holding a cryptoasset bestows that primarily matters for now. Consequently, a legal recognition under an established system of law (e.g. OECD) of an interest in cryptoassets as bestowing an interest in property ought to be a key feature that is included in the BIS assessment. In absence of any clear recognition of this type, there are significant uncertainties regarding one's ability to assert ownership.

The articulation of this feature could look as follows:

- **Legally recognised asset** – cryptoassets must benefit from recognition under an established private law system [OECD] and which identifies, and will facilitate enforcement of, property rights in respect of a cryptoasset.

2. What are the main economic and related functions and potential sources of value of crypto-assets that are relevant in the context of developing a prudential treatment? To what extent do these functions and potential sources of value affect the relative prudential risks of different crypto-assets for banks? Are there other potential sources of value that are relevant in designing a prudential treatment for crypto-assets?

Like any form of traditional asset classes, cryptoassets derive their economic value from two principal sources: 1. Legally enforceable rights and obligations which are embedded in or which are linked to the cryptoassets (and where it is possible to obtain an independent valuation of the monetary value of such rights and obligations); 2. Market value of the cryptoasset which reflects supply, demand and a host of subjective factors such as speculation on future value.

The types of cryptoassets with low or negligible inherent value under objectively agreed principles (sometime referred to as 'native' cryptoassets) would tend to be much more volatile and speculative (although this may stabilise over a sustained period of time). For this category the 'market' risk element is considerable and we would think that any analogy with the market risk component of the existing Basel framework would be inappropriate. On the other hand cryptoassets with tangible and clear inherent value on inception (e.g. cryptoassets embedding rights against a specific legal entity and/or another asset) must be examined and assessed in precisely the same way as traditional assets (as is acknowledged by the BIS).

We agree that at this stage there has to be an assessment of any 'add-on' operational risk aspects resulting from the nascent nature of the technology and the limited adoption and market experience in recognition, transfer, settlement and clearing of cryptoassets. However, this 'add-on' must be fair, proportionate and dynamic to be reducing over time as adoption and market experience demonstrates resilience associated with more conventional types of assets.

Q3. What benefits do crypto-assets provide for the banking system, and the provision of financial services more generally?

We firmly believe that cryptoassets have the capacity over time to transform the way in which financial markets operate. The potential benefits can be summarised in the following ways:

First, cryptoassets can introduce a step change in making financial market processes more efficient and effective. We see the more tangible benefits in the wholesale markets involving payments, securities and financing arrangements.

Second and related to the first, accelerate disintermediation and reduce layers of activities, participants and process to achieve end to end tasks. Advances in trade finance confirmations using distributed ledger protocols demonstrate this very well.

Third, distributed ledger has the capacity to increase speed and certainty of settlement, reduce errors and increase resilience in transaction and process execution. There are many processes in the banking system where there are chains of intermediaries involved in a single process or transaction and where there are multiple points of potential failure.

Fourthly, effective deployment of distributed ledger will inevitably lead to cost reductions to the ultimate end user and in all likelihood better transparency and availability of services currently characterised by high barriers to entry. Using distributed ledger platforms to offer, issue and service securities by Small and Medium Entities is an example of this.

Q4. What additional factors affect the risk profile of different crypto-assets which are relevant in the

context of determining a prudential treatment?

We think the BIS has identified a comprehensive list of additional factors affecting the risk profile of cryptoassets. We would suggest that the first category is modified to refer to 'Legal nature' of cryptoassets and the identity of any party involved as primary sponsor and/or obligor/issuer.

Q5. Do you agree with these general principles in guiding the design of a potential prudential treatment

of crypto-assets? Are there additional principles that should be considered?

We agree with the principle of 'same risk, same activity, same treatment'. Our concern, and that of the industry wishing to promote distributed ledger adoption, is that the BIS advocates an over cautious approach towards risk assessment thereby discouraging large swaths of the banking system from taking resolute steps to advance adoption of the technology. It is also important to note that regulators, legislators and policy makers hold the key to removing some of the pertinent risks associated with cryptoassets by creating appropriate legal and regulatory frameworks that legitimise certain segments of market activity. It is therefore possible and we believe that the BIS has to be acutely aware of this factor, that some national legal and regulatory systems will move much faster than others and where the risks associated become lower as a result. Two speed adoption practices present their own risks given the inherently global nature of financial markets – though this is inevitable in a fast moving topic like this.

Q6. Are there additional channels other than those listed above by which banks could be directly or

indirectly exposed to crypto-assets? Which channels could potentially be the most material for banks?

How do these exposure channels vary by different types of crypto-assets? What are the benefits and

risks associated with banks' crypto-asset exposures through these different channels?

We would add 'Settlement of transactions in cryptoassets' and 'Issuing guarantees in connection with the performance of cryptoassets' as additional categories. The latter would occur for example where a bank

guarantees the performance of a bond security designed as a cryptoasset. The former would occur where, given the nascent nature of tokenised securities, settlement services are offered by a custodian or multiple custodians able and mandated to deal in particular cryptoassets. We are not sure what exactly the BIS intends to cover by channel (xvii) and would appreciate a clarification. If the reference is to proposals to streamline intra-bank payments then this needs to be specified as a standalone category or added to a more appropriate category already identified for example, (iii) owning cryptoassets.

We expect that the most material channels will be (i)-(iii), (viii)-(xii) in connection with tokenised securities and intra-bank tokenised payment solutions.

These exposure channels will vary considerably depending on the nature of the cryptoasset in question. This question requires a bespoke assessment of the legal nature of the cryptoasset and any rights and obligations associated with it including its resemblance in characteristics to existing defined categories of financial instruments or products.

We refer to our answer to Question 3 with regards to benefits of banks engagement with cryptoassets.

Q8. Which risks would be the most material with respect to banks' exposures to crypto-assets? Are there

additional risks other than those listed above which banks could be exposed to as a result of holding

direct or indirect exposures to crypto-assets, or providing related services? To what extent do these

Designing a prudential treatment for crypto-assets risks differ based on the type and design of crypto-assets, and how do they differ to traditional asset

classes?

We think that a distinction needs to be drawn between two types of risks: First, risks associated purely with the technology adoption and Secondly, risks associated with the substance of the rights and obligations embedded in the cryptoasset. This would be consistent with the principles the BIS suggested at the outset of Chapter 3. The financial risks presented appear to be framed on the basis of the most high profile 'exchange' type cryptoassets and ignore the enormous potential stored in the second generation cryptoasset projects that are trying to augment traditional payment and security related protocols. We believe this results, at the top of page 10, in a rather excessively negatively framed financial risk analysis (focusing on 'higher-risk' cryptoassets).

We agree that the distributed ledger technology needs to be developed and proven as reliable and scalable in order to become truly transformational and in line with supervisory risk appetite. That said, the introduction of internet based service delivery channels has had to go through the very same process and we do not recall very negative capital penalties to count for the considerable degree of risk that has been associated with that transformation.

Technological risks are outside of our field of expertise though from our client work we have observed considerable progress in the level of investment and implementation plans in the market. Moreover, there is much focus on consortium work that would ensure enhanced vetting processes and better quality adoption protocols.

Assuming that the technology develops beyond concept proof and that the regulatory and legal regimes take appropriate steps to enshrine the certainty that is required for scalable cryptoassets to become mainstream in the wholesale markets, we do not see a material difference between cryptoassets and traditional asset classes over the medium term.

Q9. What are your views on the illustrative example of a prudential treatment for high-risk crypto-assets?

Which crypto-assets would classify as high-risk based on the criteria set out above? What other features could be considered in specifying the scope for such a potential treatment?

Our first question is whether certain 'high risk' cryptoassets should be considered of no real utility. There is a question around the risk/reward analysis and ultimately soundness of internationally active banks holding assets that have no intrinsic value and which are characterised by dramatic levels of volatility.

The illustrative example is designed to create maximum disincentives and is effectively tantamount to a ban. Whilst we don't have any arguments with this approach we note that so called 'stablecoins' would be excluded at this stage from the analysis for good reasons and expect the analysis to require much more nuance when coming to that emerging category of cryptoassets.

Q11. What are your views on the disclosure requirements related to banks' crypto-assets? Should additional information related to banks' crypto-asset exposures be disclosed?

We do not support this proposal as it deviates from the base principles of the Discussion Paper (unless it is limited just to 'high risk' cryptoassets). This proposal effectively condemns cryptoassets as a 'bad asset' and potentially toxic such that it merits separate disclosure. There may be merit in supervisory rather than public disclosure on the inherent risk involved in cryptoassets and some figures including potentially quantum of activity/inventory. Accounting treatment is a matter for the annual audit/report rather than dedicated prudential regulatory disclosure.

Q12. What are your views on the appropriate prudential treatment of these types of crypto-assets? Are there additional types of crypto-assets that would warrant a different treatment to the illustrative example outlined in this paper?

Q13. What are your views on the potential prudential treatment of specific types of crypto-assets that bear economically equivalent risks to traditional asset classes? To what extent could the prudential treatment of such crypto-assets build on the existing framework?

Q14. What specific conditions and criteria are needed for different types of crypto-assets to be subject to a different treatment to the illustrative example discussed in this paper?

Q15. Do you have other suggestions regarding the design of a potential prudential treatment of cryptoassets?

We are responding to these questions collectively. Going back to first principles, we believe that cryptoassets should fall within existing regulatory frameworks with very limited exceptions. For example, cryptoassets for intra-bank settlement appear to have the characteristics of both e-money, and also potentially an operator of DLT/ blockchain platform utilising cryptoassets, could constitute an operator of a payment clearing system. Each of these categories are subject to existing regulatory regimes. What is more pertinent is that regulators give careful thought to the extent to which existing regulatory regimes require clarifications and/or modifications so that they are fit for purpose to apply to distributed ledger technological models.

Cryptoassets using stabilisation tools may constitute investment funds, deposits, e-money or debt securities. There needs to be a discernable and reasoned explanation of why this category merits exceptional treatment from a prudential point of view absent some strong policy considerations in favour of promoting this asset class whilst subjecting it to light form of regulation. In particular, it is fundamentally important that current

risk management axioms such as ‘delivery versus payment’, real time settlement and settlement finality are adapted (rather than disapplied) to scaled cryptoasset models.

We would strongly advocate neutrality of treatment towards traditional asset classes such as securities which are effectively tokenised using distributed ledger technology.

Etay Katz

Partner