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CRYPTOASSET STANDARD AMENDMENTS

BCBS Consultative Document

STABLECOIN EXPOSURES

Composition of reserve assets

Given the implications that stablecoins could have in terms of financial stability, we fully support the enhancements to the asset quality criteria and the additional safeguards that are proposed by the Committee on the reserve assets. Indeed, we welcome the idea of a framework that establishes uniform standards for stablecoin issuers and the composition of their reserve assets. This is particularly important when the issuer ties the stablecoin's value to an underlying asset or guarantees the stablecoin's immediate conversion to a reference asset.

To foster a safe risk environment, we encourage regulators to apply the same high-level standards to stablecoins like those applying to regulated financial instruments, such as money market funds. Similar to money market funds, stablecoin issuers must manage their reserve assets to ensure adequate liquidity for redemptions. This is crucial because of the short-term nature of stablecoins holdings (use for trading of cryptoassets, payments) that does not permit long-term investment strategies by the managers of these reserves. The liquidity of these reserve assets is paramount. These assets not only act as collateral but also as a source of liquidity in the event of redemptions, necessitating their sale in the market.

The Committee, however, plans to allow significant room for maneuver to national authorities on certain points :

- the Committee rightly advocates for short-term assets but nevertheless allows the NCAs the possibility of accepting assets with longer-term maturities. It provides for overcollateralization in this case but however, it does not set the minimum level of such overcollateralization, although the transformation risk should be covered ;

- in terms of credit quality, the Committee lists the eligible types of reserve assets – central bank reserves, marketable securities representing claims on or guaranteed by sovereigns and central banks, some deposits - but also allows the national supervisors to permit other types of assets to be included ;

- it provides that a certain percentage of the reserve assets should be invested in assets that can provide daily liquidity but leaves it to NCAs' discretion to set this percentage at their level.

We believe that these latitudes given to national supervisors present several significant drawbacks.

Indeed, leaving discretion to national supervisors could lead to a wide variety of interpretations. It could create a fragmented regulatory landscape where requirements vary from one jurisdiction to another. This inconsistency can lead to regulatory gaps and encourage regulatory arbitrage, potentially at the expense of level playing field, consumer protection and financial stability.

The variability of rules would also complicate the task of national competent authorities in monitoring and assessing risks associated with international stablecoins. It could hinder cooperation and coordination among them and dilute the effectiveness of control and surveillance mechanisms at a supranational or global level.

Regulatory divergences would also create uncertainties for investors and stablecoin holders regarding the protection of their interests and the stability of the assets they hold, especially in market stress situations. It could weaken confidence in stablecoins as an asset class.

Divergent rules would also significantly complicate regulatory compliance and management for stablecoin issuers operating across multiple jurisdictions. This can not only increase operational costs but also limit efficiency and innovation by hindering the development of cross-border financial products.

Finally, divergent rules may encourage a “window shopping” of stablecoins issuers to countries where the regulation is the most favorable. This kind of practice would not pose a lot of obstacles to stablecoins issuers in a global DLT environment.

For these various reasons, we consider it necessary to limit the risk of fragmentation as much as possible by specifying certain requirements and limiting the discretions offered to NCAs. Uniform regulation would help to minimize systemic risks, facilitate cross-border operations, discourage regulatory arbitrage, improve regulatory surveillance and coordination, provide greater clarity to investors and consumers, and encourage healthy competition and innovation in the sector.

Statistical tests and evidence of stabilisation mechanism effectiveness

The shift to an approach where each bank individually conducts its own due diligence under the oversight of its national supervisor **needs to be framed by a common methodology**, set by the Committee, to ensure consistency and effectiveness across jurisdictions. Otherwise, it would raise several key concerns.

Indeed, an individualized approach without guidelines could lead to :

- inconsistencies in how risks related to cryptoassets are assessed and managed by banks in different countries ;

- gaps in supervision and a reduced ability for supervisors to identify emerging systemic risks ;

- increasing operational complexity for banks as each of them will have to develop its own due diligence and statistical testing methods ;

- a lack of comparability at the global level, which would complicate the work of international associations and supervisors ;

- competitive distortions, where some banks, depending on their jurisdiction, may find themselves either advantaged or disadvantaged due to the varying rigor of due diligence requirements imposed by local supervisors.

In an increasingly globalized financial system, international cooperation and coordination are essential. A common methodology would facilitate this cooperation by establishing a common language and

shared expectations, thus easing communication and coordination between regulators. It would be key to achieve a consistent, effective, and fair approach to managing risks associated with cryptoassets.

Liquidity, liquidity stress tests and evidence of the redemption mechanism effectiveness

A stablecoin issuer must be prepared for significant outflows particularly during times of stress. This can occur when there is a fluctuation in the outstanding volume of stablecoins due to holders selling them in the market, seeking redemption when the market lacks liquidity for the stablecoin, or if the stablecoin loses its peg, with redemption being the only way for holders to preserve their investment's value. Consequently, the issuer must liquidate reserve assets.

We advocate for strict, uniform regulation of stablecoin issuers and the criteria for investing in reserve assets.

It's important to recall that on September 16, 2008, the Reserve Primary Fund "broke the buck" when its net asset value (NAV) dropped to 97 cents per share. This marked one of the first instances where a retail money market fund failed to maintain a $1 per share NAV, sending shockwaves throughout the industry. The same scenario could unfold on a systemically important stablecoin.

Following the 2008 crisis, global regulators enacted much stricter regulations on Money Market Funds, establishing precise rules and limits regarding maturity, liquidity, interest rate exposure, credit quality, counterparty exposure, diversification, and the location of the borrowing entity (for example, term deposits to credit institutions).

Given the short-term nature of stablecoins' use in payment transactions, we believe the rules for reserve assets should at least mirror those for short-term Money Market Funds, including Weighted Average Maturity (WAM) of less than 60 days and considerations for Weighted Average Life (WAL). In fact, in contrary to money market funds, the nature of stablecoins is even more short term as the holder does not have an incentive to hold them.

SETTLEMENT FINALITY / ENTITIES THAT EXECUTE SETTLEMENT

We welcome the clarifications provided by the Basel Committee to make clear that, for cryptoassets, the requirement for applicable legal frameworks to ensure settlement finality covers settlement in both primary and secondary markets. It will strengthen legal certainty for all involved parties. Issuers, investors, and intermediaries will be able to operate with certainty regarding their respective obligations and the risks associated with their transactions. For banks it would help them to better manage their counterparty and liquidity risks.

Regarding the Basel Committee's requirement that entities conducting the settlement of cryptoassets intended to be included in Group 1 must comply with risk management standards and have a comprehensive governance framework, it is also a positive step towards robust regulation and the securing of cryptoasset-related operations. To further strengthen this aspect and ensure effective risk management of settlement activities, it would be useful to also require that these entities demonstrate proven access to markets where reserve assets are traded. Such a requirement, aligned with best market practices, would ensure that entities responsible for settlement are effectively able to liquidate the assets quickly and efficiently, which is crucial for meeting redemption requests within deadlines, especially during market stress.

After review, the Committee's conclusion is that the risks posed by cryptoassets that use permissionless blockchains cannot be sufficiently mitigated to allow for their inclusion in Group 1. As a consequence, it does not propose adjustments to the cryptoasset standard to allow for the inclusion in group 1 of cryptoassets that use permissionless blockchains. However, the Committee acknowledges that technical solutions may develop rapidly and welcomes feedback from industry participants on the development of mitigants.

We do believe that it is of the utmost importance to keep on working on these technical solutions, notably in view of the current regulatory evolution in certain jurisdictions of the world (e.g. consultation on the delimitation between cryptoassets and financial instruments in the EU). If technical solutions are not set, in cooperation with regulators, and if the status quo remains, the use of blockchain technology for traditional financial markets will be very limited. Indeed, it is clear that the characteristics of purely private blockchains, without interoperability mechanism, are not suited because of their inevitably limited scale and the market fragmentation they would induce. To use DLT technology in an efficient way, networks of private infrastructures or public infrastructures with restricted access, for example only for regulated financial institutions, would have to develop.

Permissionless blockchains vs permissioned blockchains/transactions

Beside permissionless public blockchains, work must also be carried out on permissioned public blockchains and hybrid ones (i.e. blockchains combining elements of permissionless network leading to network effects, and permissioned models for assets and atomic transactions across blockchains without sacrificing controls). While the Basel Committee states that for the time being cryptoassets that rely on permissionless blockchains will not be eligible to group 1, it does not give any explicit orientations about public-permissioned blockchains permissioned transactions or assets and their potential treatment. It is clear however that the characteristics of these models could make it possible to fulfil most of the conditions required for eligibility for the first group. It would be useful that the Basel Committee clarifies its views in this respect.

In the same vein, it is also important to distinguish the infrastructure - e.g. a distributed ledger, public network – from the assets registered on this infrastructure - e.g. a tokenization of traditional assets, compliant with financial market rules, incl. whitelisting (i.e. only accessible to authorized parties added to a "whitelist"). This can be compared to the Internet (which is a public infrastructure) on top of which some permissioned applications are built (e.g. banking apps).

Risks mitigation for permissionless blockchains

Even for permissionless blockchains, there are some potential technical approaches that can contribute to mitigate the risks :

- decentralized identity solutions such as Soulbound Tokens for instance aim to provide users with control over their personal information while enabling secure and verifiable identity verification on permissionless blockchains. These solutions could help mitigate risks related to identity theft, fraud, and compliance with anti-money laundering (AML) and counter-terrorism financing (CFT) regulations ;

- privacy-enhancing technologies (PET) - such as zero-knowledge proofs, ring signatures, homomorphic encryption - are also of interest. These technologies can enhance privacy and confidentiality on permissionless blockchains by allowing users to transact and interact with the network without revealing sensitive information. PETs could address concerns around data privacy, confidentiality, and regulatory compliance ;

- **permissioned assets (in form of smart contracts)**, incl. whitelisting and/or controller role. A model of permissioned assets (as well as other possibly permissioned / private components on top of a public infrastructure) may possibly emerge as a sustainable model: benefits of network effects with a public infrastructure (incl. no dependency on some 3rd party vendors / proprietary technology etc.), with management and permissions pertaining to financial markets regulatory requirements ;

- **interoperability protocols** intending to facilitate seamless communication and data exchange between different blockchain networks, enabling interoperability between permissionless and permissioned blockchains and traditional financial systems, could help address concerns around settlement finality, liquidity, and cross-border transactions by enabling efficient transfer of assets and information between disparate systems.

It is important to note that while these technical solutions hold promise in mitigating some risks associated with permissionless blockchains, they are not fully mature or widely adopted at present. Continued research, development and collaboration within stakeholders are essential to advancing these solutions and addressing the challenges outlined by the Basel Committee. Additionally, regulatory frameworks and industry standards may evolve to accommodate these technical advancements and promote the safe and responsible use of permissionless blockchain technology in the financial sector.

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