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10 September 2021

Via Electronic Submission to BCBS Portal

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

RE: Consultative Document, *Prudential Treatment of Cryptoasset Exposures* (Issued 10 June 2021)

Ladies and Gentlemen:

The Bank of New York Mellon Corporation (BNY Mellon) is pleased to respond to the consultative document issued by the Basel Committee on Banking Supervision (Committee), *Prudential Treatment of Cryptoasset Exposures* (Consultation).

While we participated in industry association responses to this Consultation that address important issues for a wide array of market participants, this response is intended to provide the Committee with the supplemental context as to how BNY Mellon, as a global systematically important bank (G-SIB), approaches responsible innovation involving digital assets. BNY Mellon is a global investments company dedicated to helping our clients manage and service their financial assets throughout the investment lifecycle. Our unique perspective comes from our central role in the global financial system as one of the world's largest investment services and investment management firms. As of June 30, 2021, we have $45.0 trillion assets under custody and/or administration, $2.3 trillion assets under management, have a physical presence in 35 countries, and operate in markets around the world.[1] Our customers are primarily large institutional investors, including asset owners, asset managers, corporations, official sector institutions, and state and local governments.

Over our 237-year history, we have adapted, refined, and consistently improved our products and services to reflect and meet changes in technology and customer needs. Based on the growing client demand for digital asset services, BNY Mellon announced in February 2021 the formation of a new enterprise-wide Digital Assets Unit that is developing a digital assets service offering—underpinned by digital asset custody—that is enabling our business lines to service our clients' digital and traditional assets.[2] The Consultation raises numerous principles and questions that we have considered and assessed in developing our digital asset strategy, products, and services.

BNY Mellon supports the goal of the Committee to address potential risks to the banking system due to the increase in digital asset activity. To achieve that goal, BNY Mellon encourages the Committee to adopt standards that are consistent for all market actors and promote a level playing field, and to

[1] *See* News Release, BNY Mellon Reports Second Quarter 2021 Earnings, available at https://www.bnymellon.com/content/dam/bnymellon/documents/pdf/investor-relations/earnings-press-release-july-2021.pdf.coredownload.pdf.

[2] *See* Press Release, BNY Mellon Forms New Digital Assets Unit to Build Industry's First Multi-Asset Digital Platform, available at https://www.bnymellon.com/us/en/about-us/newsroom/press-release/bny-mellon-forms-new-digital-assets-unit-to-build-industrypercent27s-first-multi-asset-digital-platform-130169.html. (Digital Assets Unit Press Release). BNY Mellon also joined Pure Digital in July 2021, a consortium of banks working with the interbank wholesale marketplace to develop a platform to support the entire digital asset life cycle. *See* https://puredigitalmarkets.com/bny-mellon-joins-pure-digital-to-build-digital-currency-platform/.

avoid overly prescriptive and less flexible standards that could inhibit innovation and the prudent development of the digital asset industry.

I. Executive Summary

BNY Mellon views innovation of products and services as an iterative process that builds upon lessons learned and best practices at each step of the process. The same is true for the development of standards and regulations. BNY Mellon therefore appreciates the Committee's acknowledgement that the Consultation is a "preliminary proposal" and agrees with the Committee that policy development here should be "an iterative process, involving more than one consultation."[3] This Consultation is therefore an important first step to address many of the threshold questions and issues facing market participants in the digital assets space, and we look forward to our continued dialogue with the Committee on these critical and evolving issues.

As part of this first step, the Committee should consider the following three key points:

- Standards should encourage digital asset activity to occur within the regulated and supervised banking sector. Otherwise, market participants might have incentives to utilize entities outside of the regulated banking sector for their digital asset activity, which will increase risk and result in an inappropriate divergence in regulation for digital assets as compared to traditional assets. *See* Part II below.

- There are categories of digital assets that may be inadvertently swept in as in-scope assets in the Consultation. The Committee should explicitly expand the list of out-of-scope assets to clarify that not all digital assets and related services that leverage DLT or similar technology are in scope and covered by the Consultation. *See* Part III below.

- Existing risk management frameworks are well-positioned to address the evolution of products and services, including any unique risks resulting from products and services that involve digital assets. No new and/or separate risk management frameworks are required to address assets falling within Group 1a, 1b, or 2 (or any new proposed taxonomy groupings). *See* Part IV below.

II. Standards Should Promote Digital Asset Activity within the Regulated and Supervised Banking Sector to Avoid Divergent Regulation of Traditional and Digital Assets

Regulated custodian banks like BNY Mellon play a critical role in the functioning of financial markets,[4] with one of the "core custody services" of banks being the safekeeping of assets.[5] Safekeeping services have evolved over time alongside technological advances—*e.g.*, a bank holding in its vault physical paper securities certificates representing clients' individual shares owned, to a bank holding

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[3] Consultation at 1.

[4] The Consultation states that "the Basel Framework does not set out a description of the requirements that apply to banks that provide services (*e.g.*, custody services) to customers that invest in traditional assets," and the Consultation "does not attempt to define a prudential treatment for cryptoassets in cases where no existing prudential treatment is defined in the Basel Framework for traditional assets." Consultation at 7, n. 10. BNY Mellon supports this position.

[5] *See* The Custody Services of Banks (July 2016), available at https://www.theclearinghouse.org/-/media/tch/documents/research/articles/2016/07/20160728_tch_white_paper_the_custody_services_of_banks.pdf.

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an electronic book-entry notation in the clients' securities account representing the relevant number of shares the bank holds for its clients' directly or indirectly through Central Securities Depositories. Safekeeping of digital asset cryptographic keys (lines of code) is a present-day example of the evolution in custody services.[6]

In recognition of this evolution, BNY Mellon announced earlier this year the formation of a new enterprise-wide Digital Assets Unit that will accelerate the development of solutions and capabilities to help clients address growing and evolving needs related to digital assets, including cryptocurrencies.[7]

A driving force behind the establishment of the Digital Assets Unit has been client interest and demand, which can be broken out as follows:

- Services: The primary services of interest to clients are digital asset custody, digital asset fund services, digital asset trade execution, and tokenization services.
- Digital Asset Classes: Clients are generally interested in the asset classes that are the subject of the groupings in the Consultation: cryptocurrencies, primarily Bitcoin and Ethereum; stablecoins; and tokenized assets.
- Types of Clients: The types of clients interested in digital assets are wide ranging across all of the core client classes that BNY Mellon covers today as well as newer market entrants for digital asset products and services. Specifically, this includes asset owners, asset managers, hedge funds, endowments, broker dealers and some native cryptocurrency companies (*e.g.,* crypto exchanges and liquidity providers).

The fact that clients are coming to BNY Mellon for a broad range of digital asset-related financial services should be an important consideration for the Committee—clients consistently have provided feedback that BNY Mellon's position as a highly regulated bank and G-SIB promotes trust and confidence as they enter the digital asset space. Accordingly, it is critical to frame at the outset the importance of standards that will promote the development of digital asset activity within the highly regulated and supervised banking sector. Doing so will avoid a bifurcated regulatory framework between traditional and digital assets that, in turn, amplifies financial stability concerns.

III. Distinctions Between In-Scope and Out-of-Scope Digital Assets

The Consultation identifies as out-of-scope digital representations of fiat currencies, specifically central bank digital currencies (CBDC)—all other digital assets are deemed in-scope and are categorized, and subject to the requirements of Group 1a, 1b, or 2. While industry association responses to the Consultation appropriately focus on the classification conditions of Groups 1a, 1b, and 2, and whether additional groups and/or subgroups should be added to prevent "cliff effects," the threshold distinctions between out-of-scope and in-scope assets warrant action by the Committee. BNY Mellon suggests that, for the avoidance of doubt, the Committee explicitly confirm the following non-exclusive categories are out-of-scope:

[6] *See also* Office of the Comptroller of the Currency, Interpretive Letter #1170, *Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers* (July 22, 2020), available at https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1170.pdf.
[7] *See* Digital Assets Unit Press Release.

1. Record-Keeping Solutions that Leverage DLT: For example, in 2016, BNY Mellon created a blockchain-based, parallel record of all its broker-dealer clearance and collateral management transactions, known as "BDS 360." In addition to the standard recording of transactions on the underlying conventional production systems plus backup solutions, the purpose of BDS 360 was to serve as an immutable third transaction record of known accuracy for automatic reconciliation of the mutable conventional systems in the event of later potential disagreement between them. The Committee should confirm that assets that have their transaction record kept on a DLT for backup purposes should not be swept in as in-scope assets for the Consultation because these assets exist regardless and outside of DLT technology.

2. Financial Assets where "Mirrored" or "Courtesy Copies" are Stored on DLT: The Consultation states that tokenized traditional assets within the scope of Group 1b are "digital representations of traditional assets using cryptography, DLT or similar technology *rather than ownership through the account of a central securities depository (CSD)/custodian*."[8] This means that a Group 1b asset is one that is natively issued on a blockchain, where the blockchain serves as the sole "source of truth" of the transaction record and ownership of the asset. By implication, excluded from Group 1b—and therefore the Consultation in its entirety—are assets that exist in the books and records of a transfer agent or, for example, the Depository Trust & Clearing Corporation (DTCC) and that are subsequently tokenized so that a record of the token ownership is "mirrored" to a blockchain (also referred to as maintaining a "courtesy copy" on a blockchain). In such a case, the blockchain does not serve as the definitive record of ownership. For example, the Paxos Settlement Service is a post-trade blockchain settlement system in which the conventional book-entry system of DTCC is the sole record of ownership of certain securities, which are mirrored in tokens on a blockchain that is used to settle the trades in the securities.[9] Confirmation by the Committee that "mirrored" or "courtesy copies" of financial assets stored on DLT are out-of-scope is important because BNY Mellon clients are interested in both native and non-native tokenization deployments.

3. Cash Settlement Assets on DLT Used to Account for Bank Deposits: Digitized fiat currency used as a settlement asset (with the ability to transfer such assets using DLT) should be subject to the existing international prudential framework. Digitized fiat currency could be used in external and internal payment networks. For example, in April 2021, the Bank of England announced a new type of account, as part of its Real-Time Gross Settlement service (RTGS), where an operator of a payment system can hold funds in the omnibus account to fund their participants' balances with central bank money.[10] This omnibus account model aligns with the Bank of England's goal "to enable RTGS to interface with a wider range of payment systems, including those using DLT,"[11] and participants here may seek to leverage tokenized fiat currency as a settlement asset on DLT. In addition, individual banks are also exploring internal solutions that similarly leverage digitized representations of fiat currencies on DLT. Potential benefits of utilizing tokenized fiat currency in this internal, closed-loop environment include instant 24/7 settlement between internal accounts (book-to-book transfers), delivery versus payment (DvP) internal swaps to settle trades in digital securities,

[8] Consultation at 4 (emphasis added).
[9] *See* https://www.paxos.com/what-is-paxos-settlement-service/.
[10] *See* https://www.bankofengland.co.uk/news/2021/april/boe-publishes-policy-for-omnibus-accounts-in-rtgs
[11] *Id.*

instant settlement of cross-border payments between existing bank clients, and programmability.

IV. Responses to Specific Consultation Questions

In these responses to specific questions posed by the Consultation, we make clear that existing risk management frameworks are well-positioned to address the evolution of products and services, including any unique risks resulting from products and services that involve digital assets. No new and/or separate risk management frameworks are required to address assets falling within Group 1a, 1b, or 2.

Q5: Would Risk Governance and Risk Control Practices for Group 1 and Group 2 Cryptoassets Differ?

The Consultation states that entities involved in the lifecycle of cryptoassets—*e.g.,* issuance, validation, redemption, and transfers—"must follow robust risk governance and risk control policies and practices to address risks."[12] BNY Mellon agrees.

The critical point in connection with this principle is that, while digital assets pose unique risks compared to traditional assets, banks can address the unique risks of digital assets (whether they are Group 1 or Group 2 assets) *within their existing risk management frameworks*—no new and/or separate risk management frameworks are required.

In regulated financial institutions like BNY Mellon with robust risk management frameworks, the process to assess risks should be the same across *all* new products and services—including digital assets. A well-designed risk management and risk governance framework like that which BNY Mellon employs for traditional and digital asset classes allows for the identification of unique risks arising from *any* new product or service and for the implementation of effective controls to mitigate the risks. The detailed risk assessment process includes procedures to identify new and/or existing processes related to the target state servicing model. Subsequently, a top-down and bottom-up assessment is performed to identify existing controls that can be leveraged, enhancements to existing controls to manage any unique risks, and net new controls requiring build to address the risk. Where the residual risk exceeds the risk appetite of the financial institution, a dialogue will ensue to either update the risk appetite statement or determine additional mitigants to bring the risks within the institution's risk appetite. *Ultimately, an existing well-defined enterprise risk framework will allow for any additional risk considerations arising from engaging in that product or service irrespective of the product or service being provided*.

Q8: Are There Ways in Which the Increased Operational Risk Relating to Cryptoassets (Relative to Traditional Assets) Can be Measured? How Should a Pillar 1 Add-On be Designed to Capture Additional Operational Risks Arising from Exposures to Cryptoassets?

The Consultation states that because digital assets and the technologies on which they are based are new and evolving, "there is potentially an *increased likelihood* that they pose unanticipated operational risks," which "could be addressed via the application of a Pillar 1 *add-on operational risk charge* for all Group 1 cryptoassets to which a bank is exposed."[13] BNY Mellon agrees in part.

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[12] Consultation at 5 (emphasis added).
[13] *Id.* at 7.

As stated above in the response to Question 5, existing risk management frameworks can be designed to accommodate assessment of unique risks posed by digital assets. For example, when evaluating risks for digital assets vis-à-vis traditional assets, most traditional asset transactions today are executed via centralized institutions which have standardized processes and time periods, whereas for digital assets, the processes may still be evolving and may have varying time periods. Further, while the assessment and mitigation of cybersecurity risk is similar for both traditional assets and digital assets, the cybersecurity risk assessment for digital assets needs to take into consideration certain factors unique to digital assets such as, for example, the generation, storage, and usage of keys. Lastly, custody of traditional assets is generally automated and streamlined, whereas custody of digital assets through cold storage, for example, may involve manual processes.

The output of that assessment will vary. On the one hand, an incremental increase in operational risk may result, but on the other hand, there may be no increase in operational risk—just like any traditional or any other asset. To the extent there is in fact an incremental increase in operational risk, it can be addressed sufficiently via the existing capital framework without the need for a separate Pillar 1 add-on operational charge, as the Committee itself acknowledges that "[c]alibrating such a charge would be a significant challenge."[14]

As technology and the accompanying risk analysis mature, answers to operational risk-related questions will come into sharper focus through that maturation. The technology underlying digital assets (*e.g.,* DLT) is comparatively nascent in its adoption by financial institutions. This is the case for BNY Mellon which, as described above, is still in the process of developing its digital asset custody solution. Once financial institutions launch digital asset products and services, and the digital asset ecosystem matures, the unique risks associated with digital assets may demonstrably be mitigated by their technological benefits, including (i) multiple parties being able to access information simultaneously and in-real time; (ii) creation of "smart contacts" (eliminating expensive, time consuming manual processes and approvals); (iii) unlocking liquidity for previously illiquid asset classes and creating new markets (*e.g.,* tokenized securities); (iv) the existence of immutable records providing a clear audit trail; and (v) faster and less costly settlement of transactions. In the interim, BNY Mellon suggests that the Committee instead focus its current attention on addressing more critical threshold issues—*e.g.,* taxonomy and asset classification.

Q15: Do You Have any Views on the Responsibilities of Banks? Are There Any Other Responsibilities or Aspects that Should be Covered by Banks for the Purposes of Supervisory Review?

Building upon the response to Question 5 and Part II above, regulated financial institutions are already well-positioned to develop and/or enhance controls to appropriately address any identified control gaps or unique risks of digital assets. For example, BNY Mellon is currently taking the following actions in connection with its digital assets servicing offering:

1. Ongoing review of changes to laws, rules, and regulations applicable to digital assets to inform internal control enhancements as necessary.
2. Enhancing policies and procedures to assure coverage of applicable laws, rules, and regulations.

[14] *Id.* at 7.

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3. Adopting enhanced controls such as:
   - subjecting Virtual Asset Service Providers to targeted role-based due diligence;
   - diversifying on-chain data sources through implementation of additional transaction monitoring providers;
   - monitoring blockchain transactions for any unusual and/or heightened risk activity;
   - identifying fiat and digital asset red flags that align to the working model; and
   - including additional typologies in traditional transaction monitoring.
4. Engaging external consulting firms and law firms with digital asset expertise to advise on:
   - BSA/AML practices to ensure compliance with applicable law; and
   - Agreements related to digital assets.
5. Conducting targeted training of personnel involved in the digital asset lifecycle to ensure right skilling.
6. Consolidating oversight of the risk and compliance functions into one group to coordinate coverage of digital assets.
7. Appointing dedicated audit teams with relevant skillsets for digital assets businesses which will provide audit of AML/CFT and other risks.
8. Planning to identify relevant key data elements and key risk indicators to support governance and monitoring of digital assets.
9. Expand the scope of Financial Crime Testing functions, plus risk assessments, to include digital asset businesses.

VI. Conclusion

BNY Mellon looks forward to further engagement with the Committee in regard to this Consultation and any future consultation papers on this topic.

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