Sella

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Object

Basel Committee on Banking Supervision - Second consultation on the prudential treatment of cryptoasset exposures

Introduction

Our Group thanks for the opportunity to contribute to this Consultation, since we believe in the importance of innovation and we pursue it by following novelties in the financial sector and developing solutions that suit the emerging needs. Moreover, because crypto-assets are increasing in importance and are likely to be crucial in the next years, our belief is that the development of an efficient framework is fundamental in order to give law certainty, reduce the risk of mis-application and mis-interpretation, as well as build the basis of a sound and equal environment.

At this stage, since the above-mentioned importance of crypto-assets and the related services are becoming central in the current financial panorama, it is therefore crucial to define a framework for this topic, in order to ensure a level playing field between the various actors (Banks and unregulated service providers, like BigTechs and FinTechs). This objective could be reached with the development of a framework that is sufficiently prudent – and thereby is sensitive to the relevant risks – but also sets the basis to involve the actors (in particular, supervised entities) in the contribution with their risk management expertise and in the enhancement of investor protection in this sector. Consequently, there would be room for a sound and secure development of the market for crypto-assets as well as the engagement of the supervised entities and regulated sectors in the provision of crypto-assed related services. To do so, the framework should be designed in a calibrated and balanced way that, on one side, encourages banks to introduce services and products in this sector and, from the other side, ensures adequate levels and techniques in the risk management.

As the proposal follows the principle of "same risk, same activity, same treatment", we believe that this approach is the most suitable one and should be followed for the design and implementation of rules in this subject. We therefore think that this could be crucial in order to deign some rules that are equal, balanced and respectful of the level playing field.

Since the crypto-assets market is new and evolving, we believe that the provision of constant monitoring of the evolution of the crypto-assets and their market is fundamental, as well as the assessment of their effective impact in the financial sector. Indeed, this approach allows the introduction of targeted adjustments and, so, the adaptation of the prudential rules to the concrete needs of the financial system and their actors.

On the other hand, the proposal in the Consultation document presents some aspects that may excessively penalize Banks. The provisions are in fact too strict and, consequently, banks could be discouraged – and sometimes unable – to provide services from which an exposure in crypto-assets is derived. Hence, because of the multitude of limits ad requirements, banks appear penalized if compared with other entities that are subject to lighter requirements, i.e. FinTechs, BigTechs and new players like Virtual Asset Service Providers. Moreover, the concentration of crypto-asset activity in the non-regulated environment might undermine the efforts to prevent financial stability risks. Also consumers would be penalized because they will choose unsupervised entities (or Extra-EU CASPs) or players that are subject to less strict regulatory and supervisory requirements if

compared to Banks (e.g. CASPs requirements under MiCA Regulation) and, so, they are less protected and guaranteed. In this context, the position of small and medium-sized banks should be highlighted: these players are negatively affected by a stricter approach because they cannot afford to comply with the proposed capital requirements, since the effort is disproportionate. Therefore, level playing field among the different players is not respected, considering both the type of service provider (regulated and unregulated entities) and their size (small and medium banks compared to the larger ones).

For each identified issue, we propose some solutions and amendments that would help banks in the significant reduction of the required efforts by balancing the prudential needs with more proportionated and equal measures and the respect of a level playing field between the different players – considering both dimensions (small/medium and large institutions) and supervisory requirements (supervised and non-supervised entities). Hence, following the proposed solutions, our belief is that smaller and medium-sized entities are not excluded to the market and could access to the services, according to the taxonomic criteria defined by the regulatory framework as well as in consistency to the current legislation.

Remarks and observations to the Consultation document

After a preliminary analysis of the contents of the consultation document, we identified some issues that should be treated with more attention in order to give concrete alternatives to the detected critic aspects.

Classification of cryptoassets.

As the previous version of the proposal, the classification in Group 1 and Group 2 is still proposed. The initial classification in two main groups may be useful in order to give an initial definition of the topic, even if it is crucial to consider two main aspects: from one hand, the misalignment between the BCBS classification and the taxonomic classes provided by the regulatory framework and, from the other hand, the consequent need of more clarity in the definitions in order to avoid grey areas and obvious misapplication of the rules.

However, we noticed that this classification has some important differences with the taxonomic classes under the regulatory framework (in particular MiCAR), since they are not aligned. The proposal, on the contrary, implicitly relies on a distinction between backed and unbacked crypto-assets which doesn't find room in any regulatory framework and constitutes an arbitrary and overly simplistic classification.

In particular, some doubts on interpretation persist when comparing the section of the document about the classification conditions (SCO60.5-SCO60.27) because of the excessive complexity of the requirements illustrated in the BCBS proposal specifically when this activity is delegated to the banks that "*on an ongoing basis, are responsible for: (i) assessing whether a cryptoasset is compliant with the classification conditions; and (ii) demonstrating to supervisors how a cryptoasset fulfils these conditions*" (SCO60.25). It is clear that this misalignment in classification requires stronger interpretative and definitory efforts of the banks, as well as it may lead the fragmentation in interpretation and enforcement of the rules in the financial sector.

Moreover, considering the variety of existing technologies and the uniqueness of each of them as well as the multitude of crypto-assets (existing and future), it is reasonable to believe that difficulties in classification are probable and, so, the identification of the level at which conditions are considered sufficient to fit all of the alternatives in the market. Hence, this issue needs to be faced in order to reach some unity and clarity, as well as being consistent with other relevant legislation.

We therefore suggest the provision of some legal presumptions for the classification of all of the stablecoins issued under some legislation in Group 1. For instance, MiCA Regulation will provide some specific requirements for most part of the stablecoins – both e-money tokens and asset-referenced tokens – on collateralization, reserve management and stabilization. The mentioned Regulation also states that the offering of these types of tokens depends on the previous approval of the whitepaper by the competent Supervisory Authority. Therefore, according to these legal presumptions, all of the crypto-assets classified as e-money tokens or asset-referenced tokens should fall in Group 1 without any verification obligation for the Bank other than the check of a Supervisory Authority-approved whitepaper, according to the classifications provided by MiCA Regulation.

Following the main theme of classification, another important issue regards the verification and analysis obligations that should be performed by the banks to classify crypto-assets in Group 1 (SCO60.8 – SCO60.18).

The wording provides for the application of excessively burdensome and over-complex obligations that are clearly unsustainable for those entities (i.e. small and medium-sized banks) which cannot afford the establishment of an internal structure that is dedicated to the verification and monitoring of any characteristic of each individual crypto-asset. This activity could be performed by those larger entities that can establish and develop such structures, but smaller banks may have some objective difficulty in it.

Specifically, in the proposal there are two tests (SCO60.12-SCO60.16) required in order to classify a crypto-asset in Group 1 that appear complex and burdensome, especially for the smaller entities:

- The redemption risk test requires that the entity must guarantee that the crypto-asset arrangement meets the prescribed value and composition of reserve assets, as well as the management of reserve assets.
- The basis risk test prescribes that, firstly, the bank monitors - daily - the percentage difference between the peg value and the market value of the crypto-asset; then, the results are used to determine whether the test is fully passed, narrowly passed or failed, with differentiated consequences depending on the results. It is evident that the performance of this test is excessively burdensome and complex, in particular for smaller entities that should dedicate resources and employees exclusively performing it.

Moreover, under SCO60.25, "*banks should have in place the appropriate risk management policies, procedures, governance, human and IT capacities to evaluate the risks of engaging in cryptoassets and implement these accordingly on an ongoing basis and in accordance with internationally accepted standards*".

It is clear that the proposal appears excessively penalizing to small and medium-sized Banks for the following reasons:

- From one side, these entities could not afford all of the analysis efforts required for the classification of crypto-assets in Group 1;
- From the other side, they cannot bear the capital requirements that are prescribed from the consequent inclusion of these assets in Group 2, considering the restrictive nature of the treatment.

As a consequence, some crypto-assets would be included in Group 1 by larger entities and in Group 2 by the smaller ones. This situation leads to an unacceptable and paradoxal application of more burdensome and different prudential requirements that penalize small and medium Banks, as well as there would be a concentration of the provision of crypto-asset related services towards the larger entities.

Moreover, the mentioned inequality has to be carefully analyzed and treated because crypto-asset market and the Decentralized Finance are becoming crucial in the redefinition of the paradigms of the provision of

financial services. Hence, the exclusion of the smaller players may significantly affect the evolution of the financial market because these entities are likely to be excluded from the new financial environment.

Having said that, we suggest the following solutions in order to face the mentioned critic aspects.

Firstly, it seems reasonable to provide that banks' exposures to stablecoins issued by regulated entities will be lower risk than those issued by unregulated subjects. Consequently, this feature (SCO60.17) could be considered as an alternative requirement to the basis risk and redemption risk test for the classification in Group 1. This solution gives more regulatory certainty that effectively reflect on uniform classification and application of the rules to the mentioned stablecoins, as well as it simplifies the procedures of classification because – at least – two tests are being replaced by this presumption. Moreover, the smaller supervised players would not have to perform excessively burdensome tests in order to classify the mentioned type of crypto-assets. This would lead to the safeguard of the participation of these entities, because they would be able to offer the services related to these crypto-assets since they would have overcome the organizational issues related to the performance of the mentioned tests. Therefore, they would not be excluded to the crypto-assets market and, so, the concentration towards few larger players (including BigTechs) is potentially prevented.

Furthermore, in order to pursue unity and certainty in the classification and to avoid misapplication and fragmentation in the interpretation, we consider useful the provision of a bridging table that compares the different classifications provided by the current legislation (e.g. MiCAR, MiFID II, EMD2) and the Groups illustrated in the proposal. For instance, e-money tokens and asset-referenced tokens could be included in Group 1 with a normative act, as well as the tokenization of traditional assets like security tokens and tokenized securities. AT the same time, the classification of the most widespread crypto-assets ("other-than" asset regerenced token and e-money token) by the Regulators is desirable, in order to overcome some interpretative and applicative difficulties and to give clarity and unity in the law enforcement. In fact, whether the Regulators classify the most widespread crypto-assets, any interpretative and applicative doubt on these instruments would be overcome and their management (including the prudential one) would be easier.

Credit and market risk.

On the further aspects related to credit risk and market risk, according to the first general principle, we believe that it is reasonable to apply the same prudential treatment to a crypto-asset that has the same economic functions and pose the same risks as a traditional asset. Considering the aspects related to the credit risks, we believe that the technology itself does not give different creditworthiness to the issuer, unless there is an automatic mechanism of redeemability triggering an on-chain reserve liquidation.

Another element in this area refers to the possibility that a tokenized asset may simultaneously exist with the correspondent asset based on traditional technology. In case of a unique and exclusive tokenized asset, no difference on credit and market risk is detected and, so, the mentioned approach seems adequate. Otherwise, in case of a tokenized asset with an equivalent asset in the traditional form, there could be difference in liquidity (hypotizing a lower liquidity in the distributed market) which may also pose some unexpected risks, also considering the opposite situation: liquidity could flow into a distributed system, bringing more risk to the traditional market.

Currently, the majority of tokenization initiatives of financial instruments based on DLT relate to the issuance and placement activity and tend to involve limited post-trading processes. In our opinion, therefore, it is crucial to monitor the implication of post-trading activities to evaluate the impact in terms of treatment of unsettled transactions and failed trades (within credit risk) of a tokenised security in a more accurate way.

Moreover, as the proposed infrastructure risk add-on referred to the DLT (SCO60.57) is quite unique, as this type of infrastructure and the technologies related to it are still evolving and similar solutions were not adopted when other technologies (e.g. cloud technology) were introduced. Hence, a monitoring to the evolution of this technology is essential in order to determine whether the proposed risk add-on is effective to face the infrastructural risks connected to the DLT and, consequently, decide if definitely adopting this solution or preferring the general operational risk framework for Group 1A activities and exposures.

Issues regarding Group 2 cryptoassets.

As previously introduced, Group 2 includes a greater variety of assets, which have quite different features as well as different risks. While we understand that in some cases the introduction of a high RW for certain exposures is reasonable, in some other cases this requirement appears disproportionate, in particular in case of exposures that deserve a lower risk weight, for example utility tokens. Moreover, these requirements may obstacle the development of a sound and equal market in crypto-assets, causing the exclusion of the smaller players, which may have objective difficulties in the bearing of them.

More specifically, the capital requirements proposed for Group 2 (SCO60.59-SCO60.91; SCO60.102-SCO60.104) appear excessive, unsustainable for smaller and medium-sized Banks and difficult to compare (if not incomparable) to the capital requirements deriving from the exposure to any other asset. As a consequence of this approach, banks could not easily provide services from which an exposure in crypto-assets is derived (i.e. the reception of crypto-assets as a collateral of financing operations) or that require to hold crypto-currencies for the payment of the fees provided by the specific DLT.

It is therefore essential to highlight that Group 2 includes all of the most widespread crypto-assets, including crypto-currencies (e.g. Bitcoin and Ethereum, as stated in SCO60.6). Hence, the limits in the proposal appear excessively penalizing because Banks would be excluded from the competition to the markets in crypto-assets and, more generally, of the Decentralized Finance, on which the new paradigm of the provision of financial services will be based. It is clear that level playing field and equal conditions would not be respected and, consequently, a concentration among larger entities and unregulated players (e.g. BigTechs and FinTechs, as well as third-country service providers that are not regulated by Supervisory Authorities) is foreseeable.

Similarly, the calculation of the total exposure to Group 2 cryptoassets (SCO60.121-SCO60.124) is not sufficiently differentiated in order to efficiently manage market risks deriving from the provision of services and products on Group 2 cryptoassets because of its excessive rigidity and with a limit of just 1% of the bank's Tier 1 capital. Consequently, the development of an efficient business and the management of the infrastructural and administrative costs related to it may be obstacled by the presence of such tight exposure limits as well as the absence of netting rules.

In order to overcome to these issues, we suggest a significant reduction of the capital requirements proposed for Group 2, in order to consent the comparison with the ones deriving from other products (also speculative). This action appears necessary in view of the fact that the most widespread crypto-assets (e.g. crypto-currencies) would be included in Group 2 and most of the services available and of interest to the banks are based on these instruments. Moreover, as a corrective of the exposure limit issue, a higher limit value and the possibility to allow for netting in the exposure calculation – similarly to the provisions under Basel III framework – are foreseeable. This intervention is crucial in order to allow the banks to operate in the crypto-asset market in a more integrated and complete way. It may also encourage competition between the different players in a more sound and inclusive environment.