

Bank for International Settlements BIS
Basel Committee on Banking Supervision
P.O. Box
CH – 4002 Basel

Comments on the Discussion Paper

Designing a prudential treatment for crypto assets

13 March 2020

Table of contents

1. Introduction Background	3
2. Key Positions	3
3. Answers and comments	4

No modification or translation of this publication may be made without prior permission. Applications for such permission, for all or part of this publication, should be made to the CMTA Secretariat by email to: admin@cmta.ch

1. INTRODUCTION | BACKGROUND

On December 2019, the Basel Committee on Banking Supervision (hereafter the "**Committee**") issued a discussion paper on Designing a prudential treatment for crypto assets for comment by 13 March 2019 (the "**Discussion Paper**").

The regulatory committee of the "Capital Markets and Technology Association" thanks the Basel Committee on Banking Supervision (BCBS) for the opportunity given and hereby submit its comments:

The Capital Markets and Technology Association (CMTA) is an independent association formed by leading actors from Switzerland's financial, technological and legal sectors to create common standards around issuing, distributing and trading securities in the form of tokens using the distributed ledger technology.

It is an association organized under Swiss law having its registered office in Geneva and registered in the Commercial Registry of the Canton of Geneva under registration number CHE-408.722.286.

It aims to facilitate the use of distributed ledger technology (DLT) in the field of capital markets and was created with the idea that DLT – and more particularly blockchain technology – has the potential to simplify the financing of companies and democratize their access to financial markets, which is for the time being, essentially reserved for large companies. The CMTA was established to promote the transparency and reliability needed to use DLT for financing purposes. One of the main objectives of the association is to promote the issuance and trading of traditional capital market instruments such as equity or debt securities in the form of digital tokens. The CMTA also seeks to adopt standards and systematize good practices at the regulatory, accounting and technical levels, in order to facilitate the treatment of digital assets by financial intermediaries. The CMTA is not intended to promote the ICO process as such, but only the emission of certain forms of tokens that have particular characteristics.

2. KEY POSITIONS

We generally welcome BCBSs initiative to provide a regulatory framework regarding the special risks related to crypto assets; in particular, we have the following key positions on the discussion paper:

- The framework should remain flexible as the underlying technology is rapidly evolving.
- The prudential treatment should be based on the principle of technology-neutrality: same risks, same rules.
- Additional risks due to a particular technology should also be taken into account, however, both as risk-mitigation factor (e.g., cryptography; DLT) and as a potentially risk-increasing factor (e.g., digitalisation without cryptography; central counterparty risk).
- For this, it seems necessary to distinguish more clearly the various types and use cases of "crypto assets", as the term may be too broad for a more focused regulatory approach.
- A strict regulatory approach should in all cases be limited to the riskiest crypto assets without intrinsic value (i.e., without counterparty or underlying assets, rights or claims). We recognize the efforts to borrow from the various Pillar standards, but we think that a Pillar 2 approach may be a more suitable way to reap the benefits of the technological innovation in banking than a Pillar 1 approach. A Pillar 1 standard would prevent banks in particular from participating in the new markets and may drive market participants into unregulated structures.

3. ANSWERS AND COMMENTS

1 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?

The following key features of crypto assets should be taken into consideration:

- As mentioned, there is no generally-recognized definition or taxonomy of crypto assets at present. A number of technical features should be considered, among which are the technical basis (e.g., open-source software; consensus mechanisms; permissioned vs public Blockchain; extent of decentralization; transparency of the holders; governance; compliance approach; etc.). Although crypto assets are digital, they should be clearly distinguished from such assets as digital money, or intermediated securities (which are also "digital" even in the current technology, although not relying on distributed ledger technologies).
- Furthermore, the nature of the underlying assets (if any) needs to be considered (e.g., does the crypto asset represent a share, a bond or another claim against an issuer, respectively another assets, rights or claims such as real estate, intellectual property, etc.).

The combination of the technical features, governance mechanisms and of the underlying assets (if any) should determine the tiered approach to prudential regulation of each category of similar types of assets.

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?

Among the main economic and related functions and potential sources of value relevant may be, in addition to the ones mentioned in the discussion paper, the following:

- Crypto assets may serve to provide enhanced liquidity as tokens can be traded on traditional or decentralised trading venues, thereby rendering investments potentially more liquid.

- If set up properly, crypto assets may furthermore be more easily traceable (depending on the technological aspects and implementation of the relevant distributed ledger technology), thereby rendering e.g. thefts from trading places less attractive.

Hence, any regulatory regime should take into consideration both the underlying assets, as well as the technical structure of a crypto asset.

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

Financial services (including but not limited to banks) may benefit in a number of ways from crypto assets, which should be seen as an enhanced digitalisation of existing services and infrastructures, as well as an opening for new types of services, the benefits of which include:

- safe storage solutions;
- automation through smart contracts;
- enhanced liquidity potential for non-liquid assets;
- instant and cost-free settlement;
- reduction of dependency from central counterparties;
- 24/7 service availability;
- direct linking to payment systems possible;
- possibility to build-in automated compliance requirements, including anti-money laundering compliance;
- depending on the set-up of the regulatory regime, significant reduction of compliance costs for financial service providers.

4 What additional factors affect the risk profile of different crypto assets which are relevant in the context of determining a prudential treatment?

In addition to the factors listed in the discussion paper, we see in particular the following factors as relevant:

- scope of decentralization;

- transparency not limited to market data, but also to the technology used and governance models;
- governance at the point of issuance and verification of the identity of the holders of the assets;
- quality of the trading platforms on which the assets are traded;
- regulation of actions such as hard forks.

5 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?

In general, we agree with the three general principles as per the discussion paper.

Additional principles could be the following:

- technology neutrality (to the extent this is not covered by the first principle "same risk, same activity, same treatment");
- integration into existing legal systems;
- recognition of special risk-mitigating features of a crypto asset (e.g., no counterparty risk in certain circumstances).

6 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?

Banks may in addition to the ones listed be exposed to crypto assets by providing the following services:

- investment management and advice;
- operating a trading venue or marketplace;
- providing further services such as asset tokenization, valuation, market making, marketing and placement services, etc.;
- providing of datafeeds, aggregation, indexes, compliance oracles and checks, etc.

7 Are any exposure channels likely to change in response to ongoing or envisaged developments in crypto asset markets?

It is likely that the various exposure channels may be combined and their relevance heavily influenced by the regulatory regime.

Furthermore, it is possible that banks will acquire a role as agent to bridge the link between real world assets and the crypto space.

8 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 risks differ based on the type and design of crypto assets, and how do they differ to traditional asset classes?

The risks will depend in particular on the underlying assets / counterparty risks and on the technical set-up. Hence, in addition to the classical bank risks in particular the following risks should be assessed:

- legal and regulatory risks;
- cyber risks, including operational risks;
- in case of asset tokenization and listings on trading places: due to low market liquidity and less transparency on the trading platform, market manipulation may be easier.

9 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?

The example refers to high-risk crypto assets only which seem to be in particular crypto currencies. Both in case of crypto currencies and in case of asset-based tokens we suggest a broader approach, taking into consideration the specific features of the token (e.g. including its market size and market liquidity, which may reduce risks even in case of pure crypto currencies), among which may be the following considerations:

- We agree on the general principles proposed by the BIS. However, under the principle "same risk, same activity, same treatment", crypto assets then should not be treated different than traditional assets. E.g. banks should be permitted to use their internally modelled approach for any crypto asset exposures.

- With regards to credit risk mitigation, crypto assets should be eligible to serve as collateral. A healthy lending and borrowing market allows for better price discovery and valuation of the underlying assets through the interest rate which in turn has the potential to draw in new investors while encouraging the movement of crypto capital out of storage and into markets which finally should decrease the long-awaited volatility.
- A reliable classification model and risk assessment criteria are indispensable. We suggest developing a holistic three-layered risk framework with a top-down focus on the functionality of crypto assets, the underlying protocol and lastly the financial risks mentioned in the Consultation paper.
- Layer 1 Basic risks / functional aspects such as
 - The underlying economic function – e.g. FINMA Taxonomy – categorize between utility, payment (incl. cryptocurrencies) and/or securities crypto assets;
 - Target use of crypto asset – e.g. medium of exchange, unit of account and store of value, access right to infrastructure, access right to application/ownership definer;
- Layer 2 Protocol related risks / Technical and conceptual aspects such as
 - Protocol type (native public blockchain, token, sidechain or permissioned chain)
 - Timestamping and consensus model (proof of work/stake/authority/hybrid or different models)
 - Hash algorithm (Scrypt/SHA/Keccak etc.)
 - Governance model
 - Launch date (history of stability)
 - Community (crypto asset distribution / number of full nodes or validators)
 - Possibility of transaction analysis (transparency vs. pseudonymity vs. anonymity)
 - Issuance schedule (centralized / decentralized / block reward)
 - Supply implementation of a unit cap / deflation model
 - Fork policy (past hard-fork history and future planned hard-forks)
 - IP rights on the underlying protocol
- Layer 3 Financial Risks such as
 - Liquidity risk
 - Market risk
 - Credit and counterparty credit risk

The following features could be considered in specifying the scope for such a potential treatment

- Loans against digital assets is unsecured (offset)
- Basel Capital Requirements / Bulk Risk,
- Segregation: normal omnibus account setup not allowed.

Formulating a standardised Pillar 1 measure of crypto asset risk which would be both sufficiently accurate to set regulatory capital and adequate to support financial innovation may be complex. The Pillar 1 standard as currently illustratively proposed would just prevent banks from participating in the crypto asset market and from offering services vital for the development of such markets – effectively promoting parallel, unregulated, activities and delaying innovation.

Hence, we believe that a Pillar 2 approach is a better way to reap the benefits of technological innovation in banking and finance in a regulated and controlled way to reconciling sustainable and beneficial financial innovation with an effective control of crypto asset risks in the banking system. Crypto assets are an immature asset class, linked to a developing technology and provide undisputed benefits, including enhanced efficiency, market liquidity and risk diversification. The Committee should allow these innovations to thrive in a regulated and risk-controlled environment. During the ongoing rapid and intense development phase of crypto assets, related activities, markets and infrastructure, it is preferable to leverage a more flexible supervisory review process. This process should be complemented by appropriate supervisory dialogue and cooperation, and by issuing qualitative standards (including for DLT / blockchain) for the digitisation processes. A Pillar 2 approach would make it possible to reconcile the need to be sufficiently conservative with the need to grant flexibility and allow further development. The prudential framework in place for interest rate risk in the banking book might serve as an inspiration. It formulates clear risk management and governance expectations, a detailed (product-based) risk measurement framework, disclosure requirements. It positions capital adequacy within the context of the internal capital adequacy process; it provides supervisory principles for the identification of outliers.

10 What further supervisory measures could be considered in specifying a potential prudential treatment for crypto assets?

We suggest that the Committee recommends to national supervisors to appoint dedicated experts to deal with issues of crypto assets.

Furthermore, the Committee could set-up a working group to discuss, together with the industry, appropriate suggestions for a regulatory framework. Our association would be happy to participate in any such working group.

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

Crypto assets should be reported and disclosed the same way as any other asset class under the rule of "same risk, same activity, same treatment".

12 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?

Any prudential treatment must take into account the economic function, the underlying assets, the technical features and a general risk assessment of the crypto asset in question. As such, crypto assets should not be treated as an asset class of its own (perhaps with the exception of pure cryptocurrencies) but rather in line with the relevant underlying assets.

13 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?

Products with a similar or identical risk profile in the form of a crypto asset should be treated under the existing frameworks, taking into consideration both the risk-increasing as well as the risk-reducing particular features of the crypto asset.

14 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?

The illustrative example discussed in the discussion paper relates to crypto currencies only; any crypto asset that is not a pure crypto currency should be treated differently, in line with its actual risk profile.

15 Do you have other suggestions regarding the design of a potential prudential treatment of crypto assets?

As outlined in our comments above.

We thank you again for being granted the opportunity to comment on your discussion paper and we are open to discuss any of the above points.

With kind regards

Capital Markets and Technology Association
The Regulatory Committee



Dr. Thomas A. Frick

cmta.

**capital markets and
technology association**

Route de Chêne 30

1208, Genève

Contact: Tel. +41 22 318 73 13

admin@cmta.ch

cmta.ch