ASSOCIATION DES BANQUIERS CANADIENS CANADIAN BANKERS ASSOCIATION

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September 29, 2022

Secretariat of the Basel Committee
on Banking Supervision (BCBS)
Bank for International Settlements
CH-4002 Basel, Switzerland

Re: CBA[1] Comments on BCBS Consultative Document – Second consultation on the prudential treatment of cryptoasset exposures

The Canadian Bankers Association (CBA) welcomes the opportunity to comment on the Basel Committee on Banking Supervision (BCBS) *Second consultation on the prudential treatment of cryptoasset exposures*. In addition to the points highlighted below, our detailed response on the proposed standards is included in the attached Appendix.

We appreciate that the second consultation has taken into account many of the industry's concerns from the initial consultation. We continue to support a holistic, risk-based approach to cryptoassets that provides regulatory clarity and promotes confidence and stability in financial markets while also enabling innovation. Cryptoassets are an evolving area and we agree that continuous review and updates are required. In particular, we look forward to the BCBS' review of the need for the proposed exposure limit and infrastructure add-on as markets and regulations evolve.

Classification of Group 1 cryptoassets
BCBS Group 1 cryptoassets are well defined in theory, however, in practice the definition is likely to exclude most asset-backed cryptoassets (e.g., stablecoins).

We appreciate the additional flexibility of the new redemption risk test to reflect overcollateralization and greater flexibility on the originally proposed basis risk test. However, we are concerned that the basis risk test remains difficult and believe it is unlikely that any stablecoin could pass. In addition, we believe there is still a significant cliff effect risk in the context of a required fall back to Group 2.

For classification condition 1, if a bank has cryptoasset exposures that only narrowly pass the basis risk test (i.e., peg to market value difference is less than 20bp no more than 10 times over the prior 12 months) we believe that an additional credit risk and market risk RWA requirement of an amount equal to

[1] The Canadian Bankers Association is the voice of more than 60 domestic and foreign banks that help drive Canada's economic growth and prosperity. The CBA advocates for public policies that contribute to a sound, thriving banking system to ensure Canadians can succeed in their financial goals. www.cba.ca

100% of the exposure value appears excessive and is not required. Any additional capital should only be required when the cryptoasset can no longer be categorized as Group 1, and we believe constant monitoring of the market value requirement should be considered sufficient. This further capital requirement is not likely to promote additional risk reduction behaviour and could limit banks' effective use of capital.

Instead, we prefer the BCBS's alternative that the issuer be supervised (as suggested in paragraph 60.17) in place of both the redemption and basis risk tests under condition 1. We find this supervisory alternative to be a more realistic and operationally preferrable alternative that the industry would fully support. Prudential supervision would allow regulators to start standardizing treatment of Group 1 cryptoassets, rather than each bank measuring/interpreting treatment for themselves. This alternative to the two stabilization tests is preferable and should also be used to encourage currently unregulated issuers towards more fulsome regulation, including prudential capital and liquidity requirements.

For classification condition 4, the industry supports the role of supervisors in approving banks' demonstration of which cryptoassets meet Group 1 categorization in their jurisdiction. Consistent supervisory approval criteria would also aid in effective and consistent monitoring by banks and provide comfort to supervisors in all jurisdictions.

Exposure Limit – 1% of Tier 1 for Group 2 cryptoassets

We believe the additional requirement of a Group 2 exposure limit of 1% of Tier 1 capital is a layer of additional conservatism that is difficult to justify. In our opinion this will limit the development of Group 2 cryptoassets by banks.

The Group 2 exposure limit of 1% of Tier 1 capital is constraining where the exposure is the sum of gross long, gross short, and derivative exposures. For consistency with current large exposure rules, banks should be able to offset long and short positions of the same issue in the trading book deemed to have no basis risk (i.e., Exchange Traded Fund (ETF) consisting of futures on Bitcoin offset by futures on Bitcoin).

If banks are restricted at a gross level of Group 2a exposures, we question why the benefits of hedging should be limited, given that there is a control to prevent banks from reaching a high gross exposure level. On the other hand, if banks are unable to recognize netting benefits (either the 65% through the SSA or via the fact that long and short sensitivities for assets on different indexes/exchanges products need to be accounted for under SBA) then the total exposure to Group 2a assets will be limited.

While the large exposure rules of the Basel framework do not capture exposures to an asset type, we note that they sufficiently limit the concentration in a particular asset type, including cryptoassets, through assessment of exposures to individual counterparties. In addition, banks have internal business-specific concentration limits, some approved by their Board of Directors, which mitigate the risk of over investment in certain products.

As such, we do not believe the additional requirement of limiting Group 2 assets to 1% of Tier 1 capital is needed, and feel this decision should be left to each bank, based on its risk appetite. At a minimum, this additional requirement should not include Group 2a cryptoassets given the availability of acceptable hedging options allowed for banks.

In addition, we are disappointed that the BCBS' categorization options fail to make a distinction for well-established cryptoassets such as Bitcoin and Ether within Group 2. Given that Bitcoin and Ether are well established in the market, we believe they should be excluded from the proposed exposure limit of 1% of Tier 1 Capital.

The requirement for all Group 2a cryptoassets to be subject to Group 2b treatment if the 1% limit is breached also appears excessive and inappropriately penalizes Group 2a cryptoassets and the underlying businesses in the bank holding these exposures. Any breaches of existing limits within a bank are normally rectified immediately given the trading nature of the holdings. Therefore, we do not see a need to address a limit breach through a revision of the capital treatment for Group 2a cryptoassets.

We request that the BCBS recognize that banks already have risk management policies and limits in place to avoid excess concentration, most of which are based on existing BCBS guidance. We request that the BCBS remove the requirement for Group 2 cryptoassets not to exceed 1% of a bank's Tier 1 capital.

Infrastructure RWA Add-on – Group 1 cryptoassets

We believe the proposed RWA add-on of 2.5% of the exposure value to reflect concerns related to distributed ledger technology (DLT) is difficult to justify both in terms of its aim and calibration. We believe this is an imprecise means of requiring banks to hold capital against an area of potential risk that may not be best addressed by holding additional capital.

In our opinion, the infrastructure RWA add-on on Group 1 assets results in double counting, whereby these cryptoassets are subject to a risk weighting, which presumably captures infrastructure risk, plus an additional charge aimed at capturing the same or similar risk. From a technical perspective, for centralized stablecoins, the integrity of the blockchain that the stablecoin transacts on should be considered.

Some blockchains have been reliably operating for several years and are well tested, although the same is not true of all blockchains. Ethereum, for example, is considered a reliable platform, and has gone through several major protocol upgrades in the past with little disruption. Other blockchains (e.g. Solana), have suffered from downtime in the past that disrupted the transfer of tokens.

The strength and integrity of the underlying blockchain network should be evaluated against the purpose of the infrastructure risk add-on. Stablecoins operated by centralized entities would have a transparent and well-evaluated governance structure in place, and the transfer and settlement finality of the on-chain stablecoin assets would be determined by the blockchain itself.

Additionally, we believe the infrastructure add-on will disadvantage tokenized assets issued by banks, given that these holdings will require an infrastructure add-on compared to those issued by non-regulated entities. In fact, the carveout from the add-on for assets issued by a central bank or sovereign seems to contradict the purpose of the add-on, which is aimed at addressing infrastructure versus issuer risk.

We are very concerned that this type of RWA add-on could also set a precedent for other areas where it is not clear whether risks are posed to banks or where they cannot be easily quantified, possibly resulting in less than optimum treatment under a risk-based approach. For these reasons, we request that the infrastructure RWA add-on be removed.

Thank you for considering our comments. We would be pleased to discuss our response to the *Second consultation on the prudential treatment of cryptoasset exposure* at your convenience.

Sincerely,

Deborah K. Crossman

cc: Lisa Peterson, Managing Director, Insurance Capital, OSFI
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CBA comments on BCBS Consultative Document *Second consultation on the prudential treatment of cryptoasset exposures*

CBA Members' Comments and Requests for Clarification
Classification conditions (pages 8 – 13)
Guidance on Exchange Traded Funds (ETFs) has not been provided under Group 1 assets, could BCBS clarify if ETFs would be allowed in Group 1? <u>Paragraph 60.12 to 15 - Tests for determining if an asset meets the stabilization requirements of Group 1b and data risks</u> Meeting all conditions of the two stabilization tests on an ongoing basis would require the development of relevant data (including on market value of these assets for the prior year), and for intricate and costly monitoring, reporting, and control processes to be in place. If retained, would BCBS consider decreasing the intricacy of the tests (for example, reduction of the frequency of required monitoring and calculation)? <u>Paragraph 60.19</u> We question the need for an independent legal opinion outside of the bank's own legal team if not related to an offering of the cryptoasset by the bank itself. In our opinion banks should be able to rely on their own legal teams and seek outside opinions when and if considered necessary. <u>Paragraph 60.23</u> In condition 4 the following wording in the last clause: "….or *subject to appropriate risk management standards.*" may be open to interpretation. We suggest amending the wording as follows: …*or subject to appropriate risk management standards <u>as can be determined based on publicly available information</u>.* <u>Paragraph 60.25 to 27</u> Does BCBS envisage a "whitelist" model where regulators approve some cryptoasset categories? We have concerns over various compliance obligations associated with group classifications and concepts ("ongoing basis"), that would be onerous as currently drafted: • <u>Paragraph 60.6</u> - Crypto assets must be screened "on an ongoing basis" to determine whether classification conditions for treatment as Group 1a, 1b, 2a, or 2b are met. • <u>Paragraph 60.13(2)(d)</u> - Public disclosure at least daily of the value of assets held in reserve against cryptoassets and at least weekly of the composition of such assets. • <u>Paragraph 60.14(1) to (3)</u> - Passing of the condition 1 basis risk test requires daily monitoring of the peg value of cryptoassets. It appears that the pass/fail mechanism could exacerbate markets stress. Assets that pass the test today but fail in the future will attract a large cliff risk for Group 2 capital requirements (60.15/60.16), leading to a first-mover advantage and a mechanism that could create instability.

CBA Members' Comments and Requests for Clarification

We note that while the intention behind the compliance obligations is understandable, meeting all the obligations as currently drafted would be quite onerous and operationally burdensome. It would be helpful if BCBS could consider defining concepts and terms (for example additional clarification on, "*ongoing basis*") in a way that retains the spirit of the obligations while reducing the associated compliance burden. More specifically, additional clarification would assist in implementing appropriate governance.

Banking/trading book boundary, use of internal models and accounting classification (pages 13 – 14)

The clarity on the banking/trading book boundary in the second consultation is helpful, however, the universe of Group 1 cryptoassets remains small.

We agree with the recommendation that model-based approaches for Group 2 cryptoassets in paragraph 60.29 are not appropriate at this time. However, we hope that as and when cryptoassets become increasingly material on banks' balance sheets that further consideration of a possible model-based approach is investigated and put forward for consultation.

One concern is the paragraph 60.34 requirements, which are particularly difficult to implement as they require confirmation of behaviour under distressed market conditions - as many assets may not have existed under such conditions but meet all other requirements.

We believe the potential for a Group 2 cliff effect may temper the appetite for this asset class. We wonder if the stated rationale for excluding Group 1b collateral due to potential counterparty credit risk in paragraph 60.44 is consistent with similar interpretations across non-cryptoasset classes? More insight into this reasoning on finalization of the standard would be appreciated.

Minimum capital requirements for credit risk for Group 1 cryptoassets (pages 14 – 17)

Could BCBS clarify that recognition of Group 1a cryptoassets as collateral can only occur where the volatility in values and holding periods under distressed market conditions can be confirmed? We suggest that guidance be provided to banks and supervisors on an acceptable test that would demonstrate this.

For Group 1b cryptoassets and recognition of credit risk related to the reference asset, we believe that risk of default of the redeemer and risks arising when intermediaries perform the redemption function is required. For purchasers of Group 1b cryptoassets, we suggest inclusion of text stating that the maximum RWA requirement for these risks would not exceed 1250% of the cryptoasset exposure amount.

CBA Members' Comments and Requests for Clarification
<u>Paragraph 60.42 states:</u> *Even if there is no legal obligation for a member bank to purchase cryptoassets from non-member holders, banks and supervisors should consider whether in practice the member bank would be obliged to step-in and purchase them in order to satisfy the expectations of non-member holders and protect the bank's reputation. Where such step-in risk exists, banks should include within RWA the amount that would apply if legally binding commitments have been made. Exceptions would only be made if the bank can demonstrate to the supervisor that such step-in risk does not exist.* Aside from the securitization framework, there is no requirement to hold capital for step-in risk on any other products/assets. It is also not clear how step-in risk would be assessed in relation to cryptoassets. As a result, we do not believe that step-in risk capital should be a requirement for cryptoassets and believe it should be dealt with bilaterally by supervisors if there is a specific concern.
Minimum capital requirements for market risk for Group 1 cryptoassets (pages 17 – 19)
Could BCBS provide guidance on the Default Risk Capital (DRC) notes for Group 1. What would the treatment be on instruments like bond forwards where the underlying duration does not match the forward instrument duration? We believe banks could run into problems with gaps being created with a forward on a tokenized asset. <u>Paragraph 60.53</u> We believe this exclusion from IMA more logically belongs in paragraph 60.60 on hedging recognition criteria.
Minimum capital requirements for credit and market risk for Group 2 cryptoassets (pages 19 – 24)
For Group 2a hedging recognition criteria, we agree that the bank's cryptoasset or the cryptoasset referenced by the derivative or exchange traded fund/exchange traded note should be highly liquid with a "large market cap". However, we suggest that BCBS resets the USD10 billion as the minimal average market capitalization over the previous year by aligning this market capitalization threshold with the FRTB large market cap definition, (i.e., USD 2 billion), in order to be consistent with market risk capital charge for traditional assets. Under the SA approach for Group 2a cryptoassets in paragraph 60.79, we do not understand the two-dimension risk factor structure for delta sensitivities, in particular the time-to-maturity dimension. The FRTB requirements do not have delta term structure for equity and FX assets, and only interest rate assets are subject to delta term structure with respect to time-to-maturity. We believe it is sensible to offset the delta sensitivity from a crypto ETF and an opposite option position referring to the same crypto ETF regardless of the maturity of the option, as with FX and equity assets/derivatives. We would appreciate clarification on the time-to-maturity dimension for delta sensitivities.

CBA Members' Comments and Requests for Clarification

In addition, we do not understand the curvature capital requirements for Group 2a cryptoassets - could BCBS share some examples?

Paragraph 60.60(1)
What is the Group 2 treatment of funds that hold ETFs?

Paragraph 60.60(2)
The $50mm daily volume seem excessive, we suggest that a lower threshold should be considered to align with FRTB.

Paragraph 60.60(3)
Regarding Group 2a hedging recognition criteria:
"(3) Sufficient data is available over the previous year.
(a) There are at least 100 price observations over the previous year. The price observations must be "real" as defined in the four criteria of [MAR31.12].
(b) Sufficient data on trading volumes and market capitalisation."

Could BCBS clarify if the 100 observations requirement for price/trading, volume/market capitalisation is for the underlying cryptoasset, or does it also apply to products that reference the cryptoasset? This impacts newly listed products such as ETFs and futures or any contracts that have a term of less than 100 days. Newly listed ETFs or derivative products should reference the price observations, trading volumes, and market capitalization of their underlying assets.

We also have concerns about the compliance obligations, which would be onerous as currently drafted.

Paragraph 60.65
"When consolidated, positions for each Group 2a cryptoasset in different markets or exchanges must not be offset, meaning those sensitivities will be calculated as separate long and short gross consolidated positions"

It is common practice to hedge exposure across exchanges or markets for non-cryptoassets, for example, equities and equity futures with the same underlying asset traded on different exchanges are allowed for risk netting. We believe the treatment should be consistent for cryptoassets, with no distinction between instruments traded on different exchanges.

Paragraph 60.66
*"Net position k = Max (Long position k, | Short position k|) – 0.65 * Min (Long position k, |Short position k |)"*

A 0.65 hedge effectiveness is still punitive for Group 2a cryptoassets. The market risk of currently popular Group 2a cryptoassets is similar to the higher risk segment of the equity market, with liquidity better than for many equities. We believe higher or full offsets for the same cryptoasset should be allowed for market risk purposes.

CBA Members' Comments and Requests for Clarification
Paragraph 60.74 Under the SA approach for Group 2a cryptoassets, we have concerns about the inability to offset between different markets/exchanges. We believe it is sensible to offset the same crypto ETFs listed on different exchanges. Paragraph 60.81: *"In order to calculate the delta (or vega) capital requirements for a single bucket b ρ_{kl} =[94%]"* We request clarification on the 94% applied in this paragraph, is this intended to be prescriptive or an example? Paragraph 60.88 Is there a de minimus exception for cryptoassets present in funds? In the case of an ETF or fund referencing Group 2b, but also other types (i.e., other groups, non-tokenised assets), how would it be treated? Paragraph 60.90 By which calculation method are banks expected to demonstrate the materiality of their short positions? Is the intent to always calculate the market risk and BA-CVA exposures and compare them with the 1250% calculation proposed for Group 2b?
Minimum capital requirements for Counterparty Credit risk (CCR) (pages 25 – 26)
We request clarification on the calculation for derivatives on Group 2a cryptoassets, for both RWA and the leverage ratio. Paragraph 60.102 specifies that Group 2a derivatives exposures are subject to the SA-CCR, where all transaction types (including crypto and non-cryptoassets) under the same netting set will be allowed for legally enforceable netting. In this case, for the purpose of the counterparty credit risk RWA calculation, could BCBS clarify if the intention is to use the risk weight of the counterparty given that SA-CCR calculates exposure for all transaction types with the same counterparty? Paragraph 60.103 The approach for Group 2b is very conservative as no netting is allowed between different cryptoasset trades nor can Group 2b cryptoassets be utilized as excess collateral against the Potential Future Exposure (PFE) under paragraph 60.104. Could BCBS elaborate on the rationale driving the PFE 50% requirement in the final standard? Paragraph 60.104 *"As with all non-eligible collateral, banks that lend Group 2b cryptoassets as part of an SFT must apply the same haircut that is used for equities that are not traded on a recognised exchange (i.e. a haircut 25%)"*.

CBA Members' Comments and Requests for Clarification
We would like clarification as to whether (1) the sentence should exclude the word "*not*", and (2) whether the haircut should be 30% instead of 25% (in order to be consistent with Basel III)?
Minimum capital requirements for operational risk (page 26)
We agree that operational risk resulting from crypto activities would be captured by the new operational risk standardized approach through the Business Indicator and Internal Loss Multiplier, and that any deficiencies identified should be left to the bank's supervisor to assess appropriate additional capital as needed. However, we suggest a distinction between physical and non-physical cryptoassets for the purpose of operational risk in paragraph 60.105, as many cyberasset related risks such as cybertheft are prevalent in physical assets but not relevant to synthetic assets. Operational risk is lower for synthetic exposures because they do not require physical custody of cryptoassets. There is no risk of cybertheft of the underlying assets as a synthetic exposure is a contract which references the price of a benchmark,and does not represent direct ownership of the asset.
Minimum liquidity risk requirements (pages 26 – 30)
Paragraph 60.107 indicates that holdings of Group 1a cryptoassets that are tokenized versions of a traditional asset can qualify as HQLA to the extent that both the underlying and the tokenized asset meet the HQLA eligibility criteria. However, guidance is not provided on how the tokenized asset should be evaluated differently from its underlying, given that these assets can require an additional liquidation step in stressed markets. In stressed conditions tokens may not be exchangeable for cash with a peg to the underlying and may involve a central provider stepping in to help move tokens to underlying, and underlying to cash. This is left to the supervisor. More guidance would be welcome on conditions when a tokenized Group 1a cryptoasset with an HQLA underlying should be considered HQLA, and when not. In paragraph 60.110, a bank's default runoff factors are calculated by reference to the cryptoliability's most similar non-crypto equivalent. However, the same class of clients may have less confidence in their crypto deposits than in similar, traditional ones and this could change runoff behavior – making crypto deposits more susceptible to runoff. We believe this paragraph should be enhanced to include guidance on assessing the additional risk of a cryptoliability over its traditional, non-tokenized equivalent. Paragraph 60.112 (4) allows for more stringent treatment of liabilities but does not provide guidance on how supervisors would determine when or how to apply this treatment, which is not part of the default treatment referenced in paragraph 60.110. References to technical design and local circumstances of the banking sector do not sufficiently cover the potential behavioral attributes of cryptocurrency liability holders and how they are distinct from traditional depositors.

CBA Members' Comments and Requests for Clarification
Paragraph 60.112 (2) (b) *…However, the issuing bank must not treat the liabilities associated with their cryptoassets as stable retail deposits.* Could BCBS clarify the rules on retail deposit classification when financial institutions issue tokenised claims on themselves in the form of deposits? In the second consultative document, stable/less stable deposits (LCR definition) in the form of cryptoassets are all treated as less stable deposits, which results in a lack of differentiation between different deposits types. For example, cryptoassets that represent insured deposits in non-transactional accounts with established relationships are subject to the same run-off as insured deposits in non-transactional accounts with no established relationship.
Group 2 exposure limit (pages 30 – 31)
The combination of the method of calculation plus the 1% of Tier 1 limit seems quite conservative. We believe this risk-insensitive metric acts at cross purposes to the Group 2a approach, in particular to the gross exposure approach. Given the materiality and potential impact, could BCBS please confirm if the 1% limit was calibrated on a net or gross basis? It would be beneficial to understand what the appropriate thresholds are under both scenarios (gross and net). We note that the formula in paragraph 60.124 appears designed to cap the amount of trading permitted under paragraph 60.60. Paragraph 60.122 How does BCBS envision the "at all times" requirement for capital numbers not visible on a daily frequency? We would expect that banks would be allowed to follow their current practices of risk limit monitoring.
Bank risk management and supervisory review (pages 31 – 34)
We acknowledge that there are likely to be increased cyber/fraud threats against cryptoassets/technology given trends in the external threat landscape. However, we continue to advocate for a risk-based approach to ensuring the security and stability of crypto related technology and highlight that banks are already well regulated on minimum expectations to manage cyber, tech, data, fraud and 3rd-party risks. As with traditional assets, there needs to be a clear expectation of liability on institutions and clients to ensure cryptoasset safeguarding responsibilities are well defined.

CBA Members' Comments and Requests for Clarification
Paragraph 60.128 requires banks to inform their supervisors of their actual and planned crypto exposures or activities in a timely manner. We suggest providing clarification in this paragraph that banks' supervisory updates related to cryptoassets can be done by way of existing updates and need not be specific only to cryptoassets. We suggest inserting the following wording: *Banks are also expected to inform their supervisory authorities of their policies and procedures, assessment results, as well as their actual and planned cryptoasset exposures or activities in a timely manner, <u>which may include standard supervisory timing updates</u> and to demonstrate that they have fully assessed the permissibility of such activities, the associated risks and how they have mitigated such risks.*
Disclosure requirements (pages 34 – 35)
We request that BCBS qualify that disclosure of cryptoasset exposure information would only be required to the extent that it does not reveal any proprietary information on trading or investment strategies.