

Crypto Council for Innovation

30 September, 2022

Basel Committee on Banking Supervision
Bank for International Settlements

Re: Second consultation on the prudential treatment of cryptoasset exposures, ISBN 978-92-9259-584-5¹

To the Committee:

The Crypto Council for Innovation (“CCI”) submits this letter in response to the request of the Basel Committee on Banking Supervision (the Committee) for comment regarding the “Second consultation on the prudential treatment of cryptoasset exposures” (“2d Consultation”).

CCI welcomes the opportunity to provide comments and to share information, expertise, and views on this vital issue with the Committee. CCI is an alliance of crypto industry leaders with a mission to communicate the benefits of crypto and demonstrate its transformational promise. CCI members include some of the leading global companies and investors operating in the crypto industry, including Andreessen Horowitz, Block (formerly Square), Coinbase, Electric Capital, Fidelity Digital Assets, Gemini, Paradigm, and Ribbit Capital. CCI members span the crypto ecosystem and share the goal of encouraging the responsible global regulation of crypto to unlock economic potential, improve lives, foster financial inclusion, protect national security, and disrupt illicit activity. CCI and its members stand ready and willing to work with the Committee to accomplish these goals.

Cryptocurrency represents one of the most significant innovations in finance—and beyond—in many years, with the potential to alter ownership structures, commercial applications, cross border payments, transaction processing and settlement, access to capital, investment opportunities, and much more. These developments contribute to equitable growth and financial inclusion, as well as investor and consumer choice and security. The prudential treatment of cryptoassets, therefore, is an important question for policymakers. Developing an appropriate prudential framework for cryptoassets requires an understanding of the technology and careful consideration.

The Committee is the leading standard setter for international banking standards, and we greatly appreciate the Committee being engaged in this meaningful public-private sector

¹ <https://www.bis.org/bcbs/publ/d533.htm> The consultation builds on the preliminary proposals set out in the Committee's [June 2021 consultation](#) and the responses received from stakeholders.

engagement, with the understanding that doing so is critical to getting the regulatory framework right. We look forward to continuing to work with the Committee and its members.

DISCUSSION

I. Infrastructure Risk Add-on

As the Committee continues to develop the new cryptoasset chapter for the consolidated Basel Framework, CCI appreciated the 1st Consultation's general principles set out in the first consultative document of "same risk, same activity, same treatment." However, CCI respectfully submits that this principle has not been adhered to in the 2d Consultation and there may be unintended consequences on the creation of digital money. For instance, as we develop digital fiat (i.e., digital dollars, digital euros, etc.) including payment stablecoins and CBDCs, the digital fiat should be considered cash equivalent with no risk weighting as treated under Group 1a of the taxonomy table. However, an infrastructure add-on to tokenized fiat would make it more expensive for banks and bank customers to use digital fiat. By adding an infrastructure add-on for even tokenized fiat, banks would be discouraged from using digital money, leading to a perverse bifurcation of the financial system in which the digital financial ecosystem is dominated by non-banks while excluding banks.

The infrastructure risk add-on for Group 1a digital fiat is also against the principle of money creation. Money is always clear of secured interests under private commercial law and should be treated accordingly under banking regulation. Commercial banks have large amounts of operational, capital and liquidity risks, yet commercial bank money is not subject to Basel capital charges. Further, e-money transmitters of Group 1a digital fiat may be subject to different capital and liquidity requirements than commercial banks, but that does not make them "not regulated." As the IMF has stated in a past study: "Prudential supervision should be proportionate to the risks to e-money users and to the financial system".²

Secondly, CCI wishes to inquire how the infrastructure add-on would be implemented. Would it be up to the bank or the Committee to determine whether one blockchain is riskier than another (and based upon what criteria?), or would the 2.5% capital add-on be unilaterally added to all holdings of Group 1a cryptoassets, negating the principle of "same activity, same risk, same regulation"?

The 2.5% capital add-on diminishes the appeal of Group 1a status for cryptoassets by further distancing their status from the "risk weights of underlying exposures as set out in the existing Basel capital framework," which may negatively skew the cost-benefit analysis of Group 1a status (such as digital fiat) versus the potentially onerous requirements of the classification conditions. Further, the justification for the add-on is vague and, other than the Committee's continued monitoring, no forward path, guidance, or standards are provided for

² IMF Departmental Paper DP/2021/027: "E-Money Prudential Supervision, Oversight, and User Protection" Prepared by Marc Dobler, José Garrido, Dirk Jan Grolleman, Tanai Khiaonarong, and Jan Nolte (Dec. 2021), file:///C:/Users/LindaJeng/Downloads/EMPSOUPEA.pdf

what developments in distributed ledger technology would lead to an elimination or downward adjustment of the add-on.

It is also not clear how infrastructure risk that this capital add-on is meant to address differs from market risk and operational risk. For instance, if issues in cryptoassets' underlying infrastructure create price volatility, that volatility is a market risk. To the extent that botched or unauthorized interaction by bank employees with distributed ledger technology could cause losses, operational risk requirements already cover such situations. Cryptoasset volatility during stressed periods also would also be already addressed by the Stress Capital Buffer as assessed under severely adverse scenarios.

The policy rationale behind the infrastructure risk add-on should be clarified and, if possible, distinguished from existing approaches to market and operational risk. Further, more precise guidance, metrics, or standards on the forward path for the Committee's evaluation of infrastructure risk, aside from mere monitoring, should be developed.

II. Classification Condition 1

The redemption risk test and basis test for Group 1b could stifle innovation and potentially conflict with national laws. It may be beneficial to make these tests more flexible and less restrictive.

The redemption risk test would impose requirements on the backing of stablecoins in order to receive Group 1b treatment. While backing stability is desirable and some requirements are welcome, these requirements would significantly reduce flexibility in backing models and also could potentially preempt more flexible requirements at the national rather than international level. If adopted, this approach could create a tradeoff between the advantages of Group 1b status on the one hand, and greater economic efficiency in arrangements that do not meet this test on the other.

The basis risk test is an improvement on the 10bp test because it creates more room for stablecoins to qualify for Group 1b by allowing for their inclusion under both the "fully" and "narrowly" passed designations. This increased flexibility for Group 1b status is welcome in that it expands banks' ability to hold these innovative and widely-used payment instruments. However, the 10bp and 20bp limits are highly constricting. While the logic of this approach is sound, a very limiting basis point test discourages Group 1b stablecoin holdings of any kind. The Committee should consider widening the limits of the basis risk test.

The alternative approach, which would tie riskiness determination and Group 1b status to the (capital- & liquidity-) regulated or unregulated status of the issuer of the stablecoin the bank holds will be determined in large part by future legislation in major jurisdictions, so it is difficult to assess at present. This approach is arguably too rigid as it requires the issuer to be subject to bank-like capital and liquidity regulation to be eligible for Group 1b status. Whether stablecoin issuers will be subject, and how, to such regulation is the subject of ongoing legislative drafting in major jurisdictions and the outcome will be heterogeneous. This approach also would replace

some form of the nuanced redemption and basis risk tests with a rigid blanket requirement that does not match the dynamic and innovative nature of stablecoins.

For example, some stablecoin issuers are currently licensed and regulated in the US as state-chartered money transmitters. But such regulation would not qualify them for Group 1b status under the alternative approach even if they passed some form of the redemption and basis risk tests. Thus, the alternative approach to the redemption risk and basis tests would provide for lower capital charge for stablecoins issued by “regulated” entities while stablecoins issued by so-called “non-regulated” entities, such as state-chartered money transmitters, would get a higher capital charge. US state money transmitters may not be subject to capital requirements due to their different business model, but they may not be any less risky than banks. We respectfully request reconsideration of using the alternative approach. The time is not ripe for the alternative approach. While legislation develops around the globe, some form of the redemption and basis risk tests would be better suited to dealing with stablecoin issuers with stabilization mechanisms.

III. Risk Weighting and Group 2 Exposure Limit

The conservative 1,250% risk weighted approach for Group 2 cryptoassets would essentially block banks from participating in the digital assets ecosystem. Further, analogizing the blockchains behind Group 2 cryptoassets to counterparties for the purposes of an exposure limit may not be the most appropriate comparison. Counterparty limits are imposed to protect against centralized, undiversified, and idiosyncratic risks specific to each counterparty. Group 2 blockchains are non-entities that rely on decentralized consensus mechanisms for their functioning, lacking the centralized executive function, centralized financial management, and associated vulnerabilities of traditional counterparty entities.

To the extent that decentralization presents different risks, they are generic asset-type risks already addressed by the super conservative 1,250% risk weighting for the more risky Group 2. This kind of non-counterparty asset-type exposure limit simply addresses price volatility, which is also already dealt with by the conservative 1,250% risk weighting. Cryptoasset volatility during stressed periods would also already be addressed by the Stress Capital Buffer as assessed under severely adverse scenarios. Relationships with counterparties that reference cryptoassets, as opposed to outright holdings of cryptoassets, will already be covered by the counterparty exposure rules.

The Committee should consider reducing the conservative 1,250% risk-weighting for Group 2 cryptoassets and further distinguish the line, if there is one, between the policy rationales for having both the conservative risk-weighting and the Group 2 Exposure Limit. The analogy to counterparty risk on which the Group 2 Exposure Limit relies should be further developed to take into account the decentralized nature of many Group 2 assets.

IV. Conclusion

In the years since the Great Financial Crisis, the Committee has developed a sophisticated and nuanced approach to the prudential treatment of assets and risks on and off the balance sheets of the world’s internationally active banks. As the Committee prepares to add a chapter on

treatment of cryptoasset exposures to the consolidated Framework, it has the opportunity to strike the crucial balance between ensuring the safety and soundness of the international financial system and fostering the innovation in blockchain technology that contributes to equitable growth and financial inclusion. We look forward to continued engagement with the Committee to accomplish these shared objectives.

Respectfully submitted,

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