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Pablo Hernández de Cos
Chair
Basel Committee on Banking Supervision
Centralbahnplatz 2,
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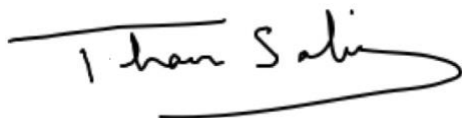
Dear Mr Hernández de Cos

Re: Prudential treatment of cryptoasset exposures

We welcome the opportunity to provide input to the BCBS's consultation paper on the prudential treatment of cryptoassets (hereinafter: "the CP"). The EMA is a trade body of FinTech, BigTech and technology firms engaging in the provision of alternative digital payment services, including the issuance of e-money. As such, the EMA has a strong interest in the digitalisation of financial services and markets, in the development of digital payment instruments and cryptoassets based on centralised as well as distributed architectures. Our members include leading payments and e-commerce businesses providing online payments, card-based products, electronic marketplaces, and increasingly cryptocurrency exchanges and other cryptocurrency related products and services.

We would be grateful for your consideration of our comments, which are set out below.

Yours sincerely



Dr Thaer Sabri
Chief Executive Officer
Electronic Money Association

Question 1: What are your views on the Committee's general principles?

1. We do not have any objections to the general principles of 'Same risk, same activity, same treatment', 'Simplicity' of design, the setting of 'Minimum Standards', and the proposed approach of a classification of cryptoassets and underlying networks in order to determine the applicable capital charges. However, whilst by definition Basel IV pillar 1 capital requirements are minimum standards, we believe that, relative to the actual risk exposures, **the capital charges generated by the proposed prudential treatment for both Group 1 and Group 2 cryptoassets are well above a risk-adequate minimum.**
2. This is not only an issue in terms of the resulting quantitative capital charges. The related **qualitative classification conditions** that have to be met in order to qualify for the classification as Group 1 cryptoasset - subject to much lower capital requirements than Group 2 cryptoassets - are **well above what we would regard as a risk-adequate minimum.** Similarly, cryptoassets that are not meeting these conditions and, as a consequence, are classified as **Group 2 cryptoassets** become subject to a capital treatment that **overstates by far the actual risk exposure**, is well beyond what we would regard as a minimum standard and is **effectively prohibitive.**
3. In this regard, the proposed prudential treatment does not live up to the general principles underlying the Basel IV capital framework. In particular, the **proposed treatment fails to strike a sensible balance between simplicity and risk-sensitivity.** The result is an approach that **in many respects is complex**, but in relation to the calculation of capital charges, **too simple to generate risk-sensitive capital charges.** This is all the more striking in light of the fact that the Basel capital framework offers a range of approaches (e.g. to FX risk and more generally to the recognition of internal models). The Committee could easily draw on this range of options to devise a much more risk-sensitive approach to capital requirements for cryptoassets. This would still offer ample room for building in flexible, and if deemed necessary, conservative buffers.
4. Moreover, by **not covering CBDCs**, which, therefore, will **not be subject to any capital charge**, but, at the same time, most likely fully recognized as risk mitigating collateral, the proposed treatment sets a strong competitive bias. Privately issued stablecoins will find it very difficult to compete with CBDCs.
5. At the same time, we do not think that effectively exempting CBDCs from any capital charge is sufficiently reflective of actual risks. The **privately-owned networks and ecosystems that central banks are likely to use** as infrastructure for the issuance and circulation of CBDCs **carry some level of operational risk.** According to the treatment proposed in this consultation, privately issued stablecoins would attract a capital charge for the same level of operational risk. Here again the **proposed capital treatment is not risk-sensitive and strongly biased in favour of CBDCs.**
6. In summary, **we do not think that the proposed prudential treatment of cryptoassets fits well with a Basel capital framework that, according to our understanding of the underlying general principles, is meant to deliver a risk-based and risk-sensitive capital treatment that sets regulatory incentives for improved risk management.** On

the contrary, the capital requirements resulting from the proposed prudential treatment are far from being risk-sensitive and create perverse incentives. The capital requirements generated for cryptoassets that do not qualify as Group 1 and therefore fall victim to the dramatic cliff-edge effect between the capital requirements for Group 1 and Group 2 cryptoassets are overly simple and at the same time prohibitively high. As a consequence banks will not even consider using cryptoassets for risk mitigation and hedging purposes despite their arguably strong potential and, going forward, likely ease of use for such purposes.

[Please note that our comments on questions 2 to 4 address the issues related to the proposed classification of cryptoassets as covered by these questions, in a different order than the questions suggest. Accordingly our comments in paragraphs 7 to 17 do not follow that order.]

Question 2: What are your views on the Committee's approach to classify cryptoassets through a set of classification conditions? Do you think these conditions and the resulting categories of cryptoassets (Group 1a, 1b and 2) are appropriate? Which existing cryptoassets would likely meet the Group 1 classification conditions?

Please see paragraph 7 – 17.

Question 3: What are your views on the classification conditions? Are there any elements of these conditions that should be added, clarified or removed in order to:

- ensure full transferability, settlement finality, and/or redeemability;
- limit regulatory arbitrage, cliff effects and market fragmentation; and
- take account of new and emerging cryptoassets?

Please see paragraph 7 – 17.

Question 4: For the first classification condition, is there an alternative methodology to assess the effectiveness of the stabilisation mechanism of Group 1b cryptoassets? Would this proposed methodology be consistent with ensuring the effectiveness of the stabilisation mechanism while also being practical?

7. We consider that the proposed **classification**, the **distinction between** (only) **two groups of cryptoassets**, and the **corresponding two layers of capital charges** will be quickly outdated. The dynamics of cryptoasset markets are such that a sensible and forward-looking prudential treatment for cryptoasset exposures, instead of imposing a binding classification, should refer to relevant and readily available market indicators of risks, including operational risks and risks related to products' liquidity characteristics. To that end the Committee should consider lowering the pillar 1 capital charge and leave **significantly more room for a discretionary prudential treatment, including capital add-ons under pillar 2**. This would

allow for a gradual movement towards a more risk-sensitive prudential treatment **responding to the growing maturity of the technology and of cryptoasset markets.**

8. In this regard we would encourage the Committee to pursue the suggestion discussed on page 7 of the CP regarding the setting of the proposed pillar 1 operational risk add-on “*as an amount that **reduces over a period of time as the underlying technology becomes more established and conditional on it demonstrating robustness through stressed events** (e. g. cyber-attacks, legal challenges etc)*”. Similarly, we very much support the proposal to allow the application of the **internal model-based approaches** to Group 1 cryptoassets. We welcome any opportunity to contribute and/or discuss with the Committee the issues arising when modelling the risk related to cryptotassets, and how these challenges could be overcome. Both aspects - inserting a time-dimension, and allowing for the use of internal models subject to specific recognition once sufficiently matured - would allow the **prudential treatment to be fine-tuned over time as operational and network-related challenges are addressed**, and the **modelling of cryptoassets progresses**. This would allow for a much more risk-sensitive prudential and capital treatment to evolve over time in parallel with the dynamics of maturing cryptoasset markets, and without a need to change the regulatory texts.
9. Accordingly, we are disappointed that the Committee’s proposals do not provide for a **trading book treatment and the use of an internal model-based approach for group 2 cryptoassets**. Subject to individual, firm- and model-specific recognition, allowing the use of an internal model-based approach would provide a strong incentive for the industry (both banks and key players in the cryptoasset markets) to tackle issues with the modelling of group 2 cryptoassets. This would pave the way for significant progress towards better individual and market-wide risk assessment and management, with important benefits to be gained not least for the Committee and the regulatory community.
10. In summary, we would very much encourage the Committee to make **much more ample use of flexible criteria tying in with the rapidly evolving maturity of the underlying technology, the cryptoasset markets and advances in the sophistication of risk measurement and management** across the full spectrum of cryptoassets.
11. Moreover, and more concretely we would urge the Committee to **review** in particular the **‘not exceeding 10 bp more than 3 times a year’ threshold, which is far too low**. In combination with the enormous difference in capital requirements for Group 2 as opposed to Group 1 cryptoassets, it creates a **dramatic cliff edge effect**. In the absence of any reasoning, related data, or other anecdotal evidence to support the proposed threshold, it is difficult to provide further comment. However, analysis of publicly available data (see spreadsheet attached) shows that the proposed threshold restricts the Group 1 classification and capital treatment to a very limited number of cryptoasstes. This is also no indication that the cryptoassets failing to meet this criterion would represent a significantly higher risk exposure, let alone an exposure justifying the 12.5 times higher capital charge applicable to Group 2 assets.

12. An alternative and more risk-sensitive treatment could be developed by **combining a tangibly higher threshold** with a **step-wise increase of capital requirements** reflecting the higher volatility. Thus, the dramatic cliff edge effect for cryptoassets that do not or no longer fulfil the Group 1 conditions could be significantly attenuated.
13. Taking as starting point a threshold of **‘not exceeding 50 bp more than 3 times a year’** to replace the current threshold would be both simple to apply and to implement, yet still offering the possibility for a very conservative calibration. The calculation of the capital charge for the broadened Group 1 category would remain the same.
14. This lowered threshold and hence widened Group 1 category of cryptoassets could then be combined with **the introduction of a third, intermediate category drawing on the current approach to closely related currencies**. Cryptoassets not meeting the quantitative or qualitative conditions for the classification as Group 1 cryptoassets which, however, are exposed to volatility not exceeding the limitations set for closely related currencies would form a separate category (e.g. Group 1 c). Group 1c cryptoassets should remain subject to the capital charge as proposed for Group 1, but in addition attract a **capital add-on drawing on the current capital charge for FX risk in the banking book**.
15. We consider the proposed combination of thresholds and risk-driven capital add-ons as **possible building blocks for designing a much more risk-sensitive prudential treatment** that would allow for both a further **differentiated approach** and - **if deemed necessary - a conservative calibration** of the capital charge. As indicated before, these building blocks should be combined with a much more specific relationship between the prudential treatment - including the classification conditions - and the **rapidly advancing maturity of products, markets and technology**, and related reliable market indicators.
16. More generally, to avoid market fragmentation and regulatory arbitrage, and to facilitate timely regulatory responses to new and emerging cryptoassets, it will be essential to **keep the finalised prudential treatment under review** and **ensure ongoing monitoring of its implementation in supervisory practices**. The dynamics of the cryptoasset markets warrant the setting up of a **specifically tasked BCBS working group**. The group should interact directly with the industry - both banks and key players in the cryptoasset markets - to facilitate and inform the collection and analysis of data covering the full risk profile of both seasoned and new and emerging cryptoasset products, networks and ecosystems (including credit, specific and general market risk, operational risk, and liquidity characteristics).
17. Regarding **condition 2** we would welcome clarification as to what is meant by **“full redeemability”**. We note for variant 2 of illustrative example 2, that the unconditional commitment of the member to buy cryptoassets from the holder means that the latter is not exposed to the risk of default of the redeemer, and hence not subject to a related capital charge. We therefore assume that the “full redeemability” condition is met if the cryptoasset, the related network and the underlying contractual arrangements ensure redeemability. In

other words, **variant two of illustrative example two** discusses a cryptoasset and network that qualifies for a Group 1 b treatment.

Question 5: For the third classification condition, (i) would risk governance and risk control practices for Group 1 and Group 2 cryptoassets differ; and (ii) are there alternatives to the required risk governance and risk control practices that would ensure that material risks of the network are sufficiently mitigated and managed?

13. It is our view that the proposed capital treatment of Group 2 cryptoassets in many cases dramatically overstates the actual risk exposure. Accordingly, it would be **grossly inappropriate to require risk governance and risk control practices as for Group 1 cryptoassets** without significantly reducing the capital charge.

14. In terms of alternatives to the risk governance and control practices applicable to Group 1 cryptoassets, we would argue again that **measurable maturity** of products and underlying networks should be taken into account. A set of specific qualifying criteria based upon market-driven indicators of **successful performance and operation of a cryptoasset over a given period of time** should go a long way towards filtering out different layers of more or less risky Group 2 cryptoassets. We suspect that this would likely warrant the **application of distinct layers of capital charges well below the proposed 1250 % risk weight**.

Question 6: For the fourth classification condition, (i) to what extent would the regulation and supervision of entities that execute redemptions, transfers, or settlement finality of the cryptoasset reduce risk in cryptoasset exposures held by banks; (ii) which entities should/ should not be in scope of regulation or supervision? For instance, are there entities involved in the transfer and settlement systems of cryptoassets (such as nodes, operators and/or validators) that should be excluded from the condition of required regulation and supervision?

15. We would hope that regulation and supervision of entities providing the services specified in question 6 reduce the risk in banks' related cryptoasset exposures. Unfortunately, we are **not in a position to provide any indication as to the extent a risk reduction can and will be achieved**. We would assume, however, that the risk reduction depends upon both the quality of the regulation and of its implementation in supervisory practices, which can vary widely depending upon the jurisdiction and the jurisdictional market environment.

16. We do acknowledge that cryptoassets and the supporting networks or ecosystems call for an **integrated regulatory and supervisory approach** that also covers related essential services provided by non-regulated companies. However, a holistic approach does not presuppose extending the regulatory perimeter. The evolving regulatory approach to outsourcing has provided evidence that risks can be contained, and high-quality services provided to customers without direct regulation or supervision of 3rd party service providers that participate in the value chain. We are, of course, well aware of the current regulatory

change proposals regarding outsourcing, but highlight that these tend to be limited to 3rd party service providers that have potentially systemic impact.

17. In parallel we see developments in the field of central bank oversight of payment systems and arrangements, namely the [ECB's PISA framework](#), which adopt a more holistic and integrated oversight approach by **introducing risk governance and management requirements that cut across the payment ecosystem and participating entities**. We see value in this approach and would encourage prudential regulation to follow that example.
18. Accordingly, we **do not consider that regulation and supervision of the specified network-related services should be a binding condition for a given cryptoasset to qualify as Group 1**. In any case, regulators retain full discretion to assess any related risks and, if necessary, impose specific pillar 2 capital add-ons on a case-by-case basis.

Question 8: 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?

19. Given its past efforts to devise an approach for the calculation of capital charges for operational risk, the Committee will be aware of the **problems and limitations of measuring operational risk**. Internal model-based approaches are difficult to develop and implement for anything but high frequency low impact operational risk events. Simple approaches to the calculation of capital charges are usually based on the exposure amount, which is however a poor proxy for operational risk. Whatever the proxy chosen, the characteristics of the respective cryptoassets should be taken into account. That in turn requires a classification based upon differences in the operational risk profile of the created classes of cryptoassets. Identifying distinctive features indicative of operational risk exposure will require the analysis of data series covering a sufficiently long period of time, preferably with a reasonably stable operational risk profile of the cryptoassets concerned. The EMA would be willing to assist the Committee's efforts to develop a better understanding of the associated operational risk, including by participating in data gathering and analysis.
20. However, at this stage, and given what we believe to be extremely conservative capital charges for both Group 1 and 2 cryptoassets, **there does not appear to be a need for a pillar 1 capital add-on for operational risks**. All risks, including any related operational risks are comfortably covered by the proposed capital charges. In any case, historically the capital charges for credit risk have been effectively calibrated to cover related operational risks. Until further evidence is provided we do not think that it can be taken for granted that operational risk related to cryptoassets is significantly higher than that related to credit.
21. Finally, **pillar 2 allows regulators to impose additional operational risk capital add-ons** whenever and wherever the supervisory review and the targeted assessment of risk and

control indicates a need to do so. The discretionary approach under pillar 2 has the additional benefit of allowing a better reflection of the maturity of cryptoassets and the underlying networks. We consider this to be the most important factor to consider in a supervisory review with regard to any operational risk, both in terms of inherent risk and the related maturing controls.

Question 9: Are there further aspects of the credit risk and market risk requirements that could benefit from additional guidance on how they should apply to Group 1a cryptoassets?

22. Regarding the application and recognition of **internal model-based approaches** for the calculation of capital charges, we agree that the **lack of data represents an important hurdle**. However, given the dynamics of cryptoasset markets, this hurdle may quickly diminish. We would therefore urge the Committee to **allow for the recognition of internal model-based approaches** as part of the proposed prudential treatment and if necessary provide related guidance for the case-by-case approval by regulators of bank-specific internal models.

23. As to the **recognition of cryptoassets as risk mitigating collateral** we acknowledge that the general conditions of the Basel capital framework must be met. However, we urge the Committee to provide additional guidance that allows for case-by-case recognition of a risk mitigating effect. This can then be subject, if necessary, to conservative haircuts.

Question 10. Do you have any views on the Committee's current thinking on the capital requirements for Group 1b cryptoassets?

Question 11. What further aspects of the credit risk and market risk requirements could benefit from additional guidance on how they should apply to Group 1b cryptoassets?

24. We reiterate that the proposed prudential treatment will result in **capital charges that significantly overstate the actual risk exposures, and create an extreme cliff-edge effect** that cannot be attenuated by discretionary pillar 2 measures. This element of the proposed prudential treatment significantly contributes to the current unfortunate lack of risk-sensitivity and corresponding creation of perverse incentives within banks.

25. We also note in variant two of example two that the **application of the risk weight of the member with the highest credit rating** still significantly **overstates the actual risk exposure**. If multiple members have committed to buy cryptoassets from holders, the risk that all of them default will be much lower than the risk represented by the risk weight applicable to the member with the highest credit rating.

Question 12. Do you think the proposed capital treatment of Group 2 cryptoassets, including the application of a 1250% risk weight instead of deducting the asset from capital (for the reasons explained above), appropriately reflects the unique risks inherent in these assets?

26. No!

Question 13. Are there alternative approaches that the Committee should consider that are simple, conservative and easy to implement? For exposures in the trading book, would it be appropriate to permit recognition of hedging via the application of a modified version of the standardised approach to market risk?

27. In our view, any alternative **approach that is “simple, conservative and easy to implement” would fail to deliver a sufficiently risk-sensitive capital charge** just as much **as the proposed approach** does. As highlighted before, simplicity cannot be an end in itself. The remainder of the Basel IV capital framework is perhaps the best example of a partly highly complex regulation that has to be as complex as it is in order to provide sensible regulatory responses to a complex business and market reality. The Committee should continue to work towards a prudential treatment of cryptoassets that reflects the market reality, and the complexities of a dynamic and rapidly maturing market. Overly simple regulatory approaches create perverse incentives and avoidable risks.

28. In that same vein we would encourage the Committee to **permit recognition of hedging for exposures in the trading book**. Calculating capital charges for trading book exposures based on gross positions is another example of an approach that is simple, apparently conservative, and easy to implement, but that generates capital charges that are not risk-sensitive and that provides strong capital incentives to leave positions unhedged thus creating risk instead of mitigating it.

29. We would also encourage the Committee to develop a modified version of the standardised approach to market risk as referred to in the question. At the same time, we would reiterate that the Committee should also pave the way for the possibility of supervisory recognition of an **internal model-based approach**.

Question 14. Do you have any views on the Committee’s current thinking regarding the leverage ratio, large exposures framework and liquidity ratio requirements? Are there further aspects of these requirements that could benefit from additional guidance?

30. We welcome the Committee’s willingness to continue to investigate the **prospect of recognising as HQLA those cryptoassets that are deemed to be equivalent to traditional assets** that themselves qualify for inclusion in HQLA. We also encourage the Committee to monitor the development of the liquidity characteristics of other cryptoassets with a view to their recognition as HQLA.

31. We would highlight in this regard, that our analysis of publicly available data shows a certain amount of friction from stablecoin cryptoassets to their underlying in the traditional financial system. However, the blockchain itself holds alternative liquidity pools to exchange cryptoassets, within minutes. This means large amounts of liquidity can be swapped (cryptoasset to cryptoasset) with little impact on price, slippage, even for large transactions of 100m or more (column R of the stablecoin analysis attached). **We believe it will be important to monitor developments very closely and we would be very happy to assist the Committee in its efforts in whatever possible way.**

List of EMA members as of September 2021:

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<u>Account Technologies</u>	<u>MuchBetter</u>
<u>Airbnb Inc</u>	<u>myPOS Europe Limited</u>
<u>Airwallex (UK) Limited</u>	<u>OFX</u>
<u>Allegro Group</u>	<u>OKTO</u>
<u>American Express</u>	<u>One Money Mail Ltd</u>
<u>ArcaPay Ltd</u>	<u>OpenPayd</u>
<u>Azimo Limited</u>	<u>Own.Solutions</u>
<u>Bitpanda Payments GmbH</u>	<u>Oxygen</u>
<u>Bitstamp</u>	<u>Park Card Services Limited</u>
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<u>Blackhawk Network Ltd</u>	<u>Paymentsense Limited</u>
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<u>Crosscard S.A.</u>	<u>Remitly</u>
<u>Crypto.com</u>	<u>Revolut</u>
<u>Curve</u>	<u>SafeCharge UK Limited</u>
<u>eBay Sarl</u>	<u>Securiclick Limited</u>
<u>ECOMMPAY Limited</u>	<u>Skrill Limited</u>
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<u>ePayments Systems Limited</u>	<u>Square</u>
<u>Euronet Worldwide Inc</u>	<u>Stripe</u>
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<u>Google Payment Ltd</u>	<u>Vivid Money Limited</u>
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