

**Finance Watch response
to the Basel Committee's public consultation on
designing a prudential treatment for crypto-assets**

Brussels, 13 March 2020

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Its 50+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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Only the questions that are relevant to Finance Watch are reproduced here.

We agree to the publication of this response.

Q1. 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.

We would like to note, in the first instance, that the term ‘crypto-assets’ is imprecise and potentially misleading, and should be treated with extreme caution. In many instances so-called “crypto-assets” are not assets in their own right but rather agreements in digital form (instruments) that give rise to contractual claims between the parties. Legislators may choose to recognise these digital instruments as title deeds under certain conditions. This does not mean, however, that the instrument itself becomes an asset but rather that the underlying claim may be documented and transferred in digital form.

The term “crypto-assets” suggests that this is a new category of assets that has not been in existence before and may require new regulation. This is, in our view, not correct. As set out above we would contend that so-called ‘crypto-assets’ are, primarily, a new class of digital instruments whose principal function and benefit is to facilitate and document a broad range of (mostly existing types of) transactions in a manner that promises to be particularly efficient, transparent and resistant against tampering and fraud. Many of these underlying transactions are extensively regulated already.

For the purposes of prudential regulation we would therefore recommend adopting a different term that emphasises the formal aspect of these instruments. The term ‘token’ is frequently used for digital instruments that rely on cryptography (for the identification, authentication and privacy of the contracting parties) and distributed ledger technology (for recording information and data related to the transaction) and could be appropriate in this context.

Q2. 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?

As discussed above (Q1.) we would prefer the use of the term ‘token’ for digital instruments that rely on cryptography and exist on a distributed ledger. In line with the ‘see-through’ principle we would suggest a general classification comprising four categories of ‘tokens’:

The first category, ‘payment tokens’, would comprise tokens that may serve as a (legal) means of payment. This category should be defined very restrictively and comprise only ‘tokens’ that represent official (‘fiat’) currencies, i.e. national or multi-national currencies issued in accordance with the law by duly authorised entities, such as central banks, and designated as legal tender in their respective country/countries of issuance. As of today, this definition would accommodate two principal ‘use cases’: ‘payment tokens’ that serve as internal units of account and settlement in intra-group and inter-bank settlement systems; and ‘central bank digital currencies’ (CBDCs). It could also cover certain categories of so-called ‘stablecoins’ provided that the value of these

units is pegged to one or more official currency/-ies and that the amount of ‘tokens’ in circulation is backed, in full and at all times, by an equivalent amount of cash deposits in the underlying currency/-ies. Any ‘stablecoins’ that do not fulfil these criteria would be classified as ‘investment (or security) tokens’.

In EU law, the 5th Anti Money Laundering Directive (AMLD 5) defines the term ‘virtual currency’ as a *‘digital representation of value that is not issued or guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency and does not possess a legal status of currency or money, but is accepted by natural or legal persons as a means of exchange and which can be transferred, stored and traded electronically’*. We believe that this definition is useful to separate ‘tokens’ that are created *ex nihilo*, e.g. based on an algorithmic process (‘proof of work’, ‘mining’), and rely solely on bilateral acceptance, from ‘tokens’ that embody a legally recognised means of payment. These ‘virtual currency tokens’, such as Bitcoin, are not currencies (as defined above) and do not meet the basic criteria of ‘money’ (medium of exchange, unit of account, store of value). They should therefore be treated as a separate category of ‘tokens’ for regulatory purposes.

The third category would comprise ‘investment (or security) tokens’, and covers, in the first instance, any ‘token’ that replicates a regulated financial transaction. If a token incorporates features of different (financial and non-financial) transactions, it should be classified according to its prevailing function. This ‘functionality test’ should take into consideration both the supply side (the issuer or beneficiary) and the demand side (the investor or subscriber). Any token that represents an underlying transaction where a) the investor (or subscriber) is incentivised primarily by the promise of a financial reward; or b) the principal objective of the issuer (or beneficiary) is to raise funds (e.g. for R&D or other corporate purposes) for themselves or a related party should be considered, by default, as an ‘investment token’.

The latter would cover, for instance, most of the ‘tokens’ issued in recent years in so-called ‘Initial Coin Offerings’ (ICOs) – often labelled, misleadingly, as ‘utility tokens’, where funds were raised from investors in exchange for the future delivery of a yet-to-be-developed product or service. In many of these cases the issuers were start-up companies and ‘token’ holders, often retail investors, effectively ended up funding their operations, and bearing full operational and financial risk, frequently without adequate financial compensation or governance rights. We do not agree that this type of transaction should be regarded as a ‘forward sale’ as it usually lacks the required certainty or, at least, predictability regarding the deliverability of the product or service with the agreed specifications at the agreed price on the agreed date. While we recognise that issues of digital ‘tokens’ could indeed become a viable, and valuable, way of lowering the hurdle for early-stage companies to access funding we are insistent that investor protection must not be compromised in the process. We are encouraged by the recent emergence of Initial Exchange Offerings (IEOs), which appear to mark a convergence between ICOs, Security Token Offerings (STOs), and the traditional, formalised process of issuing securities.

Whether an ‘investment token’ is transferable should not be a criterion for its classification. There are numerous financial instruments, such as OTC derivatives, that are *a priori* bilateral but could

conceivably be replicated in digital form, e.g. as a DLT-based ‘smart contract’, and become transferable under certain conditions. If so, they would still have to be classified, and regulated as a financial instrument according to their economic substance.

The fourth category, ‘utility tokens’, would cover any ‘token’ that provides its holder with a right to obtain or access a specific product or service. In line with the ‘see-through’ principle we would argue that regulation is appropriate, and necessary, if the economic substance of the underlying contract is primarily ‘financial’ in nature. This should be true, *a priori*, for ‘payment tokens’, ‘investment tokens’ and ‘virtual currency tokens’. We would therefore propose, *a contrario*, that any ‘crypto-asset’ that does not qualify as one of the preceding categories should be designated as a ‘utility token’. ‘Utility tokens’ would not be deemed ‘financial instruments’ and should not be subject to prudential regulation. They may well be subject to other relevant legislation, however, in particular related to consumer protection.

Q3. What benefits do crypto-assets provide for the banking system, and the provision of financial services more generally?

DLT offers a number of inherent benefits. At the general level, the in-built redundancy of a distributed database offers improved resilience of the entire network (no single point of failure) and better protection of the integrity of data due to the continuous updating and verification of datasets. The cumulative structure of ‘blocks’ contributes to the better documentation and traceability of transactions. DLT could provide a solution for issuers and managers of securities, unit trusts or other collective investment vehicles, in particular, to obtain real-time information about the structure and identities of their investor base. In due course, self-executing functionality – so-called ‘smart contracts’ – could improve the efficiency of trading and settlement, and reduce the potential for human error.

Q4. What additional factors affect the risk profile of different crypto-assets which are relevant in the context of determining a prudential treatment?

We largely agree with the risk factors identified in the consultation document. In our view, the risk profile of a particular token is determined, first and foremost, by the nature of the underlying asset or transaction. Pure-play ‘virtual currency tokens’, such as Bitcoin, would represent one end of the spectrum since they are not backed by any financial asset or claim and derive their perceived value primarily from scarcity and the dynamics of supply and demand. Tokens that are guaranteed by an issuer with a strong credit rating and/or fully supported by liquid assets, such as cash-backed ‘payment tokens’, could be seen as the opposite end of the spectrum.

Q5. 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?

We agree with the general principles proposed by the Committee, in particular the concept that tokens that fulfil the same economic function as ‘traditional’ financial instruments should be treated identically for prudential purposes (‘see-through’ principle). It appears sensible to build

on the existing prudential framework for comparable ‘traditional’ instruments. While it is true that ‘crypto-assets’ currently only make up a small proportion of the financial markets today it is important to bring them into the regulatory scope to close existing gaps and ensure consistency. We are skeptical therefore about the proposed gradual approach, i.e. starting with instruments that are perceived as ‘high risk’ while continuing to assess other categories. This sequencing does not seem compatible with the objective of restoring legal certainty and achieving regulatory consistency between the digital and the ‘traditional’ sphere. We would strongly advise against the use of so-called ‘regulatory sandboxes’ or ‘safe harbour’ arrangements that purport to encourage experimentation and innovation. We do not agree with the inherent assumption that innovation requires, or benefits from a lack of regulation. We would argue, much to the contrary, that well-considered and consistent regulation creates the legal certainty and predictability needed to encourage investment in long-term innovation.

Q6. 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?

We agree largely with the channels of exposure described in the consultation paper. In line with the categorisation we propose in Q2, we would argue that the channels of banks’ exposure to ‘payment tokens’ and ‘investment (or security) tokens’, are largely similar to those of equivalent corresponding ‘traditional’ financial instruments. We expect banks to engage, increasingly, in the issuance, placement and trading of ‘investment (or security) tokens’, including derivative instruments, and in ancillary services, such as custody. Banks are also likely to become increasingly exposed, directly and indirectly, to the use of ‘payment tokens’, e.g. by their proposed use inter-bank clearing and settlement systems and, potentially, by the introduction of CBDC.

As of today, most ‘crypto-currencies’ are still being issued, traded and held on non-traditional trading venues and market infrastructures. We do, however, observe a trend towards convergence towards issuance and trading on reputable formal exchanges (e.g. in the case of IEOs) and wallets being held with established providers. We believe that the further development of this market could benefit from the development of a cohesive regulatory framework that covers the emerging financial markets infrastructure for ‘crypto-currencies’. This framework should be in full alignment with that applicable for ‘traditional’ financial market infrastructures and provide for the same high standards, e.g. in respect of efficiency, transparency, financial stability, and investor protection.

Q7. Are any exposure channels likely to change in response to ongoing or envisaged developments in crypto-asset markets?

Banks' exposure, in general, is likely to increase through their interconnection with financial markets infrastructure providers. A very significant issue in this context is the potential role of clearing houses as a channel of exposure to 'virtual currency tokens'. As we have noted these 'tokens' lack economic substance, and their pricing is therefore characterised, typically, by high volatility and often very limited liquidity. The fact that derivative instruments based on such 'virtual currency tokens' are traded on recognised exchanges, and cleared via the existing clearing houses, is likely to put significant additional strain on these infrastructure providers and could, in due course, become a source of potentially significant systemic risk. While we are in favour, fundamentally, of moving the trading and clearing of digital instruments towards regulated infrastructures we believe that the incremental risk associated with 'virtual currency tokens' and related derivative instruments, in particular, should be assessed and monitored. If necessary, the capitalisation, and the recovery and resolution framework for relevant infrastructures may need to be revised accordingly.

Q8. 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?

Financial risks associated with 'crypto-assets' differ for each category of 'token'. The financial risk of 'payment tokens' and 'investment (or security) tokens' will largely mirror that of their 'traditional' equivalents, except that liquidity in these market may still be significantly lower for some time to come. 'Virtual currency tokens' – and derivative instruments based on such 'tokens', by contrast, are exposed to comparatively higher financial risk (market and liquidity risk) due to the absence of any inherent economic value.

In terms of non-financial risks, we note that all classes of 'tokens' pose specific legal and operational risks that need to be recognised and addressed. Legal risks include, in particular, the reliable identification and authentication of customers and counterparties, the determination of competent jurisdiction and the enforceability of claims or title. 'Virtual currency tokens' may also represent a source of heightened operational and reputational risk due to their decentralised, and largely anonymous mode of governance.

Q9. 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 illustrative example relates to a 'crypto-asset' that fits the description of a 'virtual currency token' (see Q2.). We would agree with the proposed banking book and trading book treatment, which adequately reflects the fact that such 'virtual currencies' have no economic substance, on the one hand, but do not comprise leverage, on the other.

We would like to point out, however, that ‘investment (or security) tokens’ may also be used to replicate underlying financial transactions, such as derivative trades, whose risk profile could be different, i.e. significantly higher, e.g. by including leverage and potential future exposure. In these cases the prudential treatment of a digital ‘token’ should be no less conservative than that of its ‘traditional’ equivalent.

We agree that any use of internal modelled approaches should not be permitted and ‘crypto-assets’ of the ‘virtual currency’ type should not be eligible as collateral for credit risk mitigation nor qualify as high-quality liquid assets for the purposes of the Liquidity Coverage and Net Stable Funding Ratios.

While we agree, in general, with the proposed treatment of so-called ‘high risk crypto-assets’ we are finding it difficult to see the benefit of postponing regulation of other types of ‘crypto-assets’ that are, for now, perceived to be less than ‘high risk’. It appears unclear what potential insights a continued assessment based on ongoing developments could contribute that would outweigh the benefits of legal certainty. As mentioned previously (Q5.) we would prefer an approach that prioritises regulatory convergence and legal certainty by establishing a consistent set of rules for digital and ‘traditional’ financial instruments.

Q10. What further supervisory measures could be considered in specifying a potential prudential treatment for crypto-assets?

Any assessment for the purpose of setting regulatory priorities should take into account the potential systemic risk attached to certain instruments. We note, for instance, that the concept of Libra, the ‘stablecoin’ proposed by a consortium around Facebook, involves a ‘reserve fund’ comprised of a basket of short-term government securities. Depending on the eventual amount of Libra ‘tokens’ in circulation the necessary trading involved in a) converting ‘tokens’ in and out of ‘fiat’ currency and b) managing the composition of the ‘reserve fund’ could have a direct and material impact on the underlying foreign exchange and securities markets, potentially on a global scale. We would recommend a thorough review of the possible macroprudential implications and the need for regulating prospective issuers of such instruments if they are ‘systemically important’ at a domestic or global scale.

The same rationale could apply, conceivably, in any scenario where an issue of ‘tokens’ appears liable to materially affect the integrity of the underlying market. Regulatory provisions against market abuse and relevant disclosure and supervisory regimes that exist for ‘traditional’ instruments should be extended to the digital sphere as a matter of priority.

Q11. What are your views on the disclosure requirements related to banks' crypto-assets? Should additional information related to banks' crypto-asset exposures be disclosed?

Existing disclosure regimes should be adapted and expanded as appropriate, e.g. for 'investment (or security) tokens' and 'payment tokens'. Exposures to 'virtual currency tokens', in particular, should be reported and disclosed separately given the particular risk profile of these instruments, which includes a heightened susceptibility to money laundering and funding of criminal activities.

Q12. 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?

According to the general principle of 'substance over form' (see Q5.) the prudential treatment of 'crypto-assets' or 'tokens' should follow the economic substance of the underlying transaction. The example of a 'virtual currency token' applies only to a limited sub-set of 'tokens' which are characterised, specifically, by the absence of economic substance, and of a known economic beneficiary.

'Crypto-assets' that are used exclusively for intra- and inter-bank settlement that are fully backed by official (fiat) currency should be classified as 'payment tokens' and regulated in line with existing electronic payment instruments. 'Crypto-assets' that use stabilisation tools linked to other assets represent a (derivative) claim on the underlying asset(s) and should be regulated accordingly. For illustration, Libra, the 'stablecoin' proposed by a consortium around Facebook, would be the digital equivalent of a money market fund, with users of the 'stablecoin' effectively investing in a 'reserve fund', managed by the Libra Association, that consists of short-term government debt securities. Libra 'tokens' would be classified as units in a collective investment fund, the Libra Reserve Fund, with the Libra Association as its regulated managing entity.

Q13. 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?

We agree with applying the principle 'substance over form', which is a well-established concept in accounting and a core principle in IFRS. When applied to crypto assets this means that their legal and regulatory treatment should be determined by the economic substance of the underlying transaction. This approach is not only reasonable from the perspective of regulatory consistency but necessary to provide legal certainty and forestall regulatory arbitrage.

Q14. 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?

See Q2. and Q. 12 above.

Q15. Do you have other suggestions regarding the design of a potential prudential treatment of crypto-assets?

See Q9. to Q12. above.