

10 September 2021

Re. BCBS consultation on the prudential treatment of cryptoasset exposures

Ladies and Gentlemen,

Fnality International Limited (“**Fnality**”) welcomes the opportunity to provide a response to certain topics and proposals that were set out in the BCBS’s June 2021 consultation on the *Prudential treatment of cryptoasset exposures* (the “**Consultation**”). This response focuses on the issues and proposals that are potentially applicable to large-value (wholesale) payment systems based on DLT (distributed ledger technology).

Background to Fnality

Fnality was established in 2019 with the aim of developing a peer-to-peer wholesale settlement ecosystem that offers real-time payments, settlement of foreign exchange and securities transactions in the major currencies. This ecosystem – Fnality Global Payments – consists of a network of next-generation payment systems which incorporate DLT into their technical infrastructure. Each new payment system for the currency of a jurisdiction or currency area is known as a Fnality Payment System. These are designed to lower risks and increase settlement efficiency for participants by reducing the number of intermediary parties – and, consequently, reducing the credit and operational risks faced by payment system users.

DLT-based large-value payment systems do not necessarily use cryptoassets

We note that the Consultation defines “cryptoassets” as “*private digital assets that depend primarily on cryptography and distributed ledger technology,*” and that the definition of “digital assets” explicitly excludes “*digital representations of fiat currencies*”. This approach is similar to that adopted by the Financial Action Task Force (FATF)¹, which likewise excludes digital representations of fiat currencies from its definition of “*virtual assets*” (which for these purposes can be considered analogous to “*digital assets*” as defined in the Consultation).

In our view, it is correct to exclude mere digital representations of fiat currency from the definition of cryptoassets. The use of DLT in financial market infrastructures (FMIs) does not necessarily involve the creation or issuance of cryptoassets or any other form of digital assets, as it is entirely possible for new FMIs to incorporate DLT into their technical infrastructure whilst developing settlement services based around existing asset types and regulatory frameworks.

In each Fnality Payment System, payments between participating entities are settled using a digital representation of funds held in a central bank account, denominated in the fiat currency of the relevant jurisdiction or currency area. Although the underlying technology may be novel, the settlement funds are held in a central bank account through arrangements that are either (depending on the jurisdiction) identical or analogous to those currently used by existing large-value payment systems. Such arrangements do not automatically give rise to cryptoassets simply because DLT is used as means of digitally recording the settlement of payments

¹ FATF (2019), *Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers*, FATF, Paris

www.fatf-gafi.org/publications/fatfrecommendations/documents/Guidance-RBA-virtual-assets.html

between participants. As such, we welcome the exclusion of digital representations of fiat currencies from the Consultation's definition of "digital assets".

Should standard setting bodies change their approach and decide to apply the framework set out for the prudential treatment of cryptoasset exposures to DLT-based FMIs, we would like to set out our views on the substantive proposal below.

We agree with the BCBS's approach of "same risk, same activity, same treatment"

The risk weight of an asset should reflect the risk that the asset poses to the balance sheet/solvency of the financial institution concerned. Where the asset used in a payment system has a credit risk profile similar (or equivalent) to that of central bank money, such asset should be given an equivalent risk weighting (*i.e.*, settlement assets which are convertible at par into central bank money upon demand should be given a zero-risk weighting).

It follows that where a new DLT-based payment system adopts the same arrangements and asset type as that used for settlements in existing payments systems, the settlement asset used in the new system should – following a same risk, same treatment approach – be subject to the same prudential treatment.

Prudential treatment of Group 1a cryptoassets as HQLA

In response to Q. 14 of the Consultation, we consider it crucial to recognise as high-quality liquid assets (HQLA) those cryptoassets that, according to the relevant definition in Section 2.1 of the Consultation, are deemed to be equivalent to traditional assets that themselves qualify for inclusion in HQLA. This conclusion follows naturally from a same risk, same treatment approach.

In respect of DLT-based large-value payment systems, a tokenised settlement asset backed by cash held in a central bank account, and convertible at par into central bank money, would present a credit risk profile equivalent – or even superior – to that of traditional assets (such as cash in custody) that are currently recognised as HQLA. As such, and in keeping with the principle of same risk, same treatment, these assets should be subject to the same prudential treatment.

Proposed blanket Pillar 1 add-on operational risk charge for Group 1 deters the adoption of innovation by banks

In our view, the proposed application of a Pillar 1 add-on operational risk charge for all Group 1 cryptoassets is unnecessary and would lead to an unlevel playing field with incumbent arrangements. It would have the effect of hampering sound innovation.

A mandatory operational risk charge would set a precedent for assuming that new technologies necessarily and automatically give rise to net new operational risks. Such an assumption is, broadly speaking, at odds with the many initiatives in both the private and public sectors that have adopted or are experimenting with DLT specifically because of the proven operational resilience of distributed infrastructure arrangements. Although it is true that DLT does not reduce all aspects of operational risk encountered in FMIs, it would not be correct to assume that DLT carries with it a higher risk of operational failure simply by virtue of its novelty.

Moreover, as the Consultation notes, finding a way to appropriately and fairly calibrate any such operational risk charge is likely to pose a significant challenge. In our view, any operational risk charge is likely to result in arbitrary charges being levied on initiatives that happen to be based on DLT, but which in actuality have a low operational risk profile. This would likely exacerbate the detrimental effect that an operational risk charge would have on innovation.

For these reasons, our view is that there should be no catch-all operational risk charge levied on cryptoassets; rather, wherever an operational risk add-on is appropriate, it should be applied in a targeted manner and in proportion to an identifiable (as opposed to assumed) risk.

Yours sincerely,

Gary Chu, Chief Legal Officer

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