

August 16, 2022

Re. BCBS 2nd consultation on the prudential treatment of exposures to crypto assets

Ladies and Gentlemen,

Finality International Limited ("**Finality**") welcomes the opportunity to provide a response to the topics and proposals that were set out in the BCBS's June 2022 second consultation on the *Prudential treatment of cryptoasset exposures* (the "**Consultation**").

This response mostly focuses on the issues and proposals that are potentially applicable to large-value (wholesale) payment systems whose operational infrastructure incorporate elements of DLT (distributed ledger technology).

Background to Finality Payment Systems

Finality was established in 2019 with the aim of developing a peer-to-peer wholesale settlement ecosystem that offers real-time, 24/7 payments, settlement of foreign exchange and securities transactions in the most important currencies. This ecosystem – Finality Global Payments – consists of a network of next-generation payment systems which incorporate DLT elements into their operational infrastructure to deliver new innovative functionalities and maximise operational resilience.

Each new payment system for the currency of a jurisdiction or currency area is known as a Finality Payment System. At all times the settlement balances held in each Finality Payment System are 1:1 backed by participants' deposits safekept in an account at the central bank of issue. Robust, binding legal arrangements underpin each Finality Payment System. The only dealing that the operator of each Finality Payment System, the Finality Local entity, is legally permitted to make of the participants' deposits is to withdraw and transfer it back to the relevant participant in fulfilment of their defunding request. The rights of each participant in respect of their deposit held in the central bank account are not affected by the possible insolvency of the Finality Local entity or any other participant, thereby reducing credit risk to that of central bank money. Moreover, each Finality Payment System and the relevant Finality Local entity are overseen by the central bank of issue and supervised to the CPMI-IOSCO Principles for Financial Market Infrastructures (PFMI) or equivalent standards. Thus, Finality Global Payments can be seen as private sector operated CBDC (central bank digital currency) infrastructure.

It is our current expectation to launch live operations in the first major currency in 2023.

Further clarity on scope of application needed for Group 1

We take note that the **Consultation** scopes out CBDCs and that "the Committee will give further consideration to the treatment of CBDCs if and when they are issued".

What would be needed, however, for the Committee to provide further clarity in the **Standards text** to what extent the provisions will be applied to privately operated wholesale payment systems that incorporate DLT, such as Finality Payment Systems, that rely entirely on central bank money for funding the settlement balances. Today, it is reasonable to assume that such private sector systems will be available years before similar CBDC systems may exist.

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 offering settlement services based around existing asset types and regulatory frameworks.

As mentioned above, in each Finality 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. As such the settlement balances are not claims on the operator of the Finality Payment System. The settlement balances in an Finality Payment System are funds held with, and issued by, a central bank. Finality will not issue any assets, values or rights (or any digital or other representations thereof), so that the question whether such issuances would constitute cryptoassets or other financial instruments is not relevant in the present context.

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 wholesale payment systems like CHIPS for the US dollar and EURO1 for the euro. Such arrangements do not automatically give rise to cryptoassets simply because DLT is used as part of the operational infrastructure for digitally recording the settlement of payments between participants.

In our understanding, paragraph **SCO60.40** (exemption from credit risk calculation) of the proposed **Standards text** would be applicable to DLT based payment systems that rely on bankruptcy remote set ups and central bank account types like the Joint Account (Federal Reserve), Omnibus Account (Bank of England) or Technical Account (European Central Bank). An explicit recognition of this understanding by the Committee would be desirable.

Similarly, market risk (**SCO60.45 to 60:56**) of such systems will be minimal as all funds can be redeemed instantaneously at par into central bank money or deposits at a correspondent bank.

Add-on for infrastructure risk for Group 1 cryptoassets

The **Consultation** justifies the proposed add-on for infrastructure risk with the hypothesis that distributed ledger technology is “still new and evolving and may pose various unforeseen risks”.

The technological components of DLT are well-understood areas of computer science. Cryptography and High Performance Distributed Computing (HPDC)¹ are already used widely by banks and other financial market participants. Cryptography techniques have long been used in banking to ensure the security of monetary transactions including the security of ATM cards, computer passwords, and electronic commerce. Financial institutions have also adopted computing tools such as Hadoop and Spark² to distribute data processing tasks across multiple computers. DLT is an evolution of existing computing technology, and is indeed seen by many to

¹ https://link.springer.com/chapter/10.1007/0-387-27705-6_16
<https://www.vuhpdc.net/>
<https://link.springer.com/book/10.1007/978-3-319-13497-0>

² <https://hexanika.com/hadoop-in-banking-the-game-changer/>
<https://www.datanami.com/2017/01/20/how-banking-energy-pharma-firms-use-spark/>
<https://medium.datadriveninvestor.com/distributed-data-processing-with-apache-spark-2a5e473b0cb1>

improve overall resilience and reduce points of failure compared to traditional infrastructures.³ The numerous projects of central banks in the DLT space are a good case in point.

However, possible risks arising from the use of DLT, especially by unregulated firms, may arise from weaknesses in governance, risk management and the underlying legal and contractual framework. Permissionless DLT systems typically rely on “economic incentives” to drive the behaviour of participants. This is where we believe there may be unforeseen risks and where an add-on for infrastructure risk may well be justified.

We note that other standard setting bodies like CPMI and IOSCO have a more sanguine view on DLT than the Committee. The recent CPMI-IOSCO guidance report (July 2022) on the application of the Principles for Financial Market Infrastructures (“PFMI”) to stablecoin arrangements lays out the conditions under which DLT-based FMIs can meet the existing regulatory standards. Much of the guidance focuses on comprehensive risk management (including operational risks), settlement finality and the quality of the settlement asset (“money settlement”).

In our view, it is extremely important for the Committee to keep preserving the “same activity, same risk, same rules” principle. Thus, the BCBS should shy away from the proposed infrastructure add-on (or operational risk add-on) to *all* Group 1 arrangements. More concretely, such add-ons should not be applied to entities that are already in observance of other, very challenging international standards, particular the PFMI.

Finally, **SCO60.58** states that the add-on for infrastructure risk would “not apply to Group 1a assets that are backed by the full faith and credit of a central bank or sovereign entity (eg a tokenised asset issued by a sovereign entity).” For the reasons mentioned above, this provision should be extended to include Group 1a *and* Group 1b.

Further remarks

With regulatory frameworks for stablecoin arrangements emerging in several countries such as the EU regulation on Markets in Crypto Assets (MiCA), we are of the view that only regulated entities should be eligible to be in Group 1b (**SCO60.17**). An ex-ante exclusion of arrangements that use a public blockchain, however, would not be warranted if they meet the explicit requirements of the competent authorities. If the basis risk and redemption risk tests described in **SCO60.12 to SCO60.16** (Classification condition 1) were to be kept, an external audit performed by a well-known firm should be required.

We look forward to receiving the final report later this year.

Yours sincerely,

Rhomaïos Ram (CEO)
Gary Chu (General Counsel)
Daniel Heller (Regulatory Affairs)
