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Basel Committee on Banking Supervision
Bank for International Settlements
CH-4001 Basel
Switzerland

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Response to the Request for Public Comment Regarding the Consultative Document "Prudential treatment of cryptoasset exposures"

The Global Digital Asset & Cryptocurrency Association ("GDCA") welcomes the opportunity to offer its comments on the "Prudential treatment of cryptoasset exposures" (the "Proposal"), as published by the Basel Committee on Banking Supervision (the "Committee").[1]

GDCA is a global self-regulatory association for the digital asset and cryptocurrency industry. It was established to guide the evolution of digital assets, cryptocurrencies, and the underlying blockchain technology within a regulatory framework designed to build public trust, foster market integrity and maximize economic opportunity for all participants. Our broad-based membership includes spot and derivative exchanges, proprietary trading firms, traders, investors, asset managers, brokerage firms, futures commissions merchants, custodians, decentralized technology organizations, banks, legal firms, audit firms, insurance professionals, academics, consultants, and media. GDCA is now made up of 25 such entities[2] from around the world. To fulfill its mission, the GDCA devises standards and consensus-based solutions designed to address the major challenges facing the digital asset and cryptocurrency industry. We collaborate with stakeholders around the world, industry leaders and policymakers to support the growth of the global digital economy. We:

- Advocate for a regulatory environment that facilitates innovation and protects consumers, stakeholders, and the broader public interest world-wide;
- Provide education, training, certification, and other resources to build human and technical capacity; and
- Provide thought leadership and facilitate industry engagement.

GDCA employs a self-regulatory mechanism that is guided by principles of accountability, integrity, and transparency to promote the highest professional and ethical standards for its

[1] Basel Committee, Prudential treatment of cryptoasset exposures (June 10, 2021), https://www.bis.org/bcbs/publ/d519.htm
[2] To view a listing of GDCA Members, please click here: https://global-dca.org/membership/.

members by developing a Code of Conduct and best practices and holding members accountable via enforcement mechanisms such as surveillance and a legally binding dispute resolution forum. https://global-dca.org.

After consulting with its members, and in keeping with its mission to advance the industry, protect consumers, and promote public interest, GDCA offers the following comments to the Committee for consideration:

The Proposal provides a preliminary framework for the prudential treatment of banks' cryptoasset[3] exposures. As noted in the Introduction of the Proposal, while banks' exposure to cryptoassets are currently limited, the rapid growth of cryptoassets and related services, as well as the growing interest by bank clients to gain access to these products, warrants consideration as to appropriate prudential treatment of cryptoassets. The creation of a preliminary framework of this nature is a positive development for entities engaged in the cryptocurrency and digital assets industry (the "Digital Assets Industry"). The GDCA welcomes the goals set forth in the Committee's Proposal, and is supportive of the Committee's view that an iterative process for policy development, with multiple consultations incorporating feedback from stakeholders, will help lead to a consistent, transparent and meaningful framework for banks' prudential treatment of cryptoassets, and contribute to the Digital Assets Industry's integration into the broader financial system, and the broader United States and world economies. However, to avoid unintended consequences that would discourage the legitimate use and adoption of cryptoassets by the banking industry there are aspects of the current Proposal that require further adjustment to appropriately account for potential risks arising from cryptoasset exposures.

The general principles guiding the Committee's Proposal are prudently designed to permit the Committee to construct a foundational framework for prudential treatment of cryptoassets. And GDCA is supportive of the concept of "technology neutrality" being applied to the proposed prudential framework. Additionally, GDCA agrees that a set of classification conditions is appropriate for an asset class that encompasses a number of different types and forms, and which may pose disparate financial risks. The conditions and categories of cryptoassets described by the Committee represents an encouraging initial step towards establishing appropriate prudential standards, but requires further adjustment and revision to sufficiently advance the goals set forth in the Proposal.

Tokenised traditional assets

The Committee delineates and classifies the wide variety of digital assets. Group 1a consists of tokenised traditional assets that are digital representations of traditional assets using "cryptography, Distributed Ledger Technology (DLT) or similar technologies, rather than

[3] The Basel Proposal defines "cryptoassets" as "private digital assets that depend primarily on cryptography and distributed ledger or similar technology."

recording ownership through the account of a central securities depository (CSD)/custodian." GDCA is supportive of the Committee's position regarding tokenised traditional assets and agrees that such cryptoassets should be treated as equivalent to traditional assets with regard to the calculation of minimum capital requirements for credit and market risk, so long as the relevant cryptoasset confers all of the same legal rights that would be conferred with ownership of a traditional asset of the same type. However, for the sake of clarity, we suggest adding additional language to Sections 1.1 and 2.1 to note that that the use of DLT as a delivery mechanism for traditional assets does not, on its own, result in the treatment of such traditional asset as subject to the requirements applicable to Group 1 cryptoassets. For example, the deployment by a bank of DLT for the purpose of fiat funds transfers between the bank's customers should not subject the bank to any additional requirements beyond its traditional obligations. This clarification would ensure that banking institutions are not dissuaded from adopting the usage of DLT as a delivery mechanism for traditional assets due to concern that any utilization of such technology could potentially subject a traditional asset to categorisation as a Group 1 cryptoasset.

Variance Threshold for Stabilisation Mechanisms

The Proposal notes that banks must "have a monitoring framework in place verifying that the stabilisation mechanism is functioning as intended," and that "the difference in value must not exceed 10bp of the value of the underlying traditional asset more than three times over a one-year period" (hereafter, the "Variance Threshold").

The GDCA has concerns regarding aspects of the Variance Threshold proposed in the initial iteration of the Proposal. It may be helpful for stakeholders to understand what criteria was used by the Committee to formulate the Variance Threshold. What data was utilized to arrive at the 10bp level identified by the Committee as the maximum difference between the valuation of the underlying traditional asset and the relevant cryptoasset? What is the foundational basis of the "three times over a one-year period" standard proposed in conjunction with the 10 bp level? Were any existing stablecoins identified by the Committee as being able to meet this burden and satisfy the Variance Threshold as proposed? Inca Digital conducted a study for the GDCA with an analysis of eight (8) leading stablecoins based on market capitalization for the period of September 2020 through September 2021, none of the stablecoins identified would have satisfied the Variance Threshold as currently set forth in the Proposal.[4]

Obtaining information around how this framework was structured would be useful to stakeholders when determining whether or not this aspect of the Proposal is appropriately designed to meet its goals. Additionally, the GDCA asks that any final determination regarding the Variance Threshold be postponed until stakeholders have the opportunity to better understand the factors that led to

[4] Inca Digital. 2021. "Stablecoin Volatility Analysis – BIS Variance Threshold." https://inca.digital/intelligence/variance-threshold-bis/

each element of the Variance Threshold, so that there is the opportunity to address concerns with how the Variance Threshold has been structured.

Risk Management of Stabilisation Mechanisms

The Proposal notes that any stabilisation mechanism must enable risk management based on sufficient data/or experience, and that for newly established cryptoassets there may be insufficient data and/or practical experience to perform a detailed assessment. The GDCA agrees that this is a prudent approach to adopt, in order to properly evaluate stabilisation mechanisms. However, it is not clear what evidence would be sufficient to meet the burden of satisfying supervisors of the effectiveness of a particular stabilisation mechanism, the composition of the underlying asset(s) and its valuation. It would be helpful if the Committee were to provide potential examples of the types of evidence that may be sufficient to satisfy supervisors in this regard.

Verification of Ownership Rights Underlying Traditional Assets

The Proposal requires banks to verify ownership rights of underlying traditional assets, and to verify "appropriate" storage and management. But without principles establishing what constitutes appropriate storage and management, this requirement is subjective, and could vary across banking institutions and their respective supervisors. Accordingly, it would be helpful if the Committee would consider proposing minimum standards for what might constitute appropriate storage and management. Such standards should recognize the huge potential for DLT to be fit for such purposes while including guidance as to the specifications and parameters that would be necessary to meet minimum requirements. While outside the scope of the Committee's purview, it may also be beneficial to contextualize the analysis so as to facilitate the regulatory and audit function of independent verification of such assets as well as promote greater certainty for private insurers.

Stabilisation Mechanisms Referencing Other Cryptoassets and Algorithmic Protocols

The GDCA agrees with the Committee's position regarding stabilisation mechanisms that (i) reference other cryptoassets as underlying assets, or (ii) use protocols to increase/decrease the supply of the relevant cryptoasset. A new type of derivative asset that utilizes an underlying asset that is itself new and unproven could be prone to substantial swings in volatility, and would potentially be subject to numerous untested market conditions and other external factors. And reliance upon protocols without clear controls, or dependencies upon untested external pricing mechanisms, in each case presents concerns sufficient to exclude a cryptoasset from categorisation within Group 1. This differs meaningfully from the capacity for stability inherent in tokenised stablecoins, recognized by the Committee, and applauded by the GDCA. In contrast to tokenised traditional assets, other stablecoins are either backed by assets where the price in the currency/asset of reference changes over time, forcing the volume of assets to be adjusted to price changes in order to maintain appropriate stabilisation, or they rely on algorithms balancing supply and

demand, and require a significant degree of trust in the future successful performance of the stabilisation mechanism.[5]

Sufficiently Mitigate and Manage Material Risks

The Proposal states that the functions of the cryptoasset and the network on which it operates, including DLT and similar technology, must be "designed and operated to sufficiently mitigate and manage any material risks." However, it is not clear how banks would be able to meet this burden, without more substantiated, objective criteria that could be relied upon to guide banks in constructing risk governance around this process.

Additionally, the Committee states that in order to fulfill the condition of "sufficiently mitigating and managing any material risks," a network would need to be "well-defined such that all transactions and participants are traceable." While transaction activity is potentially traceable on a permissionless blockchain network, the traceability of transaction participants is likely impossible for any cryptoasset to satisfy. Including this requirement would effectively bar stablecoins from being classified as a Group 1b cryptoasset. While the GDCA recognizes that the Committee aims to achieve complete mitigation of risk, we question imposing requirements that are inherently too difficult or impossible to fulfill. And we strongly advocate for the removal of the "traceable" condition as it pertains to participants on a network.

Regulated and Supervised

The Proposal states that banking institutions would be required to ensure that operators of the transfer and settlement systems for the cryptoasset, administrators of the cryptoasset stabilisation mechanism, and custodians of underlying assets supporting the stabilisation mechanism are all "regulated and supervised." We would appreciate if the Committee could expound on this requirement. What particular aspects should be regulated? Should it include regulation of the digital asset itself (i.e. the product)? Should intermediaries be included? And which types of entities should be included in the term "intermediary?" And how would a bank ensure that such supervision is applicable to operators? In the current regulatory environment, where significant regulatory and legal uncertainty exists, this condition would seem to prevent any existing cryptoasset from being classified as a Group 1 cryptoasset. Rather than set an unobtainable goal for banks in evaluating appropriate regulation and supervision for all of the foregoing entities, the GDCA recommends removing operators of transfer and settlement systems from the requirement of being subject to this condition.[6]

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[5] Jarno, Klaudia, and Hanna Kołodziejczyk. 2021. "Does the Design of Stablecoins Impact Their Volatility?" *Journal of Risk and Financial Management* 14: 42. In-text, page 11. https://doi.org/ 10.3390/jrfm14020042; https://www.mdpi.com/1911-8074/14/2/42/htm

[6] The GDCA is not advocating for a reduction in current regulatory or legal requirements but rather the imposition of another layer of regulation on top of what already may be well established.

Operational Risk Charge

As with traditional assets, the Committee expects activities related to cryptoassets to be subject to an operational risk charge within the Basel framework. The Committee posits that there is potentially an increased likelihood of unanticipated operational risks by dint of the new and evolving nature of cryptoassets and related technology. The Proposal suggests applying a Pillar 1 add-on operational risk charge for Group 1 cryptoassets, which could be configured as (i) a flat percentage based upon the amount of exposure, (ii) a variable amount pegged to specific features of a cryptoasset, or (iii) an amount or charge that reduces over time "as the underlying technology becomes more established and conditional on it demonstrating robustness through stressed events," such as cyber-attacks or legal challenges.

The GDCA does not question the basic proposition put forth by the Committee that additional operational risk charges may be required/appropriate. However, we have concerns with two (2) of the operational charge proposals suggested by the Committee. A flat percentage charge would perhaps be simple to apply, but it is difficult to conceive of how such a charge would accurately capture operational risk for Group 1 cryptoassets, based on substantive criteria. An operational charge based upon technology "becoming more established" or based upon stress events that may or may not occur seems, at best, nebulous in its aims, and at worst, concerningly subjective. If any operational charge is to be levied against Group 1 cryptoassets, a charge based on specific features of Group 1 cryptoassets would appear to be the most reasonable course. To this end, GDCA kindly requests that the Committee include potential specific features for variable operational risk charges in the next iterative draft of the Proposal, to give stakeholders the opportunity to consider and substantively comment on this concept.

GDCA appreciates the open acknowledgement by the Committee that calibrating such a proposed add-on operational charge would pose significant challenges. However, we have some concern around the "high degree of caution" the Committee admonishes supervisors to exercise when deciding whether or not an internal model-based approach devised by banks should be permitted for Group 1 cryptoassets. If clear guidance is not provided by supervisors in terms of required operational charges or appropriate calibration measures, we believe it is reasonable for banking institutions to adopt an internal model-based approach to bridge that gap. In fact, we posit that this concept is already inherent with respect to existing risk management frameworks and would also emphasize that an entity's self-interest is always a strong motivation towards deployment of effective risk management mechanisms. To that end, we would ask that the Committee soften its language pertaining to internal models, to avoid creating a chilling effect impacting the formulation of such models.

Treatment of Bankruptcy Remote Vehicles for Cryptoassets with Underlying Pool of Assets

The Committee notes that for cryptoassets that confer direct claims on a pool of traditional assets held in a bankruptcy remote vehicle, a banking institution could set the credit risk exposure of

bankruptcy remote assets of the redeemer to zero *only if* an institution has obtained a legal opinion for *all* laws relevant to involved parties, including the redeemer, the special purpose vehicle (SPV) and custodian, affirming that relevant courts would recognize underlying assets held in a bankruptcy remote manner as those of the cryptoasset holder. It is difficult to see how a banking institution would be able to meet that burden. It may be more constructive if the Committee were to consider proposing alternative suggestions, that could potentially offer a different standard for credit risk exposure of cryptoassets conferring direct claims on traditional assets held in a bankruptcy remote vehicle.

Distinctions Amongst Group 2 Cryptoassets

The Proposal would require all cryptoassets that do not qualify for treatment under Group 1a or 1b to be considered Group 2 cryptoassets, with a uniform risk weight of 1250% applied to the greater of the absolute value of the aggregate long positions and the absolute value of the aggregate short positions to which the bank is exposed, calculated separately for each Group 2 cryptoasset. While the initial categories proposed by the Committee represent a welcome addition to the conversation regarding prudential treatment of cryptoassets, GDCA believes that further sub-division may be appropriate for Group 2 cryptoassets, in order to capture the significant differences between consensus mechanisms utilized for transaction validation on blockchain ledgers. There are several different consensus mechanisms operating in the digital asset space today including, but not limited to, the following examples: (i) proof-of-work, (ii) delegated proof-of-stake, and (iii) pure proof-of-stake. Rather than a one-size-fits-all approach that treats each consensus mechanism as homogeneous, the distinctions between consensus mechanisms merits recognition, as they may entail – or guard against – a different set of potential risks. Accordingly, disparate consensus mechanisms may warrant different capital treatment from a risk-weighting perspective, and the GDCA asks that the Committee consider this suggestion as the iterative process continues to unfold.

Pillar 2 Supervisory Review Process

Finally, the GDCA is concerned that the conservative risk-weighting treatment applied to Group 2 cryptoassets recommended in the Proposal will prevent banks from participating in the cryptoasset market, may potentially stifle meaningful innovation in the cryptoasset space, deprive the markets of a traditional source of risk mitigation and stability typically provided by the banking sector and would have the unintended effect of promoting unregulated activity. Instead of focusing on Pillar 1 capital charges with regard to Group 2 cryptoassets, we suggest that it may be beneficial for the Committee to consider adopting a more flexible supervisory review process for Group 2 cryptoassets through Pillar 2, similar to the banking book interest rate framework.

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The GDCA appreciates the opportunity to provide comments to the Committee on issues raised with regard to the Proposal.

Respectfully submitted,

Tony Pettipiece, Chair of the Public Policy and Regulation Committee

By: The Global Digital Asset and Cryptocurrency Association ("GDCA")