Comment on Prudential treatment of cryptoasset exposures

Otar Gorgodze[1]

Dear Madame, Dear Sir,

It is a welcomed opportunity for interested parties to comment on "Prudential treatment of cryptoasset exposures". Greater regulatory clarity should encourage banks and institutional investors to increase participation and contribute to the sustainable development of financial technologies. At the same time, it is essential that the proposed regulatory framework could mitigate significant risks in some segments of the cryptoassets as well as it should not become a trigger of any increase in the systemic risk. Please see below response to some of the questions raised in the consultative document (in order of importance):

Q10. Do you have any views on the Committee's current thinking on the capital requirements for Group 1b cryptoassets?

The capital requirement might not be adequate in the sense that an unrated or risky redeemer who is close to default would have a capital requirement of 100% and 150% RWA respectively. This seems inadequate if we consider that Group 2 assets have 1250% RWA.

Q11. 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?

The document states: "Entities that execute redemptions, transfers, or settlement finality of the cryptoasset are regulated and supervised." However, what is meant by this is not clear and further details would be useful. Furthermore, section "Treatment for credit and market risk" when indicating appropriate RWA notes that redeemer might not be a financial entity at all: "(iv) how the redeeming entity is classified (eg a financial entity or corporate);"

Arguably, Group 1b assets are most important in terms of financial application potential and the development of novel DeFi solutions. Therefore, it is important to create additional clarity and mechanisms to reduce risks in Group 1b assets. One way to address this issue could be to require a bank-like regulatory framework for redeemer/stabilization mechanism providers. Alternatively, Group 1b assets could be further subdivided by regulated and unregulated redeemers. If redeemer is not regulated by the financial regulator and no Basel capital adequacy framework applies to them, applicable RWA should be significantly higher.

Q15. Do you have any views on the responsibilities of banks? Are there any other responsibilities or aspects that should be covered by banks for the purposes of the supervisory review?

In the responsibilities of the bank, there is a need to indicate the necessity to assess the credibility of the peg for Group 1b assets and evaluate the credit and liquidity risk of a redeemer. The responsibilities will

[1] Head of Financial and Supervisory Technologies Development Department. otar.gorgodze@nbg.gov.ge. National Bank of Georgia (NBG). Views expressed are of the authors and may not necessarily coincide with opinions held at NBG.

be hard to implement if there is no appropriate regulatory disclosure and assurance of the quality of redeemer/stabilization mechanism providers. This again underscores the necessity of a clear regulatory and supervisory framework for redeemer/stabilization mechanism providers outlined above.

Q12. 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?

It should be noted that the biggest segments of cryptoassets markets remain speculative and increased exposure of banks could have an adverse impact on systemic risks: (a) On the one hand, volatility from crypto assets could impact banks and might increase systemic risk in the sector. (b) On the other hand involvement of leveraged institutions like banks could increase the volatility of cryptoassets even further. So far, the high volatility of crypto assets has had a limited impact on systemic risks. A significant part of current market participants in Group 2 assets are retail enthusiasts who are not highly leveraged and have special interests and beliefs in these technologies. That could be a reason why these markets exhibited robustness and could recover easily after significant swings.

Compared to the status quo, the proposed treatment and regulatory clarity might encourage some banks to enter the riskiest segments of crypto assets. Deduction from the capital and 1250% RWA might be enough to mitigate idiosyncratic risks but might not be enough to internalize the increase in systemic risk outlined above. Additional measures to restrain the increase in systemic risk should be more explicit in the document.

Q3. 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?

The document states: “Stabilisation mechanisms that: … use protocols to increase or decrease the supply of the cryptoasset; are not considered to meet this condition.” This should not be binding criteria for classification in Group 2 assets. The main criteria should be the riskiness of the redeemer/stabilization mechanism provider. For example, stabilization mechanism could be based on ownership of traditional assets and additionally on algorithms to maintain a peg with a traditional asset. The credibility of the peg will depend on the riskiness of the redeemer and the existence of algorithmic protocols should not result in a material increase of underlying risk.

Thank you for your openness and taking these comments into consideration.

Sincerely,

Otar Gorgodze