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***PricewaterhouseCoopers response to the discussion paper on crypto assets
(BCBS 490)***

Dear Basel Committee on Banking Supervision,

we would like to thank you for the opportunity to comment on the discussion paper on crypto assets (BCBS 490) published in December 2019. The PwC network appreciates the opportunity to express their view on such an important topic and shares the concern of the Basel Committee that a regulation of crypto assets should be discussed.

We have collected feedback from our PwC network of regulatory and crypto asset experts all over the world and captured our combined comments in this document. We agree with the risks identified by the Basel Committee and the overall approach to a prudential treatment for the risks arising from crypto asset exposures. As there are different potential sources of value, we moreover agree that we should be careful not to treat all crypto assets in the same manner when developing a prudential treatment.

Yours sincerely,

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BCBS 490 - Discussion Paper on Crypto Assets

I. Overall Comment:

Based on the proposed prudential and the existing accounting treatment as well as international and local frameworks, potential inconsistencies between the accounting and regulatory/prudential treatment could arise: For instance, crypto assets could be required to be classified as intangible assets under International Financial Reporting Standards (IFRS), which might lead to a capital deduction under pillar 1, even if they were not classified as “high risk” according to the BCBS 490 criteria.

II. Response to the Committee’s guiding questions:

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 view that it is important to develop standards that consider the function and nature of the various crypto assets. Whilst there is diversity in types of assets, and new assets are being created daily, we have found the following taxonomy to be useful in highlighting the different functions which and could be useful in developing the prudential treatment.

Cryptocurrency

Cryptocurrencies are digital tokens or coins based on Distributed Ledger Technology, such as Bitcoin. They currently operate independently of a central bank and are intended to function as a medium of exchange.

Asset-backed token

An asset-backed token is a digital token based on blockchain technology that signifies and derives its value from something that does not exist on the blockchain but instead is a representation of ownership of a physical asset (for example, natural resources such as gold or oil). Stable coins could fall into this category or be categorized separately due to having a different usage and purpose from other asset-backed tokens.

Utility token

Utility tokens are digital tokens based on blockchain technology that provide users with access to a product or service, and they derive their value from that right. Utility tokens give holders no ownership in a company’s platform or assets and, although they might be traded between holders, they are not primarily used as a medium of exchange.

Security token

Security tokens are digital tokens based on blockchain technology that are similar in nature to traditional securities. They can provide an economic stake in a legal entity:

sometimes a right to receive fiat or another financial asset, which might be discretionary or mandatory; sometimes the ability to vote in company decisions and/or a residual interest in the entity.

Other

It should also be noted that some cryptographic assets might exhibit elements of two or more of the identified subclasses, or where the category is not entirely clear. Judgment will be required to applied where guidance is not available.

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?

The various crypto assets derive their relative value in different ways. For example:

- “Cryptocurrency” (i.e. Bitcoin) - Derives its value based on supply and demand
- Asset-backed token - Derives its value based on the underlying asset
- Utility token - Value is derived from the demand for the issuer’s service or product
- Security token - Value is derived from the success of the entity, since the holder of the token shares in future profits or receives fiat or another financial asset (analogous to traditional securities)

In addition, there are crypto assets that combine the characteristics of different asset classes as well as tokens that evolve during their life (i.e. change their characteristics over time or through contingent events).

The function of a crypto asset will affect the relative prudential risk of the different crypto-assets for banks. For instance, one might view Stable Coins or asset-backed tokens as having less inherent risk than a Cryptocurrency due to the fact that they are supported by an underlying asset. We are of the view that this should be considered in the development of any capital standards.

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

We see four fundamental benefits of the use of crypto assets in the banking system:

1. Process efficiency and mitigation of execution and fraud risks:

The use of token-based and DLT-related process chains can help increase the efficiency of transaction-related banking services, such as remittance and payments, trade finance, currency exchange, etc. while execution, legal and fraud risks (due to increased transparency) could be reduced thanks to solutions such as smart contracts. These benefits must also be balanced against some increased risks that exist in the market today in part due to the fact that the regulatory environment is still being developed. This is explored further in Question 4.

2. Democratization of access to assets and investment options:

The splitting of ownership of assets through tokenization may at some point create the possibility for retail investors to participate in asset holdings that were previously inaccessible due to high minimum investment amounts (such as property, art, antiques, collectibles, licenses, etc.) This development can be seen as both a measure of financial inclusion as well as a source of additional income for banks.

3. Reduction of holding and use of fiat (cash):

In particular in still fiat-focused economies, the use of crypto assets for value exchange purposes may pose an opportunity for banks or other market participants to develop fast, inexpensive and secure token-based payment systems that may help replace the use of fiat, add transparency and resolve the inherent social and macroeconomic shortfalls of fiat (such as intransparency, money laundering, tax evasion, processing cost etc.).

4. Central Bank Digital Currency (CBDC):

Central Bank Digital Currency could have many potential benefits for the issuing central bank, because digital currency could provide a real-time picture of economic activity in a country or region as well as provide more accurate and timely economic data for GDP estimates than are available today, in addition the previously mentioned advantages of establishing an alternative to fiat. For citizens and businesses, transactions would be more efficient with near instantaneous settlement at potentially a fraction of the cost. CBDCs can also help in the fight against corruption and money laundering, as authorities would be able to trace transactions far more effectively than is possible today.

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

We agree with the risks identified by the Basel Committee and the overall approach to a prudential treatment for the risks arising from crypto asset exposures.

However, we suggest that the Committee re-consider a more risk-sensitive treatment of crypto assets in certain risk areas, such as operational risk. The paper provides a list of different sources of operational and other risks (p. 10) which are deviating to some extent from the corresponding types of risks related to established types of assets.

In some situations, cyber, conduct and fraud risks in relation to some crypto assets may be higher than traditional asset types. These risks may be higher due to their probability of occurrence and potential impact of the risk event.

On the other hand, some crypto exposures (for instance, those involving smart contracts) may inherently present a lower operational, legal and fraud risk. We therefore recommend that the Committee reflect on both examples and consider whether the existing operational risk standards (that also rely on historic data which may not comprise of sufficient effects stemming from

these comparatively new business activities of banks) provide sufficient risk sensitivity to cover the operational risks inherent to crypto exposures.

We also suggest that the Committee provide more details on the proposed treatment of derivative crypto transactions in relation to the counterparty credit risk and the application of existing standards. This may involve, for instance, further guidance on the decomposition of risk drivers and the calculation of add-ons, in particular for asset classes that are not listed in the current SA-CCR standard. These considerations may be relevant for crypto assets including (yet not limited to) stable coins, asset-backed tokens, and, to some extent, utility, security, hybrid tokens and tokens that evolve during their life (i.e. change their characteristics over time or through contingent events).

We also suggest that the Committee consider providing general guidance on how to address crypto assets without an active market price.

Finally, the Committee may wish to monitor developments in the area of Decentralized Finance (DeFi). With over US\$1 billion of ETH used as collateral in DeFi contracts as of the date of this letter, this is a growing segment of the market. As new products are being developed rapidly, any guidance needs to be flexible to respond to the ever-changing developments.

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 are supportive of the general principles detailed on page 8 of the Discussion Paper. In particular, the “same risk, same activity, same treatment” is critical to avoid unduly creating an unlevel playing field for crypto participants. With the expansion of stable coins and other asset backed tokens, there is an increased likelihood that these assets may be used by banks as part of a diversified product offering or investment strategy. If the underlying assets can be audited, and are subject to a clearly identified regulatory framework, these assets should not be treated in a punitive manner.

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?

The channels that could be most material could be:

- (iii) owning crypto-assets directly
- (xii) providing custody / wallet services for third party crypto-assets
- (xviii) acting as a custodian or taking deposits from a reserve backing crypto-assets

Currently, one of the risks associated with transacting in crypto assets has been the lack of a well established custodial network. Banks are well positioned to provide this service given their strong control and governance frameworks. Presently, there are a number of significant financial institutions that are expanding their custodial offerings and providing trust in the process. We

run the risk that if capital charges are punitive, we disincentivize the major financial institutions from providing a critical service that is needed by the market. We view that the overall crypto market risk profile would increase if these major financial institutions are not involved. It is critical that regulators strike the right balance between recognizing the risks that these crypto assets may introduce, without punishing the participants who are trying to increase credibility in the process.

We are also seeing business models that are common with traditional financial institutions being launched by non-banking entities. Examples include prime brokerage, borrowing and lending or asset management. As the crypto ecosystem matures and financial institutions get active in this space, we would expect them to provide such services as well.

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

We are not aware of any exposure channels likely to change in response to ongoing or envisaged developments in crypto asset markets, other than those discussed in Q6.

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?

We view the risks detailed in the Discussion Paper cover the material risks.

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?

As there are different potential sources of value, we agree with the Committee's approach that we should be careful not to treat all crypto assets in the same manner when developing a prudential treatment.

When looking at the proposed example, while helpful, it is only focusing on a single situation and a very conservative prudential treatment. The example mentioned that it was for a high risk crypto-asset. For clarity, it would be helpful if the Discussion Paper explains if it considers Bitcoin to be such an asset as it is the most commonly used crypto asset at present. We suggest that examples be provided for the other categories that we detailed in Questions 1 and 2.

There is also no connection between the suggested prudential treatment of "high risk crypto assets" and how these assets are accounted for in accordance with IFRS. Crypto assets are frequently considered an intangible asset while others may meet the definition of a financial

instrument depending on the crypto asset structure. As well, it is unclear how a bank's capital requirements computation would account for crypto assets that are held on behalf of third parties and whether that would change if those assets were on balance sheet vs off balance sheet. It would be helpful if the Discussion Paper could clarify how the treatment follows not only the nature of the assets, but also their function at a financial institution.

For example, guidance is needed under which conditions crypto assets could or must not be treated like other assets (e.g. use as credit risk mitigation technique, eligibility as HQLA, etc.). If necessary, further requirements should be linked to the prudential treatment of crypto assets, such as transparency requirements, deductibles, historical data, etc.

Finally, detailed guidance is needed on how to determine the value of the crypto asset for prudential purposes to ensure consistency across banks and jurisdictions. As there are various exchanges globally, each of which may have a different quoted price for the same crypto asset, we would seek some guiding principles to be provided. Furthermore, guidance for situations where there is no active market for the crypto asset would be useful, along with guidance on how to address valuations that may differ based on different trading pairs (BTC trading in USD vs ETH trading in BTC).

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

We do not have additional views on this question.

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?

With respect to the interdependencies between Pillar III and financial reporting standards, it is to be noted that, for the accounting treatment of crypto-assets and related transactions, there is no accounting standard specifically addressing the accounting for those types of assets. Therefore, there are currently no disclosure requirements specifically designed for crypto-assets and related transactions. Apart from the fact that this is a judgmental area, the main reason for transparency around the relevant facts and circumstances is that crypto-assets and related transactions are a topic of significant interest for all stakeholders (especially shareholders, analysts and regulators). This becomes even more important, given that those users might have different local expectations. As a result, we believe that the Committee may consider developing clear and robust Pillar III disclosure standards. Additional information related to banks' crypto-asset exposures could be:

- What types of crypto-assets are in the portfolio
- Which crypto-assets are classified as "high risk" in accordance with the BCBS
- What effect do the crypto-assets have on the financial statement and on the regulatory requirements (capital ratio, LCR, LR, etc.)
- What effect do the crypto assets have in the business model / growth

We are aware that the European Financial Reporting Advisory Group (EFRAG) has released a discussion paper titled “Accounting for crypto-assets: Holder and Issuer Perspective” that examines various disclosure requirements. If disclosure changes are proposed to the IASB, then there may be an opportunity to align requirements to reduce the reporting burden on issuers.

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?

We suggest that the Committee provide detailed guidance on the treatment of short positions and derivatives in crypto assets.

A number of OTC brokers and exchanges are now conducting crypto lending activities with each other. However, there are no standard documents such as ISDAs that are used elsewhere in the financial services sector. As exposures increase, it is another area for the Committee to explore further.

We noted that Central Bank Digital Currencies (CBDC) are not in scope of this paper although we believe that it has the potential to become one of the relevant types of crypto asset for banks in some jurisdictions in the near future. We would appreciate it if the Committee established global standards – be it under this or a separate initiative – for the prudential treatment of CBDC exposures.

The discussion paper does not address the theoretical possibility that Initial Coin Offerings (ICO) or other means of crypto asset issuances could at some point also be used by banks to raise capital (Core Equity Tier 1, Tier 1 and Tier 2 capital) or loss-absorbing liabilities (such as TLAC instruments). ICOs can vary greatly – including tokenised equity. We believe that tokenised equity (or debt) could warrant a paragraph – particularly on how these may be considered as eligible capital for a bank in the future.

We noted that hybrid and tokens that change their form have not been addressed in this discussion paper while we feel that a fundamental or principle-based guidance on these types of instruments would be beneficial.

We noted and appreciate that the Committee clarifies the exclusion of inter-bank and intra-group fiat-backed crypto assets (p. 13) from the “high risk” classification. However, we are wondering why crypto assets which are fully backed by fiat currency have to be intra-group or inter-bank settlements. We understood the second example (“Crypto-assets that use stabilisation tools linked to other assets”) in a way that it already covers such fiat-backed crypto assets irrespective of whether they are related to intra-group or inter-bank settlements.

From our observation, the uses of fiat backed stable coins are not necessarily limited to intra-/inter-bank usage (e.g. JPM coin). For example, stable coins may be used by traders to actively hedge their positions or by customers who use them to access blockchain platforms as a medium of exchange as they are less volatile than BTC for example. Remembering of course that fiat currencies underlying stable coins themselves differ in terms of volatility, hence traders can incorporate them into their crypto FX trading strategies.

Also, if CBDCs are introduced into the banking system, as they are also stable coins albeit with significantly different characteristics of their credit and counterparty risks, it will be interesting to see whether fiat backed stable coins remain relevant.

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 suggest that the Committee include guidance on the use of crypto assets as credit risk mitigation techniques which should follow the overall “same risk, same activity, same treatment” principle introduced in chapter 3 of the paper.

In respect of the prudential recognition of crypto assets as collateral, the current version of the paper only sets out an exclusion of high-risk crypto assets from a use as financial collateral. Subject to the refined definition of high-risk crypto assets, this may or may not be consistent with the overall principle “same risk, same activity, same treatment”.

In the context of an overall clarification on the eligibility of crypto assets as collateral, we suggest that the Committee provide examples on some concrete collateralization scenarios, such as the treatment for exposures secured by tokens backed by property and the use of asset-backed tokens as a non-financial collateral for exposures under the IRB approach.

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?

We view this is covered in our response to Q12 and Q13.

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

As mentioned in our response to Q12, the paper does not really address the topic of crypto derivatives, or indeed short positions. A paragraph on these two topics may be helpful.