Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland
(By electronic submission)

30 September, 2022

Standard Chartered's response to the second Consultation (d533) on the Prudential Treatment of Cryptoasset Exposures

Dear Mr. Hernández de Cos and Mr. Esho,

Standard Chartered ("**the Bank**") welcomes the opportunity to respond to the Basel Committee on Banking Supervision's ("**the Committee**") second consultation on the prudential treatment of cryptoassets exposures ("**the Consultation**"). We understand the need for adequate capital requirements, and in that context we appreciate the Committee's work in soliciting and incorporating industry feedback through the consultation process.

We agree that at the outset, the prudential treatment of cryptoassets should be more conservative in its approach. Crypto assets have some new and unique features[1] that can help increase transparency, enhance efficiencies and reduce overall costs of providing financial services. While these attributes can help support global economic growth and improve financial inclusion, they can also be exploited by bad actors jeopardizing market integrity and undermining investor confidence.

Nevertheless, we believe that the proposed capital charges are disproportionately conservative, and if adopted they would have the effect of curtailing participation by banks and other regulated institutions in cryptoasset markets. This in turn would shift activity and drive participants to less regulated parts of the ecosystem, inadvertently cultivating potentially consequential activity outside the regulatory perimeter by unregulated actors.

We also believe that the majority of the underlying risks that cryptoassets pose to regulated institutions are not dis-similar to those posed by traditional financial services offerings – including for example equity or high yield debt instruments. The existing robust risk and capital frameworks, which support the current suite of products and services, can be modified to protect market integrity, support effective and thoughtful investment as well as develop a more efficient financial services sector.

[1] E.g., tokenisation, smart contracts, fractionalisation, and peer-to-peer exchanges.

In this regard, we are broadly supportive of the points raised in the joint comment letter from the trade associations.[2] We however have taken this opportunity to bring to your attention three areas that we believe merit more focused deliberation and have provided specific recommendations for your consideration (see Annex). These fall into three broad categories, the most important of which is the first.

1. Disproportionate capital charge with the effect of prohibiting bank participation

a. Calibrating the exposure limit at 1% of a bank's Tier 1 *capital at all times* is punitive and severely limits the products and services banks can offer clients. The consequences of a breach the proposed Group 2 exposure limit are excessive, resulting in all Group 2 cryptoassets held being subject to a risk weighting of 1250%.

   As such, we do not support a fixed exposure limit for Group 2 cryptoassets. If, however, a fixed exposure limit linked to Tier 1 capital is deemed necessary, we recommend that:

   - 15%,[3] accompanied by timely disclosure to supervisors on balance sheet exposure, is appropriate; and,

   - firms have robust tools for assessing specific risks in relation to individual Group 2 assets which would in turn limit the number of individual assets contributing to this risk;

b. The 2.5% infrastructure add-on is unnecessary and duplicates the existing risk requirements under the capital framework. We recommend that it be omitted.

2. *Inconsistent approach to that of established risk management practices*

For example, calculating the exposure limit on a gross basis without recognising any netting benefit (in particular, adding long and short positions for the same cryptoasset). Because the largest Group 2 cryptoassets on the public blockchains are ubiquitous and fungible, we recommend

- permitting netting across cryptoasset positions and/or products where applicable, i.e., across long and short positions on the same cryptoasset, which will enable the use of established, sophisticated, and reliable risk management practices.

3. Unclear conditions, requirements and definitions

For example, where a cryptoasset is a tokenised version of a traditional security or stabilises its value based on a reserve of traditional securities, that crypto asset satisfies existing eligible collateral criteria. We recommend

- that it be recognised as eligible collateral.

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[2] Global Financial Markets Association, the Financial Services Forum, the Futures Industry Association, the Institute of International Finance, the International Swaps and Derivatives Association, the Bank Policy Institute and the International Securities Lending Association dated [ ] (the "**Joint-Trade Comment Letter**")

[3] Which is analogous to the large exposures limit for G-SIBs and in keeping with the definition of risk concentration

Finally, we believe the prudential framework should remain sufficiently agile to reflect (i) the changing risk profiles of cryptoasset markets, activities and ecosystems as they mature; and (ii) developments in the broader regulatory environment that provide risk mitigating benefits. The speed and scale of adoption of cryptoassets into the financial system over the past five years indicates that cryptoassets are likely to play an increasingly large part in the future of financial services and will require regulated financial institutions and regulators to continue to work closely and adapt quickly. We need helpful guard-rails, clear rules-of-the-road and a healthy feedback loop to continue to improve and adjust the regulatory and risk infrastructure for this asset class.

The prudential regulatory system has a crucial and strategic role to play in the development of the cryptoasset ecosystem. Thank you in advance for your consideration. We appreciate the opportunity to provide you with our views and look forward to continuing this discussion with you in the near future.

Yours faithfully,

René Michau

Global Head, Digital Assets

Farisa Zarin

Global Head, Group Public and Regulatory Affairs

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I. *Disproportionate capital charge with the effect of prohibiting bank participation*

A. Group 2 exposure limit

SCO60.122 – Setting the limit at 1% of a bank's Tier 1 capital on a gross basis calculation methodology would effectively prevent banks from participating in the market for Group 2 cryptoassets for the benefit of their clients and drive the market in the direction of the unregulated non-banking sector. We do not support the imposition of a 1% limit of a bank's Tier 1 capital on the Group 2 gross exposure. In particular:

- we interpret, based on SCO60.124, that this limit does not apply to Group 2 assets that are held on behalf of clients for the purposes of safe custody by the Bank. This is in line with the Bank's risk appetite to manage risks emanating from custody of Group 2 assets, within its operational risk management framework and related operational risk capital allocation;
- the definition of the exposure amount aggregates long and short positions without recognition of hedging and effectively penalises banks for managing their risk. This is inconsistent with the Basel capital framework in general (which recognises netting as a fundamental risk management method) and also inconsistent with the treatment of hedging in the Consultation itself;
- the scope of exposures which are included in calculating the limit include exposures that do not expose banks to market risk but do not take into account risk mitigation measures which fall outside the scope of this Consultation (for example, insurance for loss of cryptoassets held in custody); and
- the consequences for exceeding the 1% limit[4] is in essence a "cliff effect", the deterrence impact of is punitive in nature and would simply result in abstaining from in the market.

We further believe that the Joint-Trade Comment Letter' proposal to raise the exposure limit to 5% of Tier 1 capital is insufficient to allow meaningful participation by banks in the market for Group 2 cryptoassets and will continue to drive the market in the direction of unregulated participants.

> ***Recommendation:*** *We do not believe there should be a fixed limit. Consistent with the existing Basel framework, we recommend that a more nuanced approach be allowed for the relation between exposure, risk and capital .*
>
> *If however, a fixed exposure limit linked to Tier 1 capital is deemed to be absolutely necessary, we may be supportive of a percentage analogous to the large exposures limit of 15% of Tier 1 capital for G-SIBs.*

This would be in keeping with the current definition of a risk concentration within the Basel framework being an exposure with the potential to produce losses large enough to pose a significant threat to a financial institution (which at 1% should not produce such an effect). Banks have already implemented measures to manage group-wide risk concentrations and can easily adapt these measures to manage cryptoasset risks.

[4] Resulting in all Group 2 cryptoassets held being subject to a risk weighting of 1250%.

B. Infrastructure add-on

SCO60.57 – We do not support the proposed application of an infrastructure risk add-on for all Group 1 cryptoasset exposures. The infrastructure risks that the add-on intends to mitigate is already covered in the standardised operational risk framework in the existing Basel framework for operational risk management. It therefore creates a standalone risk for digital ledger technology infrastructure. There is no rationale to support such duplicative treatment.

At the Bank, the potential risks associated with digital ledger technology are managed under oversight of our Group Risk Committee via our Digital Assets Risk Committee which oversees implementation of Digital Assets as an integrated risk under our Enterprise Risk Management Framework. We continue to enhance our risk management in step with evolving laws and regulations, so that we can support responsible innovation which manages risks to address regulatory, legal, information security and financial crime risks. We believe the developments in distributed ledger technology could benefit institutions and clients in supporting efficiency and transparency and at the same time mitigate and manage material risks, such as reducing settlement risk in cryptoassets.

Based on the Bank's assessment and in congruence with the industry feedback, the 2.5% add-on adds no material value in protecting the Bank and client assets above and beyond the existing Basel framework requirements for operational risk management. The proposed add-on is an additional cost that is a strong disincentive for regulated financial institutions to invest in, participate and grow our business to support client demand and activities. Leveraging the experience and capabilities of regulated financial institutions such as Standard Chartered, we could help bridge the gap between traditional finance and emerging cryptoasset ecosystem by contributing to policy and regulatory conversations and enabling safe and reliable infrastructure and access for clients who want to gain exposure to digital assets.

> ***Recommendation:*** *We consider the infrastructure risk add-on to be unnecessary and should therefore be removed.*

II. Inconsistent approach to that of established risk management practices

A. Netting

SCO 60.103 We believe that netting of notional for PFE calculation for group 2b crypto assets should be allowed. Also, for derivatives on assets in group 2, accepting the same or highly correlated group 2 spot cryptoassets as collateral against derivative positions could result in material directional and basis risk reduction.

> ***Recommendation:*** *Eligible collateral should be applied to offset the derivative exposure amount on a net basis.*

B. Additional Areas of Concern

SCO60.78 – We believe the capital requirement of 100% for position risk is unduly conservative and considerably higher than the largest price movements observed for spot BTC or spot ETH or the CME futures (which was 66% for BTC CME futures (10 days) on 13 March, 2020). By way of comparison, the highest standalone risk weight for equities delta risk in FRTB-SA-SBM MAR 21.77 is 70%.

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> ***Recommendation:*** *The capital requirement for position risk can be lowered to 70%.*

SCO60.81 We note that a major driver of the partial hedge recognition for delta (vega) capital requirements is the correlation factor $\rho_{kl} = 94\%$ but also that for the same cryptoasset, correlation across exchanges and tenors are considerably higher than 94%. For example, spot BTC vs CME BTC futures prices correlations (daily) since 2018 exceeds 98% and spot ETH vs CME BTC futures (since February 2021) also exceeds 98%.

> ***Recommendation:*** *Raise the correlation factor to 98%.*
>
> ***Note:*** *For a USD100m offsetting position long spot BTC versus short CME BTC futures and 100% capital risk weight, the respective capital requirement-RWA under the alternative correlation factors are outlined in the table below.*

Correlation factor	*Capital requirement*	*RWA*
94%	USD35m	RWA433m
98%	USD20m	RWA250m

SCO60.79 We recommend including an additional footnote to clarify that different products under SCO60.60.(1) may be netted.

> **Recommendation:**
> <u>*Footnotes*</u>
>
> *[10] Positions in the same bucket under SC60.78 but in different Group 2a categories (a) - (e) under SCO60.60.(1) may be offset.*

SCO60.96 Based on the prevailing assessments during the Bank's quarterly FRTB CVA RWA QIS (quantitative impact study) returns, it has been demonstrated that an actively risk-managed CVA portfolio under SA-CVA consumes approximately 25%-45% of the CVA RWA required under BA-CVA.

This assessment covers a comparison for all non-cleared derivatives for the SCB Group. The above comparison for CVA RWA does not consider that CVA market hedge positions (potentially including future crypto hedges) cannot be included in the BA-CVA calculation and will instead attract additional RWA under Market Risk FRTB rules, which would exacerbate the difference in total RWA requirements between the 2 approaches.

> ***Recommendation:*** *Group 2a cryptoassets should be eligible for SA-CVA treatment, which will align risk management for these assets to established and recognised prudential capital requirements.*

SCO60.114 – We note the Net Stable Funding Ratio ("**NSFR**") treatment proposed for certain Group 2 assets (100% RSF) is higher than other unencumbered non-HQLA assets (85% RSF) - their treatment is equivalent to non-exchange traded equities or non-performing assets which receive the highest RSF factor in NSFR reporting. We believe this is overly conservative and such treatment (which has not been substantiated to date) could impede the development of this emerging asset class, discourage innovation and impact market liquidity.

> ***Recommendation:*** *We recommend that the RSF be lowered to 85%*

III. Unclear on conditions, requirements and definitions

There is a risk that all digital forms of traditional assets in Group 1 may inadvertently be defined/classified as Group 2 assets. We believe this was not intended and ask that confirmation on this be provided as part of the response in due course.

The definition of cryptoassets potentially captures any deployment of DLT as a record for conventional financial markets products. It therefore appears that the use of DLT as the underlying technology would attract an add on for infrastructure risks that would make the deployment of DLT penal in cost when compared to any other tech deployment. We would seek confirmation that this is not the case as our interpretation suggests that the use of DLT would be at a financial disadvantage when compared to use of alternative technology deployments.

A. Primary Concern – Tokenisation

SCO60.8 – In keeping with the principles of technological neutrality and "same activity, same risk, same regulation", we suggest

> ***Recommendation:*** *classification condition 1 should be revised so that a digitally native cryptoasset that has the same risk profile as a tokenised traditional asset is eligible as for treatment as a Group 1 cryptoasset.*

SCO60.9(2) The requirement that tokenised forms of traditional assets should have the same level of legal rights as the corresponding traditional (non-tokenised) assets to qualify as Group 1a cryptoassets means that detailed legal analysis will be necessary to ascertain this.

The concern with this approach is that even if the legal analysis is sought,[5] it may not necessarily result in positive confirmation that the legal rights are the same as owning the underlying asset [even if the risks of owning the tokenised assets may not be different]. In the UK, the recent Law Commission Consultation Paper made a strong case for cryptoassets to be recognised as property under English law and provides a degree of certainty around their ownership, transfer, security rights and treatment on insolvency. However, this is not yet conclusive nor can it be certain that this will be followed in other jurisdictions.

> ***Recommendation:*** *This requirement should be revised to address minimum requirements including necessary conditions and risk management procedures rather than ensuring the same level of legal rights.*

SCO60.9(2)(a) – The proposed requirement that cryptoassets must confer the same level of legal rights as ownership of traditional assets raises the question as to the level of due diligence required before coming to such a conclusion. This may be difficult where there may be restrictions in the terms and conditions in the cryptoasset that could prevent obligations from being paid which may not exist in the traditional asset.

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5 This will increase the cost-of-service provision and affect the timeliness of action

> ***Recommendation:*** *Banks should be allowed to adopt a risk-based approach and establish a methodology based on established risk management principles subject supervisory scrutiny and challenge by regulators.*

SCO60.9(2)(c) The proposed requirement that cryptoassets must confer the same level of legal rights as cash held in custody raises questions as cash [in its traditional form] is not usually held in custody and it would be difficult to create similar rights through tokenisation. Although it may be possible to create a custody arrangement in respect of cash, it is likely to be a complicated process which will be expensive, may only be executed with or by a limited number of financial institutions and is unlikely that these arrangements can be replicated in many jurisdictions.

> ***Recommendation:*** *The custodial requirement be removed on the basis that this is not normally required for "traditional" cash and there should not be incremental risk.*

SCO60.10(1) We believe that this requirement will hinder banks' ability to create tokenisation arrangements which require conversion to off blockchain settlement or delivery mechanism (without affecting legal rights or the risk profile). We also note that this sub-paragraph uses the term "same legal rights" as opposed to "same level of legal rights" mentioned in SCO60.9. We believe that there should be no reason for the terms to be different and that this was not intended.

In addition, for a cryptoasset to qualify as Group 1a asset, there must not be any additional counterparty credit risks compared to the traditional asset. For example, if the tokenisation of the asset is done by one party and the token is sub-custodied with a different party, would the traditional asset also have to be sub-custodied with the same (second) party as opposed to the issuer (the first party)? Otherwise, the tokenised asset would have counterparty risk of both the first and second party, whereas traditional asset would have just counterparty risk of issuer if it also had custody, and therefore the asset would not qualify as a Group 1a asset?

> *R**ecommendation**: Amend this requirement to reflect consideration given to any increase in counterparty credit risks as well as mitigating factors including structuring, documentation and risk management of the cryptoasset.*

B. Additional Areas of Concern

SCO60.2 – The text connotes that tokenised securities that are based on a non-DLT issued underlying are in-scope.

> **Recommendation:** Both tokenised traditional assets and digitally native securities should be treated in the same way regardless of method of issuance.

SCO60.4 – We understand the term "non-fiduciary custody" may have been introduced as the result of a specific US issue where on-balance sheet fiduciary assets may attract additional capital charges.

> ***Recommendation:*** *Amend the definition so that all forms of custodial services give rise only to operational risks. As a result of this change, there should be no need to highlight non-fiduciary custody.*

SCO60.7 The proposed requirement that cryptoassets meet the classification criteria on an ongoing basis may not be practicable.

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> ***Recommendation:*** *Whether a cryptoasset meets the classification criteria should be determined at issuance. This should not change, and assets should continue to meet such criteria.*

SCO 60.11(2) – We believe that the regulatory requirements for issuers and banks should be separated. We recommend that

> - *banks should perform and complete due diligence on the stabilisation mechanism at acquisition (and this should not change) and separately,*
> - *issuers should be regulated by a competent local authority (assuming that different jurisdictions are prepared to accept mutual recognition based on agreed equivalence criteria) and be required to report reserves on an ongoing basis as part of their mandatory reporting requirements.*

SCO 60.11(3) As stated above, the regulatory requirements between banks and issuers should be separated with banks being responsible for due diligence and regulated issuers for monitoring and reporting.

SCO 60.11(4) As a practical matter, banks will need to rely on third party verification of ownership rights on an ongoing basis and should be able to rely on independent third parties. Given the requirements in this paragraph are cumulative, we believe there is a sufficient level of safety.

> ***Recommendation:*** *The requirement that "only if the banks are satisfied that the assessments are reliable" is not necessary and may be omitted.*

SCO60.13(1) The redemption risk test requires "the value of the reserve assets (net all non-cryptoasset claims on these assets) must at all times, including during periods of extreme stress, equal or exceed the aggregate peg value of all outstanding cryptoassets".

As noted above, there should be a separation of requirements for banks and issuers. Banks should perform due diligence on the valuation mechanism upon acquisition. Separately, issuers should be licensed and be responsible for structuring and documentation of the valuation mechanism including the nature of the risks giving rise to an overcollateralisation requirement and the standard for identifying sufficient overcollateralisation (in terms of what is appropriate and what is the level of stress losses required to be addressed) as well as monitoring and regulatory reporting.

SCO 60.13.2(a) The requirement that reserve assets must be "managed and invested with an explicit legally enforceable objective of ensuring that all cryptoassets can be redeemed promptly at the peg value, including under periods of extreme stress" may not be practicable and may also not survive the default or insolvency of the issuer.

> ***Recommendation:*** *This requirement is not necessary and may be omitted without affecting the risk profile of cryptoassets in any significant way.*

SCO60.14 The basis risk test as outlined in the Consultation introduces a threshold to determine if the cryptoasset has "fully passed", "failed" or "narrowly passed" the basis risk test (with attendant RWA consequences). Taking the instruments and market data which is currently available, it is unclear how many stablecoins would have fully passed the basis risk test in its proposed form and therefore the viability of the test and the classification of Group 1b.

In addition, it is not clear this test rules out non-traded cryptoassets or if an asset has not been tradeable for 12 months on the regulated market / exchange and whether this results in the asset having passed, narrowly passed or failed the basis risk test.

Therefore, we would welcome clearer guidance on minimum trade history of the asset as well as the types of data sources (e.g. exchange types or data vendors) that would be permissible for use when carrying out the basis risk test.

SCO60.17 We believe that banks' exposures to stablecoins issued by regulated entities will generally be lower risk than those issued by unregulated entities.

> ***Recommendation:*** *Such stablecoins should qualify as Group 1b cryptoassets without regard to the redemption risk and basis risk tests.*

SCO60.19 The requirement that "all rights, obligations and interests arising from the cryptoasset arrangement are clearly defined and legally enforceable in all the jurisdictions where the asset is issued and redeemed" raises the question of how and where an asset is issued (which may be more straightforward) and redeemed (which in theory, could be anywhere).

In addition, the requirement that full transferability, settlement finality and full redeemability must be maintained at all times and in all jurisdictions may depend on a particular cryptoasset and could vary across different jurisdictions. Further, the law applicable to cryptoassets are still evolving and while the level of legal certainty will increase over time, the requirement may not be met in every (relevant) jurisdiction at any given point in time.

> ***Recommendation:*** *Issuers, as part of the structuring and documentation process upon issuance, include a governing law clause and the above matters should be addressed in a legal opinion but only under the relevant governing law. This is not different from the practice relating to the issuance of traditional assets.*

We would also welcome efforts between the Committee, other market and banking regulators, market participants and legal experts to develop guidelines on what features of the underlying legal framework are necessary in order to make the requisite determinations, and how that might result in the issuance of standardised legal opinions that market participants can make use of.

SCO 60.20(2) – The requirement for an independent legal opinion to confirm this condition may not be viable in jurisdictions where the laws on cryptoassets may not have developed to a point where such opinion provides the necessary level of certainty. In addition, the requirements regarding proper documentation of cryptoassets may not be met if cryptoassets were evidenced by way a smart contract but not otherwise documented. We would welcome guidance and clarification on how banks are expected to comply with this requirement in a practical and effective way.

SCO60.21 – We agree that banks should understand and monitor all material risks associated with Group 1 cryptoassets as well as put in place measures to mitigate such risks. However, banks should not be expected to influence and be responsible for the design and operation of networks which are outside their control.

As noted above, banks should perform due diligence on or prior to acquisition of cryptoassets and have risk management responsibilities thereafter. We believe this can and should be addressed by the banks' risk management practices subject to supervisory scrutiny and challenge by regulators.

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> ***Recommendation:*** *Amend this requirement to say that "the banks are satisfied and continue to be satisfied that the functions and networks can sufficiently mitigate and manage material risks".*

SCO60.23/24 – To ensure there are robust client and asset protection mechanisms in place, our view is that regulation should apply to all wallet service providers who are operating on any public or permissionless blockchain.

SCO60.60(1) We welcome the distinction drawn in the Consultation between Group 2 cryptoassets that meet the hedge recognition criteria meet versus those that do not (SCO60.59).[6] However, we believe the criteria are too narrowly defined, and may impede market development and technological innovation. Indeed, defining the set of assets or products which meet a set of hedging criteria too narrowly will excluding assets from netting, which in turn will exclude them from the market without taking into account the correlation between the underlying asset and any related derivative product.

> ***Recommendation:*** *We propose the following additions to SCO60.60(1) to ensure that physically-settled transactions, as well as cash-settled transactions, are covered in Group 2a including swaps with multiple physical legs:*
>
> *(a) A direct holding of a spot or physically-settled forward Group 2 cryptoasset where there exists a derivative or exchange-traded fund(ETF)/exchange-traded note (ETN) that is traded on a regulated exchange that solely references the cryptoasset.*
>
> *(b) A cash-settled or physically-settled derivative or ETF/ETN that references a Group 2 cryptoasset, where the derivative or ETF/ETN has been explicitly approved by a jurisdiction's markets regulators for trading or the derivative is cleared by a qualifying central counterparty (QCCP).*
>
> *(c) A cash-settled or physically-settled derivative or ETF/ETN that references a derivative or ETF/ETN that meets criterion (b) above.*
>
> *(d) A cash-settled or physically-settled derivative or ETF/ETN that references a cryptoasset-related reference rate published by a regulated exchange.*
>
> *(e) A physically-settled swap at pre-agreed rates.*

SCO60.107 – We welcome the treatment accorded to Group 1a cryptoassets in the Consultation as high-quality liquid assets ("**HQLA**") under the Liquidity Coverage Ratio ("**LCR**") rules.

> ***Recommendation:*** *We suggest that that both the underlying assets and the tokenised form of the assets should satisfy the HQLA eligibility criteria under the LCR rules. This is consistent with the principle of "same risk, same activity, same treatment". Further, the HQLA classification should be extended to other cryptoassets if they fulfil the HQLA eligibility criteria and share key characteristics with other HQLA-eligible assets.*

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6 We recognise this is one of the major changes introduced in the current Consultation and represents a more accurate reflection of risk. This is consistent with the trading book treatment across asset classes and is recognised by the differentiation in capital treatment.

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For example, Group 1b cryptoassets with an effective stabilisation mechanism that references a traditional or tokenised HQLA asset should be treated as HQLA subject to evidence of sufficient market liquidity.

SCO60.116 We believe that as markets for cryptoassets mature and more data becomes available, LCR and NSFR factors can be recalibrated periodically to reflect the changing risk profile of the cryptoassets, the markets they are traded on as well as related activities and the wider ecosystem.

Recommendation: LCR and NSFR factors should be reviewed at lease every two years and calibrated if necessary or justified.