

Comments in Response to the BCBS' Second Consultative Document on the Prudential Treatment of Cryptoasset Exposures

The Basel Committee (committee) rightly points out that cryptoasset activities:

- have the potential to raise financial stability concerns and increase risks faced by banks;
- introduce new kinds of risk and increase certain traditional risks;
- may pose various unforeseen risks.

Actually, the word „risk“ appears more than 400 times in the second consultative document (SCD). Furthermore, the Committee claims that it seeks to achieve the general principles of “same risk, same activity, same treatment”, and „simplicity“. It is hard to see that the proposal adequately addresses the risks and follows these principles. Considering that the cryptoasset technology is relatively new and untested, particularly in times of severe financial stress, a more prudent approach than proposed should be applied.

The history of financial market crisis shows that neither banks nor supervisors can be relied on to anticipate and prudently manage new kinds of risks. Ideally, regulated banks should not trade in cryptoassets at all. An exception may be considered for a total amount of Group 1 cryptoasset exposures up to 1% or 2% of Common Equity Tier 1 (CET 1) capital. Preferably, all business activities of banks in cryptoassets should only be conducted by ringfenced separate legal entities, which must not be debt-funded by banks. Only a strict separation from ordinary banking activities would sufficiently mitigate potential risks. At the same time, banks through their ringfenced subsidiaries as well as regulators would still be able to gain experience with new technologies and risk management.

The committee's proposal to cap Group 2 exposures at Tier 1 capital is not sufficient. Group 2 assets such as Bitcoin do not provide a claim against an issuer and have no intrinsic value. In its discussion paper from December 2019, the committee itself considered Group 2 as high-risk assets which should be deducted from CET 1 capital. What developments or new insights have changed the committee's views since? The collapse of the Terra Luna network with the Terra UST algorithmic stablecoin in May 2022, which was constructed similarly to a Ponzi-scheme, illustrates significant risks of loss for investors in cryptoassets due to a lack of regulation.

Moreover, the committee's revised view to delink the capital treatment of cryptoassets from their accounting treatment means that cryptoassets and other intangible assets are treated differently. This contradicts the principle same risk – same treatment as it creates new inconsistencies. It also contradicts simplicity as any exception inevitably does.

Also, when it comes to computing the leverage ratio the deduction from capital, as is required for intangibles, is more prudent than the proposed risk weight of 1.250% for Group 2b assets or the proposed treatment of Group 2a under modified market risk approaches. As a result, Group 2 cryptoassets are privileged compared to other intangible assets.

Re Treatment of Group 1a cryptoassets:

The committee proposes to treat Group 1a assets like traditional assets if they pose the same level of credit and market risk. However, it is unknown whether assets in digital form and

traditional assets pose identical risk and it is unclear how such identity could be demonstrated given the short history of cryptoassets. Moreover, similar capital treatment would ignore that holding of cryptoassets increases other risks for example operational, cyber, reputational and liquidity risk.

Re Treatment of Group 1b cryptoassets:

The revised classification conditions for Group 1b cryptoassets are more complicated and have been diluted compared to the first consultative document (FCD).

With respect to the redemption risk test it is unclear how a stress test to ensure that reserve assets are sufficient would need to be designed. It also unclear whether a bank would have sufficient and audited information to conduct the required stress test itself.

With respect to the basis risk test the proposed softening and complication appears unjustified. The presence of value mismatches would, after all, indicate precisely that there is basis risk between a cryptoasset and its reference asset. Moreover, a cliff effect would only be relevant if a bank holds risk positions that are unduly high.

The committee itself appears to have doubts about its proposed tests as it considers to replace them by the requirement that „For a stablecoin to be classified as Group 1b the issuers must be supervised and regulated...“ (see SCO 60.17). However, there shouldn't be a trade-off between these two requirements. It should actually be self-evident that an issuer of the privileged Group 1b assets must be subject to close regulation and supervision. Regulators should not only carry out the redemption and basis risk tests (as described in the FCD), thus ensuring consistency, but also supervise the fitness of management and the verification of the existence of the assets serving as collateral. However, verification of assets should happen more frequently than just on an annual basis as proposed by the committee.

In addition, all entities responsible for redemption, transfers, storage, settlement of cryptoassets and for the management of reserve assets, should be subject to supervision and regulation (SCO 60.23) as proposed in the FCD. This requirement should not be waived if these entities are subject to "appropriate risk management standards" as proposed by the committee. In the end, compliance with the standards would have to be monitored by regulators anyway.

Cryptoassets based on permissionless blockchains should not be included in Group 1.

Add-on for infrastructure risk

Understandably, the committee points out that new technologies may pose unforeseen risks. This risk is thought to be addressed by a small capital surcharge of 0.2% of the risk position. This approach is contradictory. Precisely because one does not yet have sufficient experience with the additional, novel risks arising in connection with cryptoassets, an equal treatment of traditional assets in analog form and digital assets of Group 1 seems too naive. Therefore, a strict limitation of Group 1 cryptoasset risk positions to 1%-2% of CET 1 capital and ringfencing of additional activities would be appropriate. The introduction of a minor capital surcharge, the calibration of which is completely unclear and further inflates the regulatory framework, appears unsuitable to deal with novel risks.

Re Treatment of Group 2a cryptoassets

The SCD proposes a new Group 2a category. Instead of deducting the exposures from CET 1 capital (as proposed in the 2019 discussion paper) or using a risk weight of 1.250% (as

proposed in the FCD) modified versions of the standardized approach (SA) or the simplified standardized approach (SSA) to market risk are proposed. Obviously, both the introduction of a new category and the modifications to the approaches add another level of complexity to the Basel Framework.

How do capital requirements for Group 2a assets compare with those on other asset classes? Here, a comparison with commodity risk exposures appears to be useful.

If a portfolio consists of long positions only, the capital requirements for commodity risk positions (regularly between 20% and 80% for individual positions) may be significantly lower than those for crypto assets (always 100% capital requirement because there would be no relief from hedging or aggregation across buckets). This is especially if a bank holds positions of different commodity classes due to a diversification benefit.

If, on the other hand, a portfolio consists of long and short positions, the result may be that the capital requirement for a class of Group 2a cryptoassets is lower than that for certain classes of commodities. Assume a bank holds a long position of 100 € and a short position of 100 €.

- For a Group 2a cryptoassets, the capital requirement would be 48,99 € or 24,5% of the total amount of both positions of 200 € (with correlation coefficient $\rho_{kl}^{low} = 0,88$).
- For a single commodity, the capital requirement would be between 7,8% and 35,8% depending on the commodity risk class.

It is hard to understand that the capital requirements of the two asset classes (cryptoassets vs commodities) are so close and that three of the 11 commodity classes are considered riskier than cryptoassets, even though commodities have intrinsic value and Group 2a cryptoassets do not.

It is true that there would be additional capital relief for a more complex portfolio of commodities due to the recognition of diversification effects across commodity classes, although diversification effects are known to be unreliable for all asset classes in times of stress. The recognition of diversification across risk buckets is rightly not permitted for cryptoassets and shouldn't be permitted for other asset classes either.

Considering the diversification benefits, the difference in capital requirements between the two asset classes as well as the level of capital requirements appear far too low. Based on 1.500 simulations (500 each for the three correlations scenarios) for portfolios of cryptoassets and commodities with identical amounts of long and short positions capital requirements were as low as 9,6% for cryptoassets (diversification benefit within a bucket only) and 2,3% for commodities (diversification benefit within and across buckets).

It would also be helpful if the committee were to explain why according to SCO 60.79 it considers "exchanges" a dimension for risk factors.

Re Treatment of Group 1 cryptoassets as HQLA

In the FCD, the committee still assumed that cryptoassets would not count as high-quality liquid assets (HQLA). The committee rightly points out that market liquidity for Group 1 cryptoassets may be lower than that of traditional assets. It also emphasizes the particular additional risks compared to traditional assets and the lack of historical data. Therefore, it is unclear why the committee now believes that Group 1a assets may be considered HQLA. It will be interesting to see whether Group 1a cryptoassets will be eligible collateral for borrowing from central banks and whether they would still be considered HQLA by regulators if central banks refuse to accept them.

Conclusion

Compared to the previous proposals, the second consultative paper represents a further dilution and complication of the requirements. More than 1,600 pages of the Basel framework is evidence that the committee has constantly increased the complexity of the rules. This is due to numerous exceptions and relaxations to please the banking industry but also due to the flawed presumption that capital requirements may be computed with mathematical precision.

Although the committee emphasizes in various places the novel or unknown risks and insufficient experience with cryptoassets, it proposes equal regulatory treatment between traditional assets in analog and digital form.

Even trading in high-risk cryptoassets of Group 2, which are generally not expected to have any intrinsic value, should be eased. This is done, among other things, by exceptionally privileging cryptoassets classified as intangible assets for accounting purposes over other intangible assets. The proposed cap of these high-risk, intangible risk positions to the amount of a bank's Tier 1 capital appears far too lenient in view of the high loss potential as the collapse of the Terra Luna network shows. Moreover, there is also no apparent compelling need for banks to trade in these instruments.

Conversely, it would make more sense to gain sufficient experience with the new instruments and associated risks instead of adopting soft regulation in advance. Capping Group 1 cryptoassets at 1% - 2% of CET 1 capital and ringfencing additional Group 1 exposures and all Group 2 crypto-assets in separate legal entities would be a prudent approach without preventing the use and development of new technologies.

Climate risks caused by the high energy consumption due to the operation of the network or "mining" of new units of a cryptoasset (e.g. Bitcoin), are not addressed at all. Here, the committee refers to other publications. However, it must be doubted whether the proposed regulatory concessions for energy-intensive cryptoassets send the right signals with regard to climate protection goals.

Regards

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- Best, Stefan; Read, Oliver (2022): Erleichterungen für Banken in der zweiten BCBS Konsultation trotz Bedenken, to be published soon in: die bank