

UK Finance response to the Basel Committee on Banking Supervision: Second consultation on the prudential treatment of cryptoasset exposures

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Introduction

UK Finance is the collective voice for the banking and finance industry in the United Kingdom.

Representing more than 300 firms across the industry, we act to enhance competitiveness, support customers, and facilitate innovation.

UK Finance welcomes the opportunity to respond to the BCBS consultation on the prudential treatment of cryptoasset exposures. UK Finance is viewing this consultation as an important opportunity to help improve future frameworks for regulating digital currencies and assets, including, stablecoins and wider cryptoassets.

Our members are supportive of an international economy that supports the coexistence of different forms of money and a widening asset base in a way which supports consumers, businesses and financial institutions and ensures a long term innovative and thriving financial services ecosystem. The anticipated developments and changes surrounding cryptoassets and the application of their underlying technology represent a dynamic environment.

A fair framework for financial services firms

In recent years, the cryptoassets market has become a diverse and complex industry that is evolving rapidly. Globally, this sector is continually innovating, and the introduction of a proportionate prudential framework that does not disadvantage regulated institutions is encouraged. UK Finance is supportive of the efforts from the BCBS and the changes in the second consultation, including recognition that a cryptoasset with the same risk profile as a traditional asset should be subject to the same prudential treatment.

As digital assets continue to evolve and develop, the framework associated to these assets require a fair and proportionate prudential regulatory framework, aligned to the underlying risks, that enables financial institutions to realise the economic benefits of digital assets and the associated technology as well as allowing for future innovative assets to come into the framework.

On this basis, UK Finance has some concerns on the potential unintended consequences of BCBS's current proposals:

1. An adverse impact on technological innovation and the ability of regulated financial institutions to compete with other organisations in offering services linked to cryptoassets, for example:
 - The inclusion of an inflexible infrastructure add-on that is not aligned to the risks of DLT, nor reflects the spectrum of types and applications of DLT, creating needless and uncompetitive capital requirements;

- The scope of the framework, driven by the definition of a cryptoasset, that may encompass traditional assets simply because they are recorded on DLT, potentially disincentivising the use of DLT on a broader basis.
2. An adversely impact to financial product and service innovation, potentially preventing prudentially regulated financial institutions from realising the full benefits of cryptoassets for their customers, and incentivising a shift of financial services to unregulated or less regulated parts of the economy, for example from:
- The less punitive prudential requirements for Group 1 cryptoassets are specifically applied to certain tokenised traditional assets and stablecoins, without consideration of product innovation and the possibility of other product groups being developed that do not neatly fit into the two product categories and thus may be defaulted to a Group 2 classification irrespective of the underlying risks;
 - Classification conditions that are rigid and not always aligned to the risks of the cryptoassets.

We therefore urge the BCBS to introduce more flexibility into the framework, more closely aligning prudential treatment to the underlying risks and to more closely adhere to the ‘same risk, same treatment’ philosophy.

UK Finance believe that the BCBS standards should permit those jurisdictions that wish to bring this activity within their regulatory perimeter to do so. Some jurisdictions already have or will have cryptoasset activity and the associated risks within their economy but taking place outside of their regulatory scope. Setting the international standards too high would prohibit those jurisdictions that wish to bring the activity within their regulatory perimeter from doing so. Any jurisdiction that wishes to apply higher standards than the requirements in the final BCBS standards would be free to do so, on a permanent or on a transitional basis.

Consumer risks should non-bank players lead this market

If banks have unreasonably differential treatment of their exposures to cryptoassets they will be discouraged from engaging with the cryptoasset market. Not only will this disadvantage them compared to their less-regulated competitors, but also cryptoasset activities may become more ‘invisible’ to the authorities if it is concentrated in a lesser-regulated or unregulated environment.

There are subsequent consumer and stability risks that regulators need to consider. As consumers will continue to adopt cryptoassets outside of regulated financial services, regulators will not be able to protect consumers. We also expect high growth in the adoption of the technology that underlies cryptoassets.

There is an opportunity for the banking and finance sector to provide a robust marketplace for cryptoassets through their interest in this space. However, the BCBS’ current proposals will likely prevent these firms from providing additional stability to a market that regulators remain concerned about. We suggest that the BCBS should reconsider the most punitive points of their framework to allow for greater financial services inclusion in the digital assets market.

A flexible framework to effectively capture cryptoassets as the market moves forward

UK Finance believe whatever additional risk profile the Basel requirements end up documenting for Group 2 cryptoassets, they should be regarded as an initial and temporary measure that will equalise

over time to match the treatment of risk profiles of other assets. Accordingly, the BCBS publishing a formal timeline for reviewing the framework and its calibration would be most helpful in allowing these assets to gather the required data to measure against. Assets should be categorised based on data gathered on their market risk, not based on prejudicial concern that one type of asset is inherently more at risk than other assets.

Detailed concerns

There are several sections of the consultation that UK Finance believe need to be improved or require review by the BCBS. These are set out below, in order of importance.

1. Cryptoasset definition

Under para 60.1, cryptoassets are defined as private digital assets that depend on cryptography and distributed ledger or similar technology. Digital assets are a digital representation of value, which can be used for payment or investment purposes or to access a good or service.

We have concerns that the current definition of cryptoassets used may unintentionally capture certain assets that do not have all the characteristics of a cryptoasset. The material effect of this, could have unintended consequences for the financial services industry.

An unintended consequence here is that tokenised expressions of traditional assets and some assets that should be considered traditional could be unnecessarily forced to attract higher capital requirements that should be associated with pure cryptoassets. Therefore, the BCBS should be more explicit on what the framework does and does not cover.

The broad nature of the current definition can effectively capture traditional assets that may in the future be routinely tokenised to make use of emerging and robust technologies. New technologies provide great benefit to the efficiency of the financial ecosystem. At present it seems the framework will capture tokenised forms of traditional assets when the underlying asset has never previously been subject to such treatment. This does not follow the same risk, same treatment principle.

For example, a digital bond booked on distributed ledger technology (DLT) but where legal documentation is recorded outside of DLT would be deemed a cryptoasset under this definition, even though legal advice suggests that they are not.

2. Infrastructure add-on

Under para 60.57, BCBS propose an equivalent 2.5% of RWAs add-on for Group 1 cryptoassets to reflect risks associated with distributed ledger technologies (DLTs). UK Finance is of the view that the add-on is unwarranted. Including an infrastructure add-on may have unintended consequences leading to banks simply using traditional assets and technology. This would stifle innovation and economic potential.

UK Finance appreciates that DLT may be considered by some as a new technology, however this is not the case, and it does not necessarily follow that there is an increase in risks associated with Group 1 cryptoassets that rely on a DLT.

Blockchain has demonstrated, over the last 14 years, to retain integrity and its use is now well documented. UK Finance is of the view that blockchain, as an instance of a DLT, are an extension

of modern cryptography and IT processes within the context of the increasing digitisation of financial services. UK Finance is of the view that blockchain technologies are digital systems for record keeping purposes and adoption of this technology can even mitigate operational and security risks. Introducing capital requirements due to a technology infrastructure is unprecedented and has not place as a market or credit risk.

There will always be some degree of security risk on all digital systems and there exist suitable safeguards equivalent to other technology platforms. Accordingly, UK Finance is of the view, where records are kept both on- and off-chain, the use of DLTs should be excluded from the infrastructure add-on. If there are specific risks on the technology, this should be dealt with under operational risk, notably under Pillar 2.

Should BCBS continue with an infrastructure risk add-on, UK Finance believe this should not be the same across single firm DLT implementations versus open source/open standard and collaborative DLT networks. There are differing infrastructure and operational risks between permissioned and permissionless blockchains. We acknowledge that permissionless blockchains carry additional infrastructure risk compared with permissioned. Therefore, UK Finance believes classification criteria relating to this matter should consider different types of blockchain platforms if the infrastructure add-on is unfortunately pursued.

UK Finance is of the understanding that sovereign and central bank issued stablecoins will not be under that same treatment of an infrastructure add-on as commercial banks. For commercial banks to be subject to higher costs (than central banks) when the add-on is applied for the same technology used, would cause commercial banks to be economically uncompetitive when issuing cryptoassets associated with DLT.

Overall, as Group 1b stablecoins will be subject to strict testing conditions, and under internal supervision from within each respective institution, it unnecessary and unfair for commercial banks to be subject to higher costs through the Basel Committee suggesting that assets on a DLT infrastructure are automatically riskier.

3. Group 1b classification of stablecoins

UK Finance feels there should be more flexibility provided to banks and other financial institutions. Banks and other financial institutions that are currently prudentially regulated are subject to requirements that support financial strength and effective financial risk management. Therefore, stablecoins issued by such organisations should be granted more flexibility when considering the classification under the BCBS framework.

Group 1b inclusion requires basis risk and redemption tests. There is a suggestion from the BCBS that this may be replaced with a condition on whether the issuer is prudentially regulated. To provide greater flexibility to financial services firms, we believe the first condition should encompass both and be fulfilled if one of the following is satisfied:

- The issuer is regulated (and not in resolution) and subject to prudential capital and liquidity requirements
- OR the issuer is not subject to prudential capital and liquidity requirements and the basis/redemption tests are satisfied

4. Basis risk test

To avoid cliff edges, especially in times of general market stress, we recommend that the basis test in paragraph 60.14 carries out tests over periodic time frames (e.g., 3, 6 and 12 months) that are each separately calibrated and set the criteria to meeting X of Y (e.g. 2 of 3) of the individual tests. This would be an improvement to having a basis risk test of the stablecoin value over a 12-month period. This would provide more stability and the more frequent testing would better address issues with temporary periods of volatility.

We welcome the BCBS alternative to the basis risk test in paragraph 60.17. However, more clarity would be appreciated to better understand who the supervised and regulated entities would be.

5. Group 1a tokenised assets classification conditions

Under para 60.10(2), tokenised traditional assets do not meet the classification conditions to be eligible to be treated as Group 1a if, through their specific construction, they involve additional counterparty credit risks (CCR) relative to traditional assets.

We would welcome clarity on possible circumstances that this condition would invalidate a tokenised traditional asset from being categorised as Group 1a. We are concerned that incremental counterparty credit risk, that could be simply capitalised under the existing prudential framework could result in a highly punitive treatment of a tokenised traditional asset exposure through having to categorise the whole exposure as Group 2.

In the same way that under the existing prudential framework, a structured transaction may be capitalised through consideration of its more vanilla components, depending on its accounting treatment, and considering the “same risk, same treatment” philosophy that BCBS is adopting, we urge BCBS to apply a proportionate prudential treatment in cases where it is possible to apply prudential standards to component parts rather than defaulting to a punitive treatment for the entire exposure.

Notwithstanding that further clarity may be required on the accounting treatment of cryptoasset exposures, at a minimum, where a tokenised traditional asset that would otherwise be categorised as Group 1a but has incremental counterparty credit risk, is accounted for such that the component giving rise to the incremental counterparty credit risk is accounted for separately, then the prudential treatment should follow the accounting treatment.

6. Group 1a tokenised assets – basis points

Members suggest that positions in the traditional and digitized forms of a traditional asset, in the presence of a significant price basis point, should be treated as positions in distinct instruments. However, the capital treatment should remain unchanged. The CCR could therefore still follow internal model methods (IMM) or traditional standardised treatments.

Issuers of Group 1a tokenised assets would lose some position netting, but still have the possibility to have exposure netting and avoid opposing exposures being split between different treatments. The capital treatment should not change because the asset class of the instrument is still the same; it would be useful to therefore consider an additional risk factor to be introduced into the price and the liquidity of the trade or the collateral needed may come under different requirements. This is already handled by the existing CCR framework, therefore would be reflective of same risk, same principles thought process.

We believe it would be helpful to explore the possibility where an additional CCR could be covered by the Pillar 1 or Pillar 2A framework rather than the tokenised asset being placed into Group 2.

7. HQLA eligibility

We believe that the current approach to Group 1b cryptoassets (the more robust stablecoins) is punitive and may hinder flexibility for access into the cryptoassets market in the future. Accordingly, we urge the BCBS to consider introducing specific conditions under which Group 1b cryptoassets can be counted towards HQLA given the redeemable qualities a stablecoin could potentially offer.

Banks should have the option to look through to the underlying HQLA asset and treat the exposure as HQLA eligible (with appropriate haircuts based on the nature of the underlying HQLA eligible asset). To deny HQLA eligibility in such instances is overly punitive and runs contrary to the principle of “same risk, same activity, same treatment”.

In addition, under the proposal a bank holding another bank’s stablecoin will result in a NSFR RSF factor of 85%. This is extremely punitive for a relatively stable asset and will result in broader market impacts such as dis-incentivising market making activities.

8. Scope of framework: custody assets

Members would like more clarity from the BCBS on how the prudential framework should apply to cryptoassets in custody where exposures are required to be recognised through accounting treatment of certain jurisdictions. In particular, in the US, recent guidance means that cryptoassets held in custody may be accounted for as an asset and liability unlike the normal accounting of assets held in custody.

At present, UK Finance is of the view that the current accounting treatment for crypto asset custody in the US would only affect US GAAP and SEC filings and would not affect formal IFRS statements (other than requiring amendments for SEC filing). Therefore, it would not affect capital and liquidity requirements for non-US banks following IFRS other than for an Intermediate Holding Company of those Foreign Banking Organisations, which would be regulated in the US. However, more clarity is needed on the future consequences of this as accounting issues may arise should the US adopt this framework regardless of the direction other accounting standards or jurisdictions may take.

9. Group 2 exposure limit

The Group 2 exposure limit, as proposed, would disincentivise banks from providing Group 2 cryptoassets services for clients and effectively prohibit even the very small amounts of activity that occur today in relation to securities and derivatives with cryptoasset price risk.

UK Finance would like to highlight the role of banks in facilitating and intermediating client activity that does not entail the banks taking price risk on cryptoassets. Thus, we propose such activity should be excluded from the Group 2 exposure limit. This would enable banks to provide traditional financial services for their clients.

Such services include custody and client clearing, as well as cash prime brokerage and securities financing transactions (SFTs). Along with custody and clearing, prime brokerage is an essential service for liquidity providers who hold positions with their prime brokers on which they provide

secondary liquidity including, for example, exchange traded funds (ETFs) with crypto price risk. Without banks providing margin financing and other prime brokerage services, these liquidity providers would not be able to participate and secondary market liquidity in such crypto ETFs would dry up. Further to this, clients also use prime brokerage services to hold positions in funds or ETFs where the other side of their risk is in a cleared product such as futures.

We suggest, therefore, that both clearing and prime brokerage be out of the scope of the Group 2 exposure limit. Both should receive the same treatment to enable the provision of complete services to clients. This would reinforce the same risk, same treatment principle.

A gross limit is unmanageable because banks cannot manage their exposure without forced selling and a limit defined based on the maximum of the total long or short positions would still impede proper risk management by banks. For example, unless excluded from scope, a gross limit would effectively prohibit provision of delta-flat on-balance-sheet intermediation by banks. This would include activity such as synthetic prime brokerage and delta-one derivative financing. These business models can support the provision of regulated investment products by regulated investment managers that are required to face banks rather than crypto native firms. This activity is designed to be delta flat for banks, who earn a spread, with hedges executed back-to-back and no risk taking on the back of the activity.

A net limit applied to all activity with price risk for the bank would be an effective framework to require banks to ensure all market making activity is hedged with little or no residual risk. We therefore encourage the BCBS to consider setting the exposure limit on a net basis calibrated in line with the scope and the definition of the exposure measure. UK Finance believe this would ensure adequate capitalisation and transparency while not undermining the economic viability for banks to provide cryptoasset service to their clients.

A breach of the limit should not incur an immediate capital penalty. As with many other types of limits, it should require immediate notification to supervisors with an explanation of the cause of the breach and a remediation plan which is discussed and agreed to bring the bank back into compliance.

Gross exposure should be disclosed to supervisors. Risks such as break down in hedges and concentration of cryptoassets as collateral within and across counterparties should be managed through existing supervisory processes including stress testing of this specific asset class.

10. Group 2a market risk

We support the Joint Associations proposals for a lower risk weight and higher correlation parameters for Group 2a, particularly for the maturity dimension and also the exchange dimension of the FRTB standardised approach. In addition, a specific correlation parameter and lower risk weight for certain cryptoassets that would currently fall under Group 2a, based on available risk data, for example, Bitcoin and Ether, could be defined by providing these cryptoassets with specifically named buckets (without presuming they qualify for Group 2a).

In terms of the risk factor dimensions for the FRTB standardised approach, we believe it is essential to remove the maturity dimension from the delta risk factors at least for equity-listed products with crypto price risk such as ETFs/ETNs and derivatives on these instruments. This would align with the equity risk class treatment of such activity. We think it is also essential the exchange dimension is modified to be defined as “exchange/market or reference rate/instrument”. For example, this dimension for an NDF or future would be the reference rate while this dimension for a swap on an

ETF would be the instrument. Furthermore, all direct holdings of a cryptoasset for which execution is not tied to a specific exchange or market, and for which execution services are available that meet the criteria in that jurisdiction for best execution should be assigned to the same delta risk factor.

11. Counterparty credit risk

For clarify and confirmation, we believe paragraph 60.98 should state banks should apply the comprehensive approach to cash prime brokerage/margin lending as well as SFTs.

12. Redemption Test

Para 60.13 sets out the redemption risk test that must be satisfied to enable a stablecoin to be classified as Group 1b and para 60.13(2)(a) refers to a legally enforceable objective to ensure that cryptoassets can be redeemed promptly at the peg value, including under periods of extreme stress.

The lack of a formal and specific legal objective regarding may not preclude a stablecoin structure having a sufficiently liquid portfolio of reserve assets to facilitate prompt redemption of stablecoins, even under extreme stress. Conversely, having a legally enforceable objective may not be sufficient to ensure appropriate liquidity of reserve assets.

We are concerned that the proposed condition associated with reserve asset liquidity may not appropriately measure the liquidity of reserve assets for the purpose of classification conditions which may result in inappropriate prudential treatment being applied to certain stablecoins. We therefore recommend that BCBS consider whether an alternative approach to assessing stablecoin reserve asset liquidity should be included in the redemption test.

13. Synthetic CBDCs

Synthetic CBDCs are hybrid of central bank digital currencies (CBDCs) and stablecoins issued by private organisations, being privately issued but backed by a central bank, for example through reserve assets of central bank reserves.

Under para 60.3, CBDCs are not covered by the proposed framework. We ask BCBS to clarify under this paragraph whether this extends to synthetic CBDCs or whether such cryptoassets fall within the scope of the proposed framework.

14. Banking/trading book boundary

Under para 60.28, for Group 1 and Group 2a cryptoassets, the determination of banking book or trading book is made in relation to the reference asset(s) or non-tokenised equivalent. Further clarity is required on how this would work in practice, since trading intent, a key test of the determination, can only be done in reference to the cryptoasset.

If you have any questions relating to this response, please contact William Lee, Analyst [will.lee@ukfinance.org.uk].

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