Vontobel



# Vontobel comments on BCBS Consultative Document on prudential treatment of crypto asset exposures

September 10, 2021

Vontobel appreciates the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) consultation on a preliminary proposal of the prudential treatment for crypto assets, published on June 10th, 2021. Considering the continued growth of the crypto markets and a maturing of the industry it is important that any regulatory response is built in close collaboration with all stakeholders.

## 1. General remarks

Generally, Vontobel shares the view that while the market for crypto assets is still relatively small in relation to the size of the global financial system, and that prudentially regulated institutions' exposures to crypto assets are currently limited. However, it is significant in absolute terms, and it is significant in terms of technological innovation.

The current proposal provides a Risk Weighted Assets ("RWA") weighting that cannot be objectively justified compared to other asset categories. Furthermore, hedging transactions are not considered or rewarded in any way within the framework of the planned regulation. Moreover, derivatives on cryptocurrencies and cryptocurrencies themselves are treated equally within the framework of what we consider to be an overly simplistic approach.

The proposed RWA charges are so high that an exposure to cryptocurrencies would not be economically justifiable for a prudentially regulated institution. We are therefore of the opinion that the proposed regulation is too conservative and can lead to unintended consequences.

We believe that both prudentially regulated institutions and supervisory authorities have both a duty with respect to the financial well-being of an economy. The proposed RWA will result in the crypto business being pushed into the unregulated sector because such industry participants would have a factual unjustifiable competitive advantage over prudentially regulated institutions. We are of the opinion that the crypto sector will continue to grow, hence significant risks for the broader population (especially young investors), and systemic risks would build up outside the regulated area.

Sensible regulation of the specific activities, allowing prudentially regulated institutions to continue to play a vital role in this market is something we would welcome. In this case, prudentially supervised institutions could contribute to stabilize this market and gain further experience and knowledge in this potentially disruptive technology.

## 2. Comments in detail

| *Q1. What are your views on the Committee's general principles?* |
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We agree with and highlight the importance of the principle "**Same risk, same activity, same treatment**" so that the concept of "**technology neutrality**" is the ultimate starting point for the prudential framework. This already incorporates that additional risks of crypto assets needing proper consideration. It is important to clearly verify in each unique situation whether is an additional risk associated in fact, e.g. custody risk in relation to the specific crypto asset related underlying.

**Simplicity** is a favorable principle in general. However, **overemphasizing** this principle will result in a disadvantage for the new asset class. A later revisit will take too long given the fast development of the crypto asset markets observable in the past and continuing in the future.

**Minimum standards** are a prudent approach in general but may lead to regulatory arbitrage. Given the borderless activities and availabilities of crypto assets, we believe that in this case an alignment of standards would be more appropriate.

*Q2. What are your views on the Committee's approach to classify crypto assets through a set of classification conditions? Do you think these conditions and the resulting categories of crypto assets (Group 1a, 1b and 2) are appropriate? Which existing crypto assets would likely meet the Group 1 classification conditions?*

The introduction of the proposed set of classification conditions distracts the focus from the very important general principle "same risk, same activity, same treatment". Hence, we believe a set of criteria should be developed to identify activities which are entirely new and pose additional risks. Regulation should focus on regulating specific activities which pose higher risk, rather than regulating institutions, which introduces further market distortions.

In our view, which is driven by the structured products business we offer, the only significant new factor and risk that (some) crypto assets pose is additional operational risk, for example the loss of private keys, cyber theft etc. We are of the opinion, that this outcome is covered by the current capital regime, if appropriate risk mitigation measures are taken. Hence, proper operational risk charge could be considered, but market risk should not be affected. We do not think that a risk multiplier of 1250% is justified.

Moreover, the stabilization mechanisms can and should be handled under the current framework. We think that charges for underlying risk **AND** counterparty risk in category 1 are not technology neutral.

*Q3. What are your views on the classification conditions? Are there any elements of these conditions that should be added, clarified or removed in order to:*
- *ensure full transferability, settlement finality, and/or redeemability.*
- *limit regulatory arbitrage, cliff effects and market fragmentation; and*
- *take account of new and emerging crypto assets?*

*Q4. For the first classification condition, is there an alternative methodology to assess the effectiveness of the stabilization mechanism of Group 1b crypto assets? Would this proposed methodology be consistent with ensuring the effectiveness of the stabilization mechanism while also being practical?*

*Q5. For the third classification condition, (i) would risk governance and risk control practices for Group 1 and Group 2 crypto assets differ; and (ii) are there alternatives to the required risk governance and risk control practices that would ensure that material risks of the network are sufficiently mitigated and managed?*

*Q6. For the fourth classification condition, (i) to what extent would the regulation and supervision of entities that execute redemptions, transfers, or settlement finality of the crypto asset reduce risk in crypto asset exposures held by banks; (ii) which entities should/ should not be in scope of regulation or supervision? For instance, are there entities involved in the transfer and settlement systems of crypto assets (such as nodes, operators and/or validators) that should be excluded from the condition of required regulation and supervision?*

*Q7. Do you consider the responsibilities of banks and supervisors to be clear and appropriate? Are there any other responsibilities for banks or supervisors that the Committee should consider?*

*Q8. Are there ways in which the increased operational risk relating to crypto assets (relative to traditional assets) can be measured? How should a pillar 1 add-on be designed to capture additional operational risks arising from exposures to crypto assets?*

*Q9. Are there further aspects of the credit risk and market risk requirements that could benefit from additional guidance on how they should apply to Group 1a crypto assets?*

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

*Q11. What further aspects of the credit risk and market risk requirements could benefit from additional guidance on how they should apply to Group 1b crypto assets?*

*Q12. Do you think the proposed capital treatment of Group 2 crypto assets, including the application of a 1250% risk weight instead of deducting the asset from capital (for the reasons explained above), appropriately reflects the unique risks inherent in these assets?*

As mentioned above, we question the proposed classification and we believe that the proposed application of a 1250% risk weight is far too conservative, considering the maturity and relevance of the market.

To define an adequate risk weighting, the following points should be considered:

1. *Netting should be considered*
   In our opinion and in line with our risk management procedures we cannot understand that all positions shall be treated equally. If a product with underlying crypto is issued and sold on the market and the originated risk position is fully hedged with the very same underlying, we do not understand the economic rationale to set the risk weight equal to an unhedged position. As a result, the proposed regulation implies that hedging transactions are not useful or are useless.
2. *Verified crypto asset storage capabilities should be considered*
   If a storage capability is externally reviewed by experts, fully audited by internal and external audit, operated by a fully regulated entity and no major findings are unaddressed, this must be taken into consideration when it comes to calculate RWA based on operational risks as mentioned earlier. Also, we believe that using the worst case (i.e. all crypto assets lost) is not a feasible approach to calculate RWA.
3. *Futures and Exchange Traded Products (ETPs) on crypto assets should be treated equivalent to Futures and ETPs on other underlying assets*
   The usage of exchange traded assets, especially Futures (Bitcoin Future or Ether Future traded at CME), or also ETPs listed at SIX with crypto assets underlying the value of the instrument should be treated equally to traditional assets traded on such venues from a risk weight perspective, since the risks are equivalent.

*Q13. Are there alternative approaches that the Committee should consider that are simple, conservative and easy to implement? For exposures in the trading book, would it be appropriate to permit recognition of hedging via the application of a modified version of the standardized approach to market risk?*

The non-inclusion of hedging transactions cannot be understood. For example, if an ETP is issued on a Bitcoin and exactly one Bitcoin is bought as a hedge, this should be balance sheet neutral from a market risk perspective. We therefore believe that hedge recognition must be a core element in determining the risk to a balance sheet of a prudentially supervised institution.

*Q14. Do you have any views on the Committee's current thinking regarding the leverage ratio, large exposures framework and liquidity ratio requirements? Are there further aspects of these requirements that could benefit from additional guidance?*

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

*Q16. Do you have any views on the responsibilities of supervisors? Are there any other responses that could be considered by supervisors when conducting supervisory review?*

*Q17. Do you have any views on the adjustments to minimum Pillar 1 capital requirements to capture additional credit and/or market risk? Are there any other potential modifications that supervisors may need to consider?*

*Q18. Do you have any views on the potential design of disclosure requirements?*

A disclosure requirement for these new, unique operational risks might be considered.