Comments to second consultation on the prudential treatment of cryptoasset exposures

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Vontobel is a globally active investment firm with Swiss roots, specialized in wealth management, active asset management and investment solutions. Vontobel began in 2016 with the launch of the first tracker certificate linked to Bitcoin, followed by other cryptoasset underliers, as well as cryptoasset linked notes with leveraged and asymmetric structures. In 2019, Vontobel issued a security token, a traditional structured product launched in the form of a smart contract on Ethereum blockchain.

Vontobel welcomes the efforts undertaken by the Basel Committee on Banking Supervision´s (BCBS) to address the issues raised by us and other respondents with regards to the initial proposals in 2021. Hence, we welcome the opportunity to participate in the BCBS´s second consultation, too.

1. General remarks

The events of the past few months in the cryptoasset industry around the globe bring back memories of times long past in the traditional financial industry. Lessons were learned from mistakes, and appropriate regulation was coordinated and established internationally. To avoid repeating the same mistakes again in the crypto world and harming thousands of investors, this industry should urgently be subjected to the same rules as the traditional financial industry.

On the other hand, this means that banks – as trusted institutions – must not be completely shielded from this industry. The source of concern about cryptoassets is the lack of regulation – so banks in particular are part of the solution. If they are kept out, a young technology cannot get off the ground. We strongly believe that it is possible for banks to participate responsibly in this industry, taking sufficient account of legitimate concerns and, on the other hand, giving the technology room to develop and grow.

Therefore, it is of utmost important to stick to the three basic principles:

– “Same risk, same activity, same treatment”,
– Simplicity,
– Minimum standards,

In our opinion the current proposals do pay to little attention to these principles. Instead, we argue to limit additional and new regulation only to those issues which are really new with cryptoassets – those are rather few.

The only new thing on cryptoassets is that public blockchains like Bitcoin and Ethereum does not have a central coordinator or controller, that would allow for corrections in case of theft, fraud, technical defaults, etc. Volatility and strong influence of public media and news is not specific to cryptoassets, but does occur with other asset classes, namely equities, too.
Hence, we think that this single particularity of cryptoassets – irretrievability in case of theft, fraud, etc. – brings the previous definition and delimitation of operational, credit and market risk frameworks to its limits.

This – and only this – **new issue** should be addressed by **new regulation**.

We propose to amend the Large Exposure Rules or apply them accordingly within the Operational Risk framework to limit a banks exposure to such public, uncontrollable blockchains. We further recommend to the Committee to **follow a technology neutral approach** and let regulators and banks apply existing frameworks to the new technology.

All other DLTs and associated issues can perfectly be handled by the existing framework, business continuity management procedures, etc. It does not matter whether an asset is securitized, registered in an electronic database, or tokenized. Principles can all be applied equally.

Despite us arguing for a complete overhaul of the proposals, we would like to comment on specific items of the current proposals.

2. Infrastructure risk add-on

The reasoning of "various unforeseen risks" is contradictory to the concept of "technology neutrality" as established in BCBS' 1st consultative paper. Unforeseeable risks may only stem from the fact, that DLT and similar technology may have no correction functions to e.g., account for mis-trade, fraud, theft etc. But if there are such mechanisms and reliable, trustful organizations and processes available, there is no difference to technology used in traditional assets.

Due to the multitude of technologies available, also within DLT sector itself, a general risk add-on would hence contradict the first basic principle. It is only a new technology, nothing more. If there are risks not capable to mitigate by proper Business Continuity Management, then such operational risks shall be backed with capital in accordance with applicable rules.

3. Definition of exposure

SCO60.4 defines the term "exposure" including on- or off-balance sheet amounts that give rise to credit, market, operational and liquidity risks. The next sentence further mentions non-fiduciary custodial services, that may only give rise to operational risk.

Prudential supervision requires clear standards. The introduction of such broad unclear definition, including custodial services, is rather surprising and confusing. It also does not follow the general principles mentioned above. Instead, it has broad, unforeseeable consequences. For example, no bank seems to be able to offer custody services anymore when read together with the Group 2 exposure limit.
We therefore ask the Committee to clarify this, at least regarding custodial services mentioned in SCO60.4 and as well as "indirect holding (i.e., those via investment funds, ETF/ETN, special purpose vehicles)" mentioned in SCO 60.121.

4. Group 2a hedging recognition criteria

We believe that the proposed criteria are overly complex.

Regarding the qualification criteria in SCO60.60 (1) we do not understand why a regulatory approval, consent or other involvement with the admission of an ETF, ETN or derivative shall provide support for hedging eligibility at all. Further, the wording in (a) "trading on a regulated exchange is sufficient" vs. (b) requiring "explicit approval by a jurisdiction's markets regulators" is inconsistent. Regarding (d) we'd like to add that only reference rates by regulated benchmark providers should be acceptable; or by such other providers subject to similar regulation like IOSCO's Principles for Financial Benchmarks.
Overall, we recommend deleting this section completely.

With regard to the liquidity criteria in SCO60.60 (2): we think that the criteria are unnecessarily restrictive. Comparing them with capitalization and trading volumes of many equities around the globe, we can't comprehend these restrictive values. Factually, this limits the scope of the hedging recognition to few existing, dominating cryptoassets only. New developments will suffer as a result and have less chance of gaining acceptance. One should be conscious of such consequences when stipulating such restrictions.

Further, we would like to highlight, that data to fulfil the requirement in (b) "trading volume with major fiat currencies" is not readily available. Reliable data is only available for the trading volume of a cryptoasset in general, not against specific currencies. This requirement may have the unintended consequence that even cryptoassets like Bitcoin and Ether do not fulfil this criterion.

When set against the liquidity criteria mentioned above, we are convinced that there is not need for the criteria stipulated in SCO60.60 (3). Consequently, the hedging recognition criteria can be concentrated, limited, and simplified to the liquidity criteria only.

5. Market risk rules

Our introductory remark already made clear that the existing rules are – in our opinion – capable of dealing with risks associated with cryptoassets in general and broadly. We do argue alike in particular regarding market risk.

The very conservative proposals in 60.71-60.78 for all Group 2a assets despite their high capitalization and liquidity requirements as proposed will effectively impede any bank to offer non-linear products (e.g., reverse convertibles or warrants) due to the high capital charge.

From our experience with linear and non-linear products linked to Bitcoin and Ether which Vontobel has been offered since 2016, we have learnt that risk weights and methodology for equities or FX are perfectly capable and reasonable to deal with cryptoasset associated market risk.

We therefore propose to align market rules to existing frameworks for equities which provide for risk weight determination based on a set of factors. This would be a very prudent approach because it allows to consider the particularity of each cryptoasset, such as market cap, etc., when determining the weight.

6. Operational risk clarifications

We recommend switching the order of sections in 60.127. [The bank should have a sound … of these risks] could be the start, then continue in the proposed order and close with [Particular attention should be paid to the assessment …]. This would enhance comprehensibility.

We propose to further elaborate on SCO60.128 which is rather unclear. Supervisory authority reporting requires clear standards and expectations and needs which should be formulated more detailed.

Regarding SCO60.131 we do think that it does not add new elements to the supervisory process which would not exist already under the current supervisory framework.

7. Group 2 exposure limit

Unfortunately, the second consultation paper hardly provides reasons for many of the proposals and why they deviate from existing principles. This is the case regarding the proposed exposure limit.

A general limit to Group 2 exposures would constitute a step back after the introduction of the hedging recognition in for Group 2a assets. Hence, we propose to refrain from such limit at all or at least to limit that proposal to Group 2b assets.

7.1. Large exposure rules

We do not agree that the large exposure rules of the Basel Framework would not be capable of dealing with Group 2 exposures.

Volatility, liquidity, and almost all risks associated with Group 2 assets can be dealt perfectly with existing rules of the Basle Framework. The only new and specific risk is caused by the permissionless blockchains, that there is no gatekeeper, no single responsible or controlling person; actually, there is no counterparty against whom one could assert one's rights.

Instead of introducing a new concept, we endorse to develop the existing concept of Large Exposure Rules further, by amending it with concentration restrictions – per cryptoasset. The “default” (theft or loss of private key) of a cryptoasset is 100% comparable with the default of a counterparty, leading to a loss of 100%.

Cryptoassets using the same blockchain may be grouped into one bucket (i.e., form a group of connected “counterparties”), in order to adequately take into account, the common technical platform and thus also the dependency between each other.

7.2. Limit of 1% of Tier 1 capital

The proposed limitation of 1% represents a factual deprivation of entrepreneurial freedom. Such limit de facto prevents business activity and discriminates against smaller institutions. Instead, one would have expected such tight limits only for systemically relevant banks instead of lumping everyone together.

Given the high limits large exposure rules provide for single counterparty exposures – for instance regarding hedge funds as counterparties – which makes the proposal even more incomprehensible.

The introduction of a provisional limit with periodic review does effectively hit existing business models and is not suitable to introduce banks slowly to the subject of cryptoassets and let them learn carefully. The proposal does not provide reasons for the limit in general or for the 1%. For this reason, it is unclear what the periodic review will look like and what specifically it will review.

We strongly argue to stick to existing concepts and emphasis the general principles of the 1st consultative paper, instead of creating completely new concepts without need. If such limit shall still be introduced, we propose to apply such only to Group 2b assets, allowing banks to still participate in a business that needs regulated players urgently.