Prudential treatment of cryptoasset exposures – Executive Summary

The rapid evolution of cryptoassets and their growing interaction with mainstream finance could raise financial stability concerns and accentuate the microprudential risks of banks. Although the cryptoasset market remains small relative to the size of the global financial system and banks' exposures to cryptoassets are currently limited, the market's absolute size is still meaningful. Moreover, certain cryptoassets have exhibited a high degree of volatility and may intensify risks for banks as exposures increase, including credit, market, liquidity and operational (including fraud and cyber) risks; money laundering/terrorist financing risks; and legal and reputation risks.

Against this backdrop, the Basel Committee on Banking Supervision (BCBS) finalised its standard on the prudential treatment of cryptoasset exposures in December 2022. The standard outlines minimum regulatory, supervisory review and disclosure requirements of banks' cryptoasset exposures under Pillars 1, 2 and 3 of the Basel Framework. Internationally active banks in BCBS member jurisdictions are expected to adopt the standard by 1 January 2025.

Cryptoasset classification

Cryptoassets are a type of private sector digital asset that depends primarily on cryptography and distributed ledger or similar technology. Such assets are a digital representation of value that can be used for payment or investment purposes or to access a good or service. There are a range of different types of cryptoassets, and their underlying risks vary based on their characteristics. Accordingly, the prudential treatment of a bank's cryptoasset exposures varies according to the prudential classification of the cryptoassets. To determine this classification, cryptoassets must be reviewed regularly and categorised into two broad groups, initially by banks but subject to supervisory review. These groupings, as noted below, are used as the basis to apply the Basel Framework to banks' cryptoasset holdings:

- *Group 1 cryptoassets* include tokenised traditional assets (Group 1a) and cryptoassets with effective stabilisation mechanisms (Group 1b). To qualify, all Group 1 cryptoassets must meet the full set of classification conditions as specified in sections SCO 60.8–19 of the standard. These conditions include a redemption risk test for cryptoassets with a stabilisation mechanism (ie stablecoins). This is to ensure that the reserve assets are sufficient to enable the cryptoassets to be redeemable at all times for the peg value, including during periods of extreme stress. Furthermore, only stablecoins issued by supervised and regulated entities are eligible for inclusion in Group 1b.
- *Group 2 cryptoassets* include all unbacked cryptoassets and tokenised traditional assets and stablecoins that fail to meet any of the Group 1 classification conditions. Cryptoassets that meet hedging recognition criteria[1] (as specified in SCO 60.55 of the standard) are allocated to Group 2a and receive limited hedge recognition. Others are allocated to Group 2b where hedging is not recognised.

[1] The criteria include various thresholds relating to market capitalisation, trading volume and price observations.

Cryptoassets and application of the Basel Framework

The tables below summarise the applicability of Pillars 1, 2 and 3 of the Basel Framework to cryptoassets.

<table>
<tr><th>Pillar 1 requirements</th><th>Group 1 cryptoassets</th><th>Group 2 cryptoassets</th></tr>
<tr><td>Risk-based capital (RBC) – credit and market risk</td><td>• Capital requirements based on the risk weights (RWs) of underlying exposures as noted in the Basel Framework.
• Subject to add-on RWs to cover infrastructure risk (initially set at zero) based on supervisory review of weaknesses in the infrastructure on which cryptoassets are based.</td><td>• Subject to more stringent capital requirements than Group 1 cryptoassets.
• Group 2a: subject to 100% capital charge (equivalent to a RW of 1,250%), with some hedging recognition.
• Group 2b: subject to a RW of 1,250%, with no hedging recognition.</td></tr>
<tr><td>RBC – operational risk</td><td colspan="2">• Standardised approach applied as set out in the existing Basel Framework (OPE 25).</td></tr>
<tr><td>Liquidity standards – Liquidity Coverage Ratio and Net Stable Funding Ratio</td><td colspan="2">• Generally follows a treatment consistent with current methods for traditional exposures with economically equivalent risks. Refer to SCO 60.101–112 for details.
• Group 1a: tokenised versions of high-quality liquid assets (HQLA) may be considered HQLA only if both the underlying assets and the tokenised form meet HQLA requirements in the Basel Framework.
• Group 1b and Group 2: cannot be considered HQLA.</td></tr>
<tr><td>Leverage ratio</td><td colspan="2">• Included in the exposure measure according to their value for financial reporting purposes, based on accounting treatment for exposures with similar characteristics.</td></tr>
<tr><td rowspan="2">Large exposures</td><td colspan="2">• Generally follows the same principles as other exposures set out in the large exposures standard with a difference regarding limits on maximum exposures for Group 2.</td></tr>
<tr><td>• Group 1 subject to same exposure limits as in the large exposures standard.</td><td></td></tr>
<tr><td>Asset class limit</td><td></td><td>• Group 2 subject to exposure limit of 2% of Tier 1 capital but should not generally be higher than 1% of banks' Tier 1 capital. Any breach of the 1% limit must be communicated to the supervisor and rapidly rectified.</td></tr>
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<tr><th colspan="2">Pillars 2 and 3</th><th>Considerations</th></tr>
<tr><td rowspan="2">Pillar 2</td><td>Bank responsibilities</td><td>• Banks with direct or indirect exposures or that provide related services to any form of cryptoasset must establish policies and procedures to identify, assess and mitigate risks related to cryptoassets or related activities on an ongoing basis.
• Risk management of cryptoasset activities must consider cryptoasset technology risk; general information, communication and technology and cyber risk; legal risks; money laundering and financing of terrorism risks; and valuation.</td></tr>
<tr><td>Supervisor responsibilities</td><td>• Supervisors need to review the appropriateness of banks' policies and procedures for identifying and assessing risks related to their cryptoasset activities and require banks to address any identified deficiencies.
• Supervisory actions, depending on the nature of the identified deficiencies, may include imposing additional capital requirements, requiring provisions for losses related to cryptoassets or imposing other mitigation measures, such as requiring the bank to establish internal limits.</td></tr>
<tr><td colspan="2">Pillar 3 – disclosures</td><td>• Banks must disclose information regarding any material Group 1a, 1b, 2a and 2b cryptoasset exposures on a regular basis (as specified in SCO 60.129), including information on: (i) the direct and indirect exposure amounts (including the gross long and short components of net exposures); (ii) the capital requirements; and (iii) the accounting classification.</td></tr>
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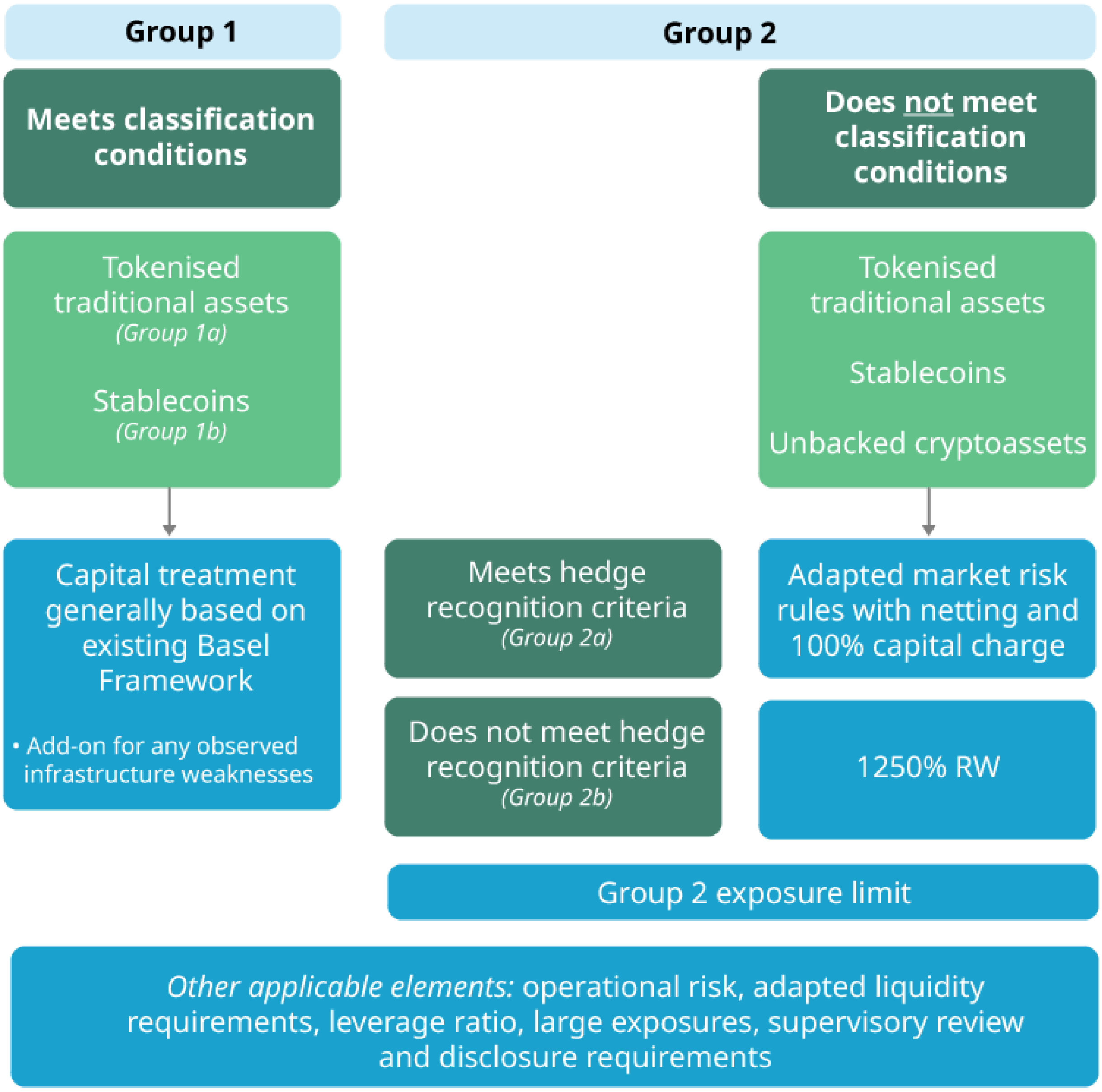
Cryptoassets standard – an illustration

The following diagram provides a high-level overview of the BCBS's cryptoasset prudential standard, including its application to Group 1 and Group 2 cryptoasset exposures.



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