POSITION PAPER

ESBG response to the Basel Committee consultation on the prudential treatment of cryptoasset exposures

ESBG (European Savings and Retail Banking Group)

Rue Marie-Thérèse, 11 - B-1000 Brussels

ESBG Transparency Register ID: 8765978796-80

September 2021

ESBG

Dear Sir/Madam,

Thank you for the opportunity to comment on the Basel Committee on Banking Supervision (BCBS) public consultation on its preliminary proposals for the prudential treatment of banks' crypto asset exposures. We would like to share with you the following reflections that we hope will be considered by the BCBS.

Consultation questions:

Question 1: What are your views on the Committee's general principles?

ESBG supports the development of a framework for the prudential treatment of crypto assets and general principles to address the prudential treatment of crypto assets. However, we think that the approach could be further improved in some specific aspects while being a bit more risk-sensitive in others. For instance, as described below in the following questions, to use two very different categories (Group 1 and Group 2) may trigger cliff effects, therefore, it might be useful to explore the use of some subcategories to achieve a more granular approach according to risk-based considerations.

Question 2: 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 cryptoassets (Group 1a, 1b and 2) are appropriate? Which existing crypto assets would likely meet the Group 1 classification conditions?

We can understand the proposed categorization and its different regulatory treatments in principle. Crypto assets which are merely a digital form of a traditional asset and which grant the owners the same rights as conventional assets, should - as envisaged - be treated as conventional assets. We consider the necessary classification into groups 1a, 1b, and 2 to be correct in principle, even if group 2 should be further subdivided in our view, as the approach in group 2 is too conservative and not risk-sensitive. Also, to enrich the classifications of crypto assets, it might be useful to draw on existent taxonomies in place or that are being proposed by different jurisdictions (for example, in the EU taxonomies like the MiCa – Markets in Crypto assets regulation)"

In our view, it would not be appropriate in terms of the applicable prudential treatment to consider a stable coin that has a safe pool of assets but that falls into Group 2, for example, because of a value fluctuation of 11 basis points during the year instead of the allowed ten basis points, in the same way as a cryptocurrency without a collateral pool that an unknown company just founded. We assume that many stable coins do not meet the ten basis point maximum variation criterion.

This fact is especially actual as well since the condition attached to classification as a Group 1 asset of either tokenizing a traditional asset or using a stable coin quickly leads to the category as a Group 2 asset for new business models if the crypto relates to a new (traditional) asset class, even if the risks are not higher. Given the dynamic development of the market, we welcome that the Basel Committee is striving for continuous development of the regulations.

Question 3: 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?**

While ESBG considers a good approach to establish classification conditions to categorize the different types of crypto assets, we also believe that more information on the stability of the proposed conditions could be provided. In addition, due to the global, disaggregated and large number of the operating networks that currently exist, it might not always be possible for banks to get full complete data and review all the aspects required. Collaboration from global bodies and authorities might be necessary in this respect.

We would also encourage further research and guidance on the market criteria to be used as benchmarks.

To use two very different categories (Group 1 and Group 2) may trigger cliff effects. Using some sub-categories might be explored.

Furthermore, the capital treatment of Group 2 crypto assets should not be dependent on the applicable accounting framework. A risk-based capital requirements approach should be adopted based on the risks posed by the different exposures to crypto assets.

Question 4: For the first classification condition, is there an alternative methodology to assess the effectiveness of the stabilisation mechanism of Group 1b crypto assets? Would this proposed methodology be consistent with ensuring the effectiveness of the stabilisation mechanism while also being practical?

As stated in the previous response, further research would be useful to assess the actual stability that can be achieved with the stabilisation mechanisms being proposed by crypto assets in this group. It would be good to provide empirical evidence on how the pool of backing assets behaves in normal and stress times.

Question 5: 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?

The risk control mechanisms are likely to differ for Group 1 and Group 2 crypto assets. Finally, for Group 1, it must be ensured that there is a legal link between the underlying asset and the token. For a Group 2 crypto asset, such as Bitcoin, this aspect is omitted.

Question 6: 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?

N.A.

Question 7: 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?

Regulators and supervisors may want to coordinate and publish their initial assessments of the conditions for a broad range of crypto assets. That would help to reduce possible gaps in the analyses and contribute to a more level playing field at the global level. It would avoid any regulatory arbitrage across jurisdictions.

<u>Question 8</u>: 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?

We think that the development of a specific methodology for calculating an add-on for operational risk may not be that necessary and may add undesirable complexity to the framework. An adequately designed regulatory framework for operational risk should be sufficient to capture all risks (technology, legal, etc.) irrespectively of the use case for a particular technology. Including discretional add-ons would make it more difficult to achieve a consistent and stable regulatory framework.

<u>Question 9</u>: 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?

We generally agree with the proposed approach.

<u>Question 10</u>: Do you have any views on the Committee's current thinking on the capital requirements for Group 1b crypto assets?

N.A.

<u>Question 11</u>: 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?

N.A.

<u>Question 12</u>: 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?

Firstly, we would like to point out that the risk treatment of crypto assets should not be subordinated to their accounting treatment. In our view, it should rather be adjusted only to the underlying risk of the asset. Eventually, some crypto assets may have some realizable economic value that might be monetized provided there is a liquid market.

Moreover, we believe that category 2 may be further refined and perhaps it would be good to consider some sub-classifications therein.

We believe, that were it says "The requirements only apply to those Group 1 crypto assets which have not been deducted from Common Equity Tier 1 (CET1) capital, for example due to classification as intangibles under the applicable accounting frameworks" should be "The requirements only apply to those Group 1 crypto assets which have not been deducted from Common Equity Tier 1 (CET1) capital, according to applicable prudential framework".

<u>Question 13</u>: 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 standardised approach to market risk?

N.A.

<u>Question 14</u>: 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?

We generally agree with the Basel Committee's proposed approach. Given that markets for these assets are in constant development, some of the proposed treatments may need to be revised in the future – for example, in relation to the depth and stability of their markets, or the actual effectiveness of pool of backing assets.

<u>Question 15</u>: 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?

Given the actual or potential global nature of some of the crypto assets, we believe that risks attributable to money laundering and financing terrorism should remain of central attention. Global monitoring, coordination and collaboration among authorities would be required to mitigate and address these risks. Crypto assets issuers should put in place right processes and controls, provide all the necessary information and have the right organisational arrangements to permit their supervision in this regard.

Regarding preventing and addressing cyber-risks, the companies issuing crypto assets should be the first responsible for taking the adequate measures and adopting processes to help mitigate these risks.

<u>Question 16</u>: 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?

Please, refer to our response to question 7.

<u>Question 17</u>: 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.

N.A.

<u>Additional comments:</u>

We would like to add that the paper refers to direct and indirect exposures but also to "other activities" performed by banks on behalf of clients (there is no description, but custodian of crypto assets can be one). But neither the proposed prudential treatment nor the expectations in terms of responsibility for banks discriminate between the different ways in which a bank can be involved with these assets. In this respect, it is necessary to do so as it is probably more likely in the short term that banks act as custodians or provide wallets for individual customers to securely store the crypto assets, rather than directly investing in them.

The proposed prudential treatment (although very conservative) makes sense for direct investments that are in the banking book (or trading book) of the bank. On the other hand, the responsibilities in terms of anti-money laundering (AML), cybersecurity etc maybe are more aligned with services provided to customers, where the risk is higher.

About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 21 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 900 banks, which together employ more than 650,000 people driven to innovate at roughly 50,000 outlets. ESBG members have total assets of €5.3 trillion, provide €1 trillion in corporate loans (including to SMEs), and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking. Our transparency ID is 8765978796-80.

European Savings and Retail Banking Group – aisbl
Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax: +32 2 211 11 99
Info@wsbi-esbg.org ■ www.wsbi-esbg.org

Published by ESBG. September 2021.