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Basel Committee Consultation

A Prudential Treatment of Banks' Cryptoasset Exposure

The Digital Regulator

Redefining Finance for the New Economy

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Executive summary

The Basel Committee on Banking Supervision (BCBS) commenced in June 2021 the consultation on the 'Prudential treatment of cryptoasset exposures' document as an initial step towards the promulgation of the internationally binding capital and liquidity rules applicable to banks' exposure to cryptoassets. Building on a discussion paper issued in December 2019, this consultation document introduces the distinction between tokenised traditional assets and non-algorithmic stablecoins and other cryptoassets, such as bitcoin, ether, utility tokens, DeFi tokens, and other network tokens, as well as algorithmic and crypto-backed stablecoins. The 'Pillar 1' formulaic minimum capital charge for banks' exposure to tokenised traditional assets should be at least equivalent to those of traditional assets. However, the exposure to non-algorithmic stablecoins should be subject to new, dedicated Pillar 1 guidance. Other cryptoassets (e.g. bitcoin, ether, utility tokens, DeFi tokens, and other network coins), as well as algorithmic and crypto-backed stablecoins, should be subject to the one-size-fits-all, harshest possible Pillar 1 charge (1,250% risk-weight) corresponding to the full exposure deduction from the capital base. The BCBS plans to supplement the Pillar 1 minimum charge with an operational risk add-on, as well as provide additional guidance under Pillar 2 (supervisory review process) and Pillar 3 (disclosure), and extend the current leverage ratio, large exposures, and liquidity ratio frameworks to cryptoassets.

While the consultation paper recognises the ineluctability of asset tokenisation and stablecoins, it disappoints by continuing to apply the one-size-fits-all, harshest possible capital charge to the exposure to all cryptoassets other than tokenised traditional financial assets and non-algorithmic stablecoins. From a risk viewpoint, this approach assimilates diverse cryptoassets such as bitcoin, ether, utility tokens, DeFi tokens, and other network coins, as well as algorithmic and crypto-backed stablecoins, to a single asset, akin to the worst externally rated traditional securitisation tranches.

It thus evidences a poor understanding of the natures of these diverse cryptoassets. The BCBS recognises that the specification of final rules will likely require more than one consultation. Further, it is important that this process includes the know-how of the cryptoindustry, which typically resides outside the scopes of BCBS-regulated entities. As such, it can lead to a deeper understanding of cryptoassets and the recognition of the diversity of their economic functions, governance arrangements, and risk profiles. However, an implementation of the proposed blunt approach would likely stifle innovation and promote parallel, unregulated cryptoasset activities.

The Basel Committee recognises the ineluctability of asset tokenisation, but proposes to subject exposure to bitcoin, ether, utility tokens, DeFi tokens, and other network coins to a one-size-fits-all, harshest possible capital charge. A constructive dialogue with the industry is thus needed to promote better regulation.

1. BCBS's consultation document – 'Prudential Treatment of Cryptoasset Exposures'

The BCBS issued this paper for consultation from June 2021 until 10 September 2021, following the initial discussion paper issued in December 2019 and building on the comments received in early 2020. This consultation paper introduces distinct rules for tokenised traditional assets and non-algorithmic stablecoins ('Group 1 Cryptoassets') and for other cryptoassets such as bitcoin, ether, utility tokens, DeFi tokens, and other network coins, as well as algorithmic and crypto-backed stablecoins ('Group 2 Cryptoassets'). This distinction formally acknowledges the ineluctable nature of asset tokenisation and of stablecoins. The proposed treatment of the exposure to cryptoassets such as bitcoin, ether, utility tokens, DeFi tokens, and other network coins, as well as algorithmic and crypto-based stablecoins remains unchanged from the concept put forward in the 2019 discussion paper–a one-size-fits-all harshest possible Pillar 1 charge (1,250% risk-weight) corresponding to the full exposure deduction from banks' capital base. The consultation paper also anticipates a Pillar 1 add-on for operational risk and proposes detailed rules for governing Pillar 2 (Supervisory Review Process) and Pillar 3 (Disclosure). In the following paragraphs, we detail the key aspects of the proposed rules.

Group 1 cryptoassets: Classification conditions

- The categorisation of a cryptoasset into Group 1 is subject to a set of specific conditions the cryptoasset must always meet cumulatively. Specifically, the cryptoasset must either be a tokenised traditional asset or have a stabilisation mechanism that is always effective. Algorithmic stabilisation mechanisms are out of scope. The legal enforceability in the issuing jurisdiction of all elements characterising the cryptoasset arrangements must always be effective. The operating environment of the cryptoasset must be designed and operated so that it grants an adequate and effective management of material risks. The entities in charge of redeeming, transferring, or settling cryptoasset transactions must be regulated and supervised. The responsibility for determining and monitoring compliance with the classification conditions is shared between banks and supervisors.

Group 1a cryptoassets: Pillar 1 charge

- The BCBS intends to extend the Pillar 1 charge for bonds, loans, deposits, equities, commodities, and cash held in custody to cryptoassets, thus representing the tokenisation of such instruments. The BCBS clarifies that the differences between the treatment of tokenised assets and that of traditional assets may be needed in case of liquidity differentials, if the availability of the data underpinning risk modelling varies, or if the parameters supporting the use of these assets as credit risk collateral diverge.

Group 1b cryptoassets: Pillar 1 charge

- The BCBS explains that non-algorithmic stablecoins are only considered to be Group 1 cryptoassets if they are redeemable for their underlying assets. This is the case unless a stablecoin confers the same level of legal rights as the ownership of a traditional asset. The BCBS is not yet proposing rules for stablecoins qualifying as Group 1 cryptoassets, but informs that it currently considers elements such as the way the cryptoasset holders transact with the redeemer (directly or indirectly), the treatment of bankruptcy remote vehicles for cryptoassets with underlying pools of assets, and the approach of credit risk for cryptoassets with a stabilisation mechanism backed by a pool of assets.

Group 1 cryptoassets: Pillar 1 operational risk add-on

- The BCBS notes that the Pillar 1 charge specified above is minimal. The cryptoasset environment is permeated by material and evolving operational risks. On this basis, the BCBS considers a specific add-on Pillar 1 charge for all Group 1 assets, which will be specified in a subsequent step.

Group 2 cryptoassets: Pillar 1 charge

- The BCBS proposes to subject cryptoassets such as bitcoin, ether, utility tokens, DeFi tokens, and other network coins, as well as algorithmic and crypto-based stablecoins, to new capital requirements. These cryptoassets should be subject to a 1,250% risk weight applied to the greater value between the absolute value of the aggregated long positions and the absolute value of the aggregated short positions to which a bank is exposed. The risk-weighted assets are calculated for each Group 2 cryptoasset separately. The same rule applies to equity investments, derivatives, or short positions for the funds of Group 2 cryptoassets. There is no distinction between banking and trading book positions. The proposed treatment captures both credit and market risks, including the credit valuation adjustment risk.

  The BCBS also specifies rules to calculate counterparty credit risks for derivative exposures having Group 2 cryptoassets as underlying assets and proposes rules for securities financing transactions and margin loans involving these cryptoassets. Finally, it notes that, as short positions could potentially lead to unlimited losses, a supervisory dialogue is needed to monitor and determine the appropriate risk weight for such short positions.

Large exposure rules and leverage and liquidity ratios

- The BCBS is not proposing new approaches for these rules and ratios. Rather, it suggests extending the current frameworks to cryptoassets. Therefore, the treatment of cryptoassets for large exposure purposes will follow the rules applicable to traditional assets, and cryptoassets will be included in the leverage ratio calculation according to their financial reporting values. The BCBS states that cryptoassets will not qualify as eligible high-quality liquid assets in the calculation of banks' liquidity coverages and net stable funding ratios.

Pillar 2 or the supervisory review process

- The BCBS specifies different sets of responsibilities for banks and supervisors. Banks are expected to ensure that risks not captured under Pillar 1 are assessed, managed, and mitigated appropriately, on an ongoing basis, and following internal policies. The scope includes operational and cyber risks, technology risks, and anti-money laundering risks. Supervisors should review the appropriateness of banks' policies and procedures and the adequacy of their results. Depending on the outcomes, supervisors may require stress testing and scenario analyses, additional provisioning (including in the form of capital charges), and mitigation measures.

3. Assessment and Conclusions

The consultation paper issued in June 2021 by the BCBS is much more elaborate than the initial discussion paper from 2019. There is a clear effort by the BCBS to assimilate cryptoassets to traditional assets whenever possible. To this end, the consultation paper proposes relatively detailed rules for tokenised traditional assets and anticipates specific rules for non-algorithmic stablecoins. The BCBS also considers a Pillar 1 add-on for cryptoasset-specific operational risks and extends the prevailing Pillar 2 (supervisory review process) and Pillar 3 (disclosure) frameworks to cryptoassets.

However, no progress has been made with respect to cryptoassets such as bitcoin, ether, utility tokens, DeFi tokens, and other network coins, as well as algorithmic and crypto-based stablecoins. Instead, the BCBS continues to propose the one-size-fits-all, harshest possible Pillar 1 charge (1,250% risk-weight) for this diverse and growing cryptoassets class. This lack of progress in the analysis and understanding of what constitutes the most genuine asset addition since the emergence of blockchain-based finance is rather disappointing. Bitcoin, ether, utility tokens, DeFi tokens, and other network coins, as well as algorithmic and crypto-based stablecoins differ widely in terms of their economic functions, risk profiles, and governance arrangements.

In perspective, the blunt assimilation of these diverse assets to the worst externally rated securitisation tranche comes across as a simplified treatment compared to the risk-weighting system introduced in 1988 for bank (traditional) assets (the so-called Basel 1 framework). Those initial rules at least considered five different risk weights applicable to five different categories of assets. These rules were subsequently significantly developed over time (Basel 2 in 2004, Basel 3 in 2010, and Basel 4 in 2017).

The BCBS indicates that the development of a capital treatment for banks' exposure to cryptoassets is likely to require multiple iterations and consultations with the industry. This indicates the willingness of the BCBS to continue to follow an evolutionary approach in its rule-making, as it has been the case since 1988 for traditional banking assets. It is thus essential that the cryptofinancial industry is integrated in this process, although this is not within the general BCBS scope. The inclusion of the cryptoindustry operating outside BCBS' scope and perimeter will be instrumental to achieving better bank capital regulation for cryptoasset exposure over time and supporting a thriving cryptoasset industry within its regulated perimeter.

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