Financial Services Management

Bank Crypto Safety-and-Soundness Standards

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Impact Assessment

- Stablecoins and other cryptoassets eligible for relatively-favorable capital treatment could not "break the buck" without costly consequences. Preventing this increases the cost of issuance but also the stability essential for their widespread use as a medium of exchange or even store of value.
- Tokenized assets have no mandatory capital or liquidity disadvantage to the underlying real assets, encouraging their use. Internal systems may be most immediately favored and provide significant operational efficiency.
- Any crypto exposure outside the most punitive requirement would need not only to be fully-reserved, but also backed in ways to ensure ready redemption and virtually no valuation risk. This would be costly, but might also persuade central banks and other payment-system providers to open access to these currencies via banks or even their issuers.
- Private digital assets with additional safeguards might also lead some central banks to defer CBDC.
- Higher-risk cryptoassets would come under punitive capital and liquidity standards, further increasing their cost in ways likely to diminish all but speculative and illicit use.

Overview

Advancing some of the most controversial ideas in a 2019 discussion paper,[1] the Basel Committee has now formally proposed capital, liquidity, risk-management, and supervisory standards it believes nations should apply to bank

[1] See **CRYPTO13**, *Financial Services Management*, December 19, 2019.

cryptoasset exposures. Global regulators have adopted a cautious approach that, despite high-cost proposals for higher-risk cryptoassets, may create a framework in which banks can profitably engage in a wide array of cryptoasset activities and thus expand cryptoassets with the stability and liquidity essential for many of the uses now proposed for them. Conversely, the rules could limit the extent to which higher-risk cryptoassets could interact with the banking system, likely limiting them to niche speculation or marketing products unless cryptoasset issuers outside the reach of bank regulation still have access to the payment system or have the market heft to challenge bank-acceptable cryptoassets. Although all of the proposed standards are stringent, the new capital framework -- already more costly than many in this arena envision -- is meant only as a bare minimum, with the consultation also laying out additional capital and risk-mitigation requirements for consideration by national supervisors. To the extent these are deployed, the crypto construct could either be still more costly and resilient or provide opportunities for regulatory arbitrage in jurisdictions that comply only with Basel's bare minimum.

Impact

As crypto currencies and assets have grown from fringe products largely used for illicit transactions to penetrate the retail-finance, payments, asset-management, and wholesale finance sectors, banks have wanted to or believed themselves compelled by market developments to hold or otherwise engage in crypto activities. Many are also building digital ledger technology (DLT) or other platforms to host internal activities using both blockchain and digital currencies to speed transactions or gain other operational efficiencies. Some bank regulators have even actively urged banks to launch significant external crypto operations, with the Trump Administration's acting Comptroller not only authorizing numerous novel cryptoasset charters,[2] but also making the national-bank charter technology-neutral when judging permissible assets and activities.[3]

Central banks now also feel compelled not only to consider digital currencies to ensure fiat-currency supremacy, but also to enhance financial inclusion, innovation, and even the appeal of national financial markets. The Bank for International Settlements, which houses the Basel Committee, believes that central-bank digital currency (CBDC) has many benefits, but it and the Basel Committee take a considerably dimmer view of other cryptoassets, thus publishing this tough regime (which does not affect CBDC) for public comment.

The most controversial aspect of the consultation is the new capital charge proposed for cryptoassets or exposures tied to them. However, the standards (see below) are nuanced. They do not generally apply punitive capital charges to cryptoassets if the asset is likely to hold its value by virtue of reserves in fiat currency or other stable assets, instead looking through to these underlying assets to set risk-based capital (RBC) weightings. Thus, if a cryptoasset is pegged to cash and an offsetting amount of cash is held under conditions that meet Basel's other requirements, then the credit-risk weighting is zero, as would also be the case for reserves of qualifying sovereign obligations. If the cryptoasset is instead backed by a basket of currencies held in suitable amounts,

2 See **CRYPTO17**, *Financial Services Management*, January 12, 2021.

3 See **CHARTER27**, *Financial Services Management*, June 9, 2020.

then RBC would be based on the domicile jurisdiction's RBC requirements for relevant currencies, which is also generally a low weighting. Conversely, if the reserve asset is the stock of the issuing entity, then the weighting would be high, just as the RBC for the equity itself is at least 100 percent. Because market- and operational-risk capital charges also apply, no qualifying cryptoasset is likely to have a zero capital requirement in the final calculation, but all would be equivalent to underlying assets unless supervisors determined that add-ons are required. Were another approach followed, then significant incentives could arise for the conversion of assets with high RBC requirements into cryptoassets linked to the value of the assets without the cost of a like-kind capital charge.

Where the capital charge is costly is for cryptoassets that do not qualify for this like-kind treatment. Here, the credit RBC weighting is 1,250 percent – i.e., dollar-for-dollar capital for a bank holding only the minimum eight percent total of risk-based capital and more than the financial value of the asset for the majority of banks that hold considerably more RBC. The Basel III rules impose few standardized charges this high for non-cryptoassets, reserving it for example for first-loss securitization tranches.[4] The impact in these cases has been very small bank holdings of these positions and a sharp reduction in the types of securitizations where a bank first-loss position is deemed essential by investors (e.g., private-label MBS). The Basel Committee clearly hopes that a similar result will befall higher-risk cryptoassets, but the very different nature of investors in this arena makes this uncertain.

However, even if cryptoassets were cost-effective under the capital rules, they still face hurdles under liquidity requirements. High-quality cryptoassets come under like-kind liquidity rules in a manner comparable to the capital standards described above. This may make them equivalent to traditional assets in this regard, but the combination of capital and liquidity rules, including that of the leverage ratio applied to offsetting high-quality liquid assets may nonetheless significantly and adversely affect cost calculations now common with regard to tokenized cryptoassets or certain stablecoins. The liquidity rules for higher-risk cryptoassets are draconian, adding to the high capital costs described above to make them essentially off-limits for virtually all banking organizations in any material way.

The Basel approach not only defines the cost of holding these assets and related risks, but by default also how the cryptoasset market may evolve to the extent that market participants prefer exposures within the regulatory perimeter. For example, it is possible that the FDIC would grant coverage to cryptoasset deposits if these are reserved in accordance with the Basel standards (see below) in cash. Similarly, the Fed might decide that an entity holding all the capital and liquidity demanded of it for eligible cryptoassets meets the prudential considerations in its proposal to consider opening the payment system to non-depository institutions.[5]

[4] See **CAPITAL201**, *Financial Services Management*, July 19, 2013.

[5] See **PAYMENT22**, *Financial Services Management*, May 10, 2021.

However, even though the valuations and monitoring for these offsetting reserves are set strictly by Basel, it is unclear if reserves must also be sterile (i.e., not rehypothecated or otherwise put to use). To the extent that regulators follow only the Basel standards without adding a sterilization requirement, cryptoassets might be especially appealing to traditional banks if the return earned on the underlying cryptoasset exceeds that possible on a traditional deposit or bank reserve held at a central bank.

This cost-benefit assessment is further complicated by the qualitative requirements also proposed in this consultation. For example, Basel contemplates strict risk-mitigation standards including supervisory stress testing and/or scenario analysis. If these standards are incorporated in those governing like-kind assets, then cryptoassets carry no additional costs; if not, not. Further, the like-kind capital rule is only the minimum Basel thinks warranted under optimal circumstances. If national authorities "gold-plate" the Basel rules through add-on charges, a ban on the use of models, or other strictures, then the like-kind cost comparison may favor traditional – not crypto – asset holdings unless – a big unless – the cryptoasset provides a higher return on even this greater amount of capital.

What's Next

The consultation was released on June 10; comments are due by September 10. In addition to this consultation, the Basel Committee is monitoring digital-asset developments and measuring bank exposures.

Analysis

As noted, this consultation focuses on private cryptoassets, not CBDC.

A. Principles

Those governing this framework are:

- same risk, same activity, same regulatory treatment;
- technology neutrality;
- simplicity, with greater complexity added as warranted by sector change; and
- establishment only of minimum standards which nations may exceed as desired. Jurisdictions that simply bar cryptoasset exposures would be in compliance with these standards.

B. Capital Requirements

1. Group 1

Group 1a cryptoassets are cryptoassets that are equivalent to tokenized traditional assets – i.e., digital representations of a traditional asset where the value is set by cryptography, DLT, or a similar technology – not, however, by recorded ownership in a custody account.

Group 1b cryptoassets must have eligible stabilization mechanisms effective at all times determined via a qualifying daily monitoring protocol linking these assets to underlying traditional assets or a pool of traditional assets. The consultation provides for a very narrow threshold of valuation volatility that may rarely be breached and must always be restored. Banks must also have demonstrable risk-management capabilities and satisfy supervisors if a new cryptoasset lacks enough history to establish an objective valuation. Banks would also have to verify ownership of the assets underlying cryptoasset valuation and secure the assets if they are physical in nature, a requirement that could enforce sterilization requirements on certain assets (e.g., gold) depending on how national regulators determine security. Cryptoassets that rely on other cryptoassets or valuation protocols are not eligible Group 1b instruments.

Further, all of the rights relevant to Group 1 cryptoassets must be clearly defined, legally enforceable where the asset is issued and redeemed, ensure full transferability, settlement finality, and full redeemability (i.e., the ability to exchange the instrument for cash or other traditional assets at "all times"). Numerous documentation requirements are also specified.

In addition, the cryptoasset's function and the exchanges on which it is transmitted (including DLT) must demonstrably manage and mitigate credit, liquidity, market, operational, and other risks including those to data integrity and AML/CFT compliance. Entities that execute redemption, transfers, or settlement would also need to be regulated and supervised. As a result, crypto exchanges would need to come under rules satisfactory to bank regulators, not just national securities or commodities regulators where they have jurisdiction.

2. Capital Requirements

Group1 cryptoassets that are not deducted from capital (i.e., intangibles) would carry market and credit minimum RBC comparable to that for traditional assets, with the proposal detailing how to judge if a tokenized asset is indeed comparable to a traditional one. No tokenized asset that has to be redeemed to be comparable or where collateral rights are complex is considered like-kind.

Like-kind assets would also be subject to operational risk-based capital, possibly via an additional charge directly applicable to cryptoassets. Advanced-approach models may be used, but only with great caution.

The consultation outlines various approaches to any such operational RBC requirement. Credit and market RBC could also be increased in supervisors believe like-kind minimum requirements do not fully reflect cryptoasset risk. Step-in risk should also be considered and addressed via a capital charge if appropriate.[6]

Numerous issues remain unresolved, as Basel readily recognizes (i.e., how a capital charge for custody risk would be approach). A set of illustrative examples

6 See **RECOURSE5**, *Financial Services Management*, March 22, 2017.

of applicable capital charges is also provided.

3. Group 2 Cryptoassets

Again, capital requirements apply only when assets are not otherwise deducted from capital. The standards apply to these assets and assets comprised of them (e.g., ETFs). As noted, there is a 1,250 percent risk weight applied to the absolute value of long and short positions, which may be decreased if the maximum loss on a derivatives position is less than the absolute value. There is no separate banking or trading book treatment, with RWAs reported on the credit book for simplicity's sake. Basel notes that this capital treatment still may not suffice, instructing supervisors to ensure that banks effectively demonstrate adequate capitalization for material exposures; supervisors should add a Pillar 1 surcharge if they are unpersuaded.

Group 2 cryptoassets are also not eligible collateral and thus may not be used to reduce risk weightings on other assets, although limited recognition is allowed in certain securities-financing transactions.

4. Add-Ons

Given what Basel considers the risks involved and the uncertainties of its requirements, it also tells supervisors to consider:

- prohibiting models-based approaches for all banks;
- requiring longer liquidity time horizons for models-based capital;
- requiring measurement of crypto basis risk for market-risk capital; and
- Scaling Pillar 1 requirements if cryptoasset features create additional risks of delayed payment or operational interruption.

C. Other Regulatory Requirements

These include:

- Leverage Ratio: There is no special leverage requirement, with cryptoassets coming under applicable leverage ratios based on applicable accounting treatment valuations.
- Large Exposures: Cryptoasset standards here also follow those for other assets. Cryptoassets without an issuer (e.g., bitcoin) do not give rise to any large-exposure limits.
- Liquidity Ratios: Group 1 cryptoassets come under the LCR and NSFR like other assets. However, the extent to which some cryptoassets could be considered high-quality liquid assets under these rules will continue to be evaluated. Group 2 cryptoassets receive a zero percent inflow and a 100 percent outflow under the LCR – i.e., very tough treatment; similar factors apply under the NSFR.

D. Supervisory Standards

1. Banks

Banks would need not only to follow all the usual risk-management and governance standards, but also set out special cryptoasset policies and procedures. Risks of concern include those related to:

- operational and cyber exposures;
- governance, especially around codes, protocols, and other features;
- IT;
- platforms (e.g., DLT) stability, program validations, service accessibility, node-operator trustworthiness and diversity;
- AML; and
- third-party risk management.

2. Supervisors

Supervisors are to:

- identify risks not captured by minimum capital requirements and consider add-ons or exposure limits;
- ensure risk remediation;
- engage in stress testing and scenario analysis; and
- require adequate provisioning.

E. Disclosures

These should follow general disclosure principles,[7] but also provide both the quantitative information above and the qualitative information necessary for third-party risk analysis. The consultation also lists qualitative-disclosure elements.

F. Request for Comment

Views are sought on:

- the guiding principles noted above;
- the cryptoasset groups, conditions, and capital standards. Basel is also interested in the extent to which Group 1b conditions are practical, with comments also sought on whether the requirement for regulation/supervision of certain service providers is warranted or could be revised;
- the capital treatment of Group 2 cryptoassets, including with regard to if some forms of hedging might be recognized for trading-book capital;

[7] See **OPSRISK20**, *Financial Services Management*, January 8, 2018.

- operational-risk measurement in this arena and the need for an operational-risk capital add-on. Comments are also sought on the proposed approach to credit-and market-risk capital;
- the proposed leverage, large-exposure, and liquidity standards;
- the risk-management responsibilities proposed for banks;
- supervisory responsibilities; and
- proposed disclosures.