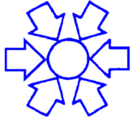 Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: June 21, 2021

FedFin's in-depth analysis of the Basel Committee's cryptoasset proposal kicked up quite a fuss. The major point of contention is our conclusion that the new approach might recast crypto in favor of regulated banks. Some said instead that the new capital requirements are punitive to the point of prohibitive. However, a close read of the consultation persuades me that, despite the need for refinements in several critical places, crypto counterparties outside the lure of illicit finance or high-flying speculation will prefer doing business with a bank and that the new rules make it possible for banks to do business with them. After all, each of us can always give our money to any person or business to hold for us; we instead deposit our money in the bank because, thanks in good part to FDIC insurance and the rules it requires, we know we'll get our money back.

Stripped to its capital essentials, the consultation creates two classes (inexplicably called groups) of crypto assets. Those which are tokenized versions of other assets – e.g., fiat currency, a mortgage loan – come under risk-based and leverage capital rules largely comparable to those now applied to the underlying asset. Although there are additional risk-management considerations, the difference between a tokenized-digital and a "real" asset is likely a capital and liquidity wash.

Digital assets more like stablecoins get similar like-kind capital treatment, but tough standards also apply to ensure that the underlying real asset is always there and always worth what the digital representation would lead one to expect. This requirement could put bank-issued stable-assets at a disadvantage to other issuers – e.g., Facebook's Diem – that need not adhere to rigorous capital or reserving or have balance sheets big enough to bear it.

But, unless these nonbanks also have access to the payment system – a big if thanks to the Fed's pending proposal – banks are likely to retain a major and probably dominant position in critical liability and asset arenas. Think of the reserve requirement as essentially FDIC insurance and you'll quickly see why.

Where Basel bites is in its treatment of cryptoassets that don't get specified tokenized or stable criteria. These cryptoassets get the highest risk weighting bank regulators have yet created: 1,250 percent, or more than dollar-for-dollar capital charged to any bank that holds more than Basel's eight percent minimum, i.e., pretty much every U.S. bank.

But, there's a good reason for this: see, for example, Mark Cuban's sixty-to-zero crypto catastrophe in algorithmic crypto assets. Supporting the hypothesis that cryptoasset holders will come to favor regulation, see also Mr. Cuban's subsequent call for new crypto rules.

2101 L Street, N.W. – Suite 300
Washington, DC 20037
Phone: 202.589.0880

E-mail: info@fedfin.com
Website: www.fedfin.com

As we learned yet again in the aftermath of the great financial crisis, rules usually arise long after the need for them was all too evident. Whether it's too late to prevent a crypto bubble remains to be seen. However, Basel is at least acting before one might blow and surely ahead of still more widespread cryptoasset adventures by individual regulators – that means you, Brian Brooks – and entities within and outside the regulatory perimeter tempted to play with fire. It's also acting ahead of the point at which banks are left even farther behind the valuable efficiency and inclusion benefits digital assets clearly afford.

While the crypto consultation raises at least as many questions as it answers, it's a welcome foray by global regulators on to a field that clearly needs an umpire to prevent a bloody free-for-all.