Financial Services Management

Global Standards for Bank Cryptoasset Exposures

Cite

Basel Committee on Banking Supervision, Second Consultation on the Prudential Treatment of Cryptoasset Exposures

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Impact Assessment

- Detailed capital, operational, liquidity, and governance standards are likely to be advanced in national jurisdictions, including the U.S., even as Basel takes its time formulating final standards.
- To the extent new rules stabilize cryptoassets and create the certainty needed for major capital investments, digital-asset innovation could quickly advance, perhaps creating regulated private stablecoin options that supplant the need for CBDC.
- Although complex risk-management and compliance standards complicate innovation, tokenized cryptoassets could advance quickly across an array of bank payment, investment, and trading activities.
- Regulatory arbitrage remains possible since only banks would be covered by these requirements although recent market events may encourage greater client and investor reliance on regulated cryptoassets.

Overview

Global banking regulators are trying a new, but still stringent, approach to governing bank exposures to certain types of crypto assets, revising an initial consultation to focus more on supervisory limitations than on extremely punitive capital requirements for what are deemed to be lower risk cryptoassets.[1] Under the new approach, it will be easier for banks to offer, facilitate, or otherwise enable tokenized forms of traditional assets without disproportionately-costly capital charges as long as an array of risk-mitigation restrictions are met. Higher-risk cryptoassets would come under exposure limits as well as costly capital requirements, although the new consultation does permit these to be reduced via various hedging methods that might make such stablecoins viable products in certain circumstances. Many of the

1 See **CRYPTO19,** *Financial Services Management*, June 15, 2021.

standards would require new policies and procedures but reflect what bankers may believe to be prudent safeguards within the boundaries of sensible risk tolerance as a new asset class takes shape at a time of severe market stress. This compromise approach appears to sit uneasily with at least some Basel Committee members in light of ongoing market turmoil, with the panel noting upon release that final standards may be significantly tightened without resort to a third consultation. It is unclear how well investors, consumers, and the overall financial system would be safeguarded by even these restrictions given the explosive growth of cryptoassets regardless of the small role banks have played to date, but recent market experience combined with new standards that enabled bank participation might lead to a new approach to digital assets within the regulatory perimeter that permits greater, stable growth.

Impact

The second consultation retains the first's emphasis on an FSB-policy priority: same risk, same rules. However, it attempts to refine this by alleviating some of the first round's most stringent requirements and restrictions that commenters argued were disproportionate to likely risk compared to like-kind bank assets given more generous regulatory treatment. However, due to the Committee's continuing view that crypto exposures are almost always high risk, the consultation lays out how prudential rules are to be applied to all but the digital assets that are essentially the same as traditional assets. These are meant to ensure that, even if banks take a significantly bigger role in crypto assets, it would not in the near term be large enough to directly threaten bank solvency. Other risks – notably those pertaining to liquidity, operations, and reputation – are addressed in additional standards to supplement capital rules. In many cases, the cost of these rules may still outweigh the return expected from direct exposure to cryptoassets unless there is consumer, client, or investor demand for cryptoassets without the highest-risk features that have so far characterized much of this market.

The new proposal is not as stringent with regard to some stablecoins as the initial consultation, but the criteria for more lenient treatment would require significant revisions by virtually all current offerings. For example, the standards detailing eligibility for more favorable capital treatment include both redemption and basis-risk tests designed to ensure that banks and coin holders are not at risk of loss of principal and coin issuers are not themselves prone to run risk or able to pose this risk more broadly in the financial system. The consultation speaks to the need for ready redemption, but the details specify redemption only within five days. This may not be rapid enough to handle redemption demand under stress and thus to address run-risk fears. The proposal's basis-point test is also backward-looking, likely not capturing risk under novel conditions that might expose investors and the financial system to hazard. Comment is sought on an alternative in which these criteria would be eased if broader prudential rules apply. The extent to which these are well-designed for stablecoin-specific risks is not detailed, presumably because the Basel Committee believes that regulation on its own might suffice.

The proposal also favors bank-issued stablecoins even if the option for an overall safe harbor is not adopted. This might well encourage privately-issued stablecoins under prudential standards that could reduce or even eliminate the need in some jurisdictions for central bank digital currencies. However, to the extent these bank-issued coins became a medium of cross-border payments, risks to payment-system finality, emerging-market liquidity, bank competitiveness, and monetary-policy transmission might arise due to widely different bank regulations and an appeal of the dollar as a reserve currency and that of other currencies in relevant markets. However, these risks are also of considerable concern with regard to CBDC.[2]

The standards do not address one significant crypto-specific consideration: climate risk. The consultation states that Basel is not doing so in order to incorporate crypto issues into the "holistic" climate-risk framework, one now taking shape with draft climate-risk management principles.[3] CBDC-specific considerations are also not addressed; here, Basel says it will take this up when it otherwise considers CBDC. The consultation also does not lay out prudential standards for stablecoin issuers, leaving these for national jurisdictions; the U.S. as noted below may soon turn to these.

What's Next

This consultation was released on June 30; comments are due by September 30. Basel plans to issue final standards by year-end. The U.S. may well act before then at least with regard to proposed capital and prudential standards for banks that hew to these Basel proposals to the greatest extent regulators deem appropriate for the U.S. Work is also expected to begin in earnest on federal legislation. This will follow the general lines of the President's Working Group on Financial Markets' stablecoin report,[4] with the significant exception that the PWG no longer believes it essential to house all stablecoin activities in insured depositories. It is now open to the idea of allowing nonbanks to do so under federal standards likely structurally akin to those in the Toomey draft bill,[5] rather than the still more lenient Lummis-Gillibrand proposal.[6] However, consumer and investor protections will need to be considerably more stringent than authorized in either of these bills to win approval from the White House and Treasury. Negotiations on these and other controversial issues are not likely to conclude by the end of this Congressional session and could take very different form should Republicans gain more control in the next session.

Analysis

Banks would need to screen crypto assets on an "ongoing basis" to determine which classifications apply.

A. Group One Crypto Assets

These are generally tokenized traditional assets with all of the same risks and legal rights (1A) or those with a stabilization feature that is effective at all times and linked to traditional assets or pools of them (1B). These are further divided into Group 1A and 1B assets, with banks required to conduct a legal analysis before determining the classification that is appropriate for their exposures. Banks must also consider crypto-

2 See **CBDC9,** *Financial Services Management,* October 20, 2021.
3 See **CLIMATE12,** *Financial Services Management,* November 22, 2021.
4 See **CRYPTO16**, *Client Report*, December 28, 2020.
5 See **CRYPTO27,** *Financial Services Management,* May 20, 2022.
6 See **CRYPTO28,** *Financial Services Management,* June 14, 2022.

specific risks to, for example, determine the boundary between credit and market risks, paying attention also to crypto-specific issues that differentiate a tokenized asset from a real one (e.g., smaller, less liquid markets). Settlement-finality, DLT-system, and transferability conditions also apply, with these spelling out regulatory and risk-management procedures for operational resilience, AML, and other arenas.

To be included in Group 1B, stablecoins would also need to be issued by an entity subject to capital and liquidity standards along with other prudential requirements. Algorithmic stablecoins may be classified as 1B if they meet all the eligibility criteria. The consultation also details situations in which a bank could believe itself compelled to support non-members in certain crypto arrangements if they are non-member holders, taking on risks related to member default. Capital requirements here include calculations specific to these crypto risks, including the "step-in" risk a bank might assume due to reputational risk.[7]

Group 1B assets would also need to meet a redemption test that ensures the coin can always be redeemed within five calendar days even under extreme stress as determined by the value of reserve assets and a basis-risk test that sets a peg value and a ten-basis point threshold for market-risk pricing differences between the stablecoin and its underlying reserve assets. A coin that does not fail this basis-risk test more than three times in the past twelve months passes this test. If the peg value exceeds twenty basis points ten times over the past year, then the coin fails this test. If it passes the ten bp test but not the twenty test, then it has "narrowly passed" and is subject to an add-on capital requirement. Supervisors are told to gather evidence of the stabilization mechanism, which banks must test on a continuing basis with adequate evidence to substantiate all claims regardless of the cryptoasset issuer. However, banks may use independent third parties for some requisite determinations. Reserve-asset management must be comprehensive and transparent under conditions specified in the consultation. Reserve-management factors must also be made public, with at least daily disclosures of asset valuation and at least weekly composition reports. An independent audit evaluating these criteria would also be required on at least an annual basis.

The consultation also includes an option under which stablecoins issued by "regulated entities" or notes that meet certain risk-management conditions would generally be considered low-risk. This would be an alternative to the redemption and basic-risks tests. Comment is solicited on how this might work as well as on how best to handle permissionless blockchain arrangements given that the consultation's standards now make most unlikely Group 1 classification.

Although Basel believes these conditions make Group 1 exposures akin to the risk of traditional ones, the consultation nonetheless includes numerous requirements germane to calculating crypto risks within the standardized and advanced credit- and market-risk standards, as well as an add-on capital charge of 2.5 percent of an exposure related to "unforeseen risks." This will be modified as regulators better understand DLT-related risk.

B. Group 2

The factors leading to Group 2 classification would have to be disclosed. A new exposure limit would also apply to these assets, setting a "provisional limit" of one percent of Tier 1 capital determined by gross exposures without regard to eligible

[7] See **RECOURSE5,** *Financial Services Management,* March 22, 2017.

hedging or diversification. Internal models are not allowed for capital determination.

Unlike the first consultation, certain forms of hedged risk mitigation would be recognized to reduce the dollar-for-dollar risk weighting still applied to them in this version. A Group 2A category is proposed to reflect exposures with eligible hedges; standardized options for market risk would then apply to risk-weighting calculations.[8] The standardized approach to credit-risk recognition of counterparty risk would also apply.[9]

Group 2B assets are any that do not fit into the above classifications.

C. Additional Provisions

Proposals to link capital treatment to an exposure's accounting treatment are removed from the second consultation pending further work by accounting regulators on this issue. Operational-risk requirements are clarified to, the Committee believes, better address when current operational-, market-, or credit-risk standards apply. The consultation now also includes detailed capital standards based on a cryptoasset's characteristics and better describes how the liquidity coverage ratio (LCR)[10] and net stable funding ratio (NSFR)[11] are to apply to cryptoassets, with Group 1A assets considered high-quality liquid ones if they are tokenized versions of current HQLAs. Bank-issued cryptoassets would be treated in the same fashion as other bank-issued liabilities, with a detailed classification system spelling out the liquidity standards in more detail. The consultation also details risk-management requirements, including the need for express policies and procedures.

8 See **CAPITAL223,** *Financial Services Management,* March 28, 2018.

9 See **CAPITAL203,** *Financial Services Management,* December 27, 2013.

10 See **LIQUIDITY17**, *Financial Services Management*, October 1, 2014.

11 See **LIQUIDITY32**, *Financial Services Management*, October 27, 2020.

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