



Financial Services Management

Bank Crypto Safety-and-Soundness Standards

Cite

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Impact Assessment

- After lengthy disputes in which Basel's crypto standards were considered too onerous, global regulators adopted still more stringent restrictions that surely reflect FTX and other recent crypto crises.
- Standards may foster "responsible innovation" by virtue of allowing banks to use DLT and even DeFi, but unregulated entities will be essentially barred from bank lending, trading, settlement, payment, and custody services unless they meet strict standards often at odds with current business models
- Requirements that banks advise supervisors well ahead of time of the classification in which their digital asset exposures fall create a sweeping prior-notice construct likely to impede bank interactions and exposures with any but the most stable cryptoasset entities establishing a long-term business relationship with the bank.
- Even where prior notice is feasible and there are no supervisory objections to an activity, stringent capital, liquidity, exposure, and risk-management standards apply to all but tokenized digital assets issued by regulated entities that will surely constrain other crypto activity.
- Exposures to the highest-risk cryptoassets are limited to no more than one percent of capital without application of a costly capital surcharge up to a flat ban on holdings above two percent of capital.
- Barriers to host-country entry is based on extraterritorial application of applicable rules and resilience standards, limiting exposures to crypto activities housed in safe-haven regimes.

Overview

The Basel Committee has finalized its second try at global standards governing bank cryptoasset exposures,¹ laying out a path that U.S. agencies plan quickly to implement even as Congress continues to wrestle with this fast-changing sector. In general, the final Basel approach allows banks both to undertake cryptoasset activities and hold exposures in this sector. However, the

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

conditions applied to all but the most straightforward digital assets issued by regulated entities and to all stablecoins are extensive and costly. These are likely to dampen bank exposures and thus contribute to the small amount of crypto interconnectedness that regulators believe was the reason that recent crypto meltdowns posed no systemic risk.

Impact

Basel issued a second crypto consultation after its first was deemed by both banks and crypto-friendly regimes to be overly prescriptive.² In its final standards, Basel has not only gone back to its initial objective of sharply circumscribing cryptoasset exposures at banking organizations, but also has gone beyond what was initially proposed in light of the “crypto winter” experience beginning the summer of 2022. The final standards not only follow the like-kind risk/like-kind rules construct defined as a guiding principle in the second consultation, but also add numerous restrictions for all but the simplest and fully regulated cryptoassets that, as detailed below, run counter to much previously done across the cryptoasset and stablecoin sector.

To be sure, areas in which the second consultation are considerably toughened are accompanied by some pullbacks. The committee, for example, decided against mandating a basis test as a condition of meeting redemption requirements. However, it did so only in concert with requiring that the reserve asset demonstrate minimal credit and market risk and that the issuer be governed for capital and similar purposes. The flat limit on riskier stablecoin offerings has been altered to provide greater flexibility and there is now also a less onerous, mandatory capital add-on for “infrastructure” risk.

Reflecting the Basel Committee’s ambit, nothing in these rules prohibits nonbanks from engaging in any form of crypto activity they prefer with any customers they can find, but Basel’s approach creates robust firewalls between crypto companies unwilling to meet stringent regulatory and redemption standards and the banking and payment systems. Theoretically, crypto companies could evade these restrictions by working with banks in safe-haven jurisdictions with access into global financial, securities, and commodities markets. However, anticipating this, banks in more regulated regimes are to be barred by their domestic regulators from doing business with crypto companies that do not comply with host-country standards in areas such as reserve asset quality, redemption rights, risk management, and orderly and immediate resolution. It is rare for Basel to approve of host-country entry standards based on extraterritorial application of host-country rules, but the nature of digital assets makes them essentially supranational financial products.

As detailed below, the final standards now classify cryptoassets into four groups. Capital, liquidity, and certain exposure standards directly apply only to Groups 1 and 2 (i.e., to tokenized assets, certain stablecoin offerings, and less regulated crypto products). However, other crypto exposures and relations with DeFi entities or any firm providing crypto-related services (e.g., settlement finality, custody) come under detailed risk-management requirements intended to make

² See **CRYPTO29**, *Financial Services Management*, July 7, 2022.

it difficult for banks to do business with firms offering these services that are not also regulated banking organizations.

What's Next

The Basel Committee issued these final standards on December 16 following endorsement by its governing body, the Group of Central Bankers and Heads of Supervision. This body also pledged rapid implementation by member nations no later than January 1, 2025. Doubtless reflecting current market turmoil, Basel plans to review its standards in light of emerging risks and reserves the right to revise them even as nations begin the implementation process. It will also review the extent to which a statistical redemption test would work and, if it does, then revise redemption-test standards for cryptoassets in the 1b classification. Basel also plans to do additional work on reserve-asset composition with regard to the redemption test. The extent to which permissionless blockchains should be allowed in Group 1 is also under immediate review, as is the extent to which Group 1b assets could be deemed collateral for credit risk mitigation (CRM) purposes. An array of issues related to Group 2 are also under review for possible tightening.

Under the final standards, banks must inform supervisors of relevant classifications of cryptoassets to which they are now exposed, preferably doing so well before national implementation of these standards. This requirement is already in effect to some extent in the U.S. by virtue of FRB standards³ and similar notice requirements from the OCC⁴ regarding all crypto activities. All three banking agency supervisory heads also said that they will impose standards at least as stringent as those finalized by Basel;⁵ FRB Chairman Powell agreed to the same plan.⁶

Analysis

CBDCs do not fall under this framework, with Basel planning to consider their prudential treatment at some later date.

A. Classifications

1. Group 1

Group 1a cryptoassets are tokenized assets posing the same level of risk and having the same legal-ownership and resolution rights as the traditional asset they represent without the need to first convert the cryptoasset into a traditional one.

³ See **CRYPTO31**, *Financial Services Management*, August 22, 2022.

⁴ See **CRYPTO22**, *Financial Services Management*, December 1, 2021.

⁵ See *Client Report REFORM215*, November 16, 2022.

⁶ See *Client Report FEDERALRESERVE70*, June 22, 2022.

Group 1b assets are similar to 1a but may include a stabilization mechanism as long as that mechanism minimizes market-valuation fluctuations at all times based on a peg asset and sufficient reserve assets. To gain this classification, banks would need to ensure that they not only have this monitoring capability, but also sufficient data on which to ensure stable market values. Thus, some stabilized assets could only be considered Group 1b once significant historical data are available. In addition, the stabilized asset would need to pass a redemption test (see below) and be issued by a firm subject to capital and liquidity regulations.

2. Group 2

These are cryptoassets with stabilization mechanisms linked to other cryptoassets and/or mechanisms that increase or decrease the asset's value – i.e., algo stablecoins. Regardless, all rights related to these coins must be enforceable in every jurisdiction where offered, with banks required to conduct legal reviews to ensure that this is indeed the case prior to assuming any risks related to this group. The stabilization mechanism would also always need to ensure transferability and settlement finality, provide robust legal claims against the issuer and/or underlying reserve asset, and ensure full redeemability.

3. Group 3

These are cryptoassets generally associated with decentralized finance for which the operating platform is built and operated to manage its risks, posing no material risks to transferability, settlement, or (where applicable) redemption. The final standards also detail all the risks that must be managed (e.g., credit, market, third-party, AML). All key actions must also be traceable (i.e., which nodes, governance, and other arrangements).

4. Group 4

This covers companies that manage nodes or execute redemptions, settlement, transfers, storage, or offer custody of or invest reserve assets. These companies also must be regulated, supervised or subject to “appropriate” risk-management standards and must have and disclose a “comprehensive governance framework.”

Banks are required at all times to ascertain compliance with these Group 4 standards along with the appropriate classification of underlying cryptoassets and new hedging-recognition restrictions. Banks would also need to retain full documentation of their compliance with these requirements.

B. Redemption Test/Reserve-Asset Quality

To pass the redemption test, reserve assets must always equal or exceed the aggregate peg value of all outstanding cryptoassets being stabilized. If the reserve asset exposes the holder to risks, then reserves must significantly overcollateralize the reserve asset to ensure redemption rights under severely adverse stress.

The standard also details criteria for eligible reserve assets designed to minimize market and credit risk. Reserve-asset management must also be comprehensive and transparent with enforceable rights and an appropriate operational-risk and resilience framework that includes secure custody (although this provision does not appear also to require that this be from a third party). Key features of this framework must also be publicly disclosed, including on a daily basis for asset valuations, and subject to an independent external audit on at least an annual basis.

Group 2 cryptoassets are generally subject to these standards but redemption is mandated only within five calendar days. Numerous documentation requirements and disclosures are also unique to all Group 2 assets to clarify who is entitled to what under which circumstances. If these documents and disclosures are approved by the “relevant” regulator, that suffices; otherwise, independent legal opinions verifying them are required.

C. Banking/Trading-Book Boundaries

In general, book assignment is based on existing market-risk standards under Basel’s final 2017 framework for like-kind or reference assets.⁷ Group 2 assets fall under market-risk capital rules without reference to models or certain deductions.

D. Capital Treatment

This is as follows for credit risk-based capital:

- Group 1a assets in the banking book fall under the same RBC weightings as like-kind assets if the tokenized assets have the same legal rights as the like-kind asset. However, despite this broad alignment, banks are required to assess indirect credit risks and revise RBC as needed under circumstances such as differing amounts of market liquidity for a tokenized versus a like-kind asset or the collateral backing it. Tokenized assets may qualify as collateral for credit-risk mitigation purposes under certain conditions.
- Banks must analyze their Group 1b positions to identify all circumstances that could lead to a loss and then capitalize accordingly, with the final standards providing various examples of how this might be done. Notably, banks would be required to hold “step-in” capital in cases where reputation risk might lead them to step in for a defaulted redeemer; these Basel standards have yet to be expressly implemented in the U.S. Group 1b cryptoassets are not eligible collateral in the trading book.
- A capital add-on for “infrastructure risk” also applies to Group 1 assets. It is initially set at zero, but supervisors can increase it based on any observed infrastructure weaknesses.

⁷ See **CAPITAL221**, *Financial Services Management*, January 2, 2018.

- Group 2a assets are differentiated from 2b by virtue of use of a hedging framework. 2b assets fall under stringent standardized rules without recognition of any hedging that would otherwise reduce RBC. Hedging recognition is based on factors such as the bank's ownership stake or the extent to which the asset is traded in recognized derivatives or ETF markets. Several add-ons also apply to Group 2 assets.
- Minimum capital requirements for operational risk are also set under Basel's 2017 final standards. Banks are required to apply add-ons when these standards do not effectively capture crypto exposures.
- Cryptoassets are expressly included in the leverage ratio based on values established for financial reports.

E. Minimum Liquidity Requirements

The LCR⁸ and NSFR⁹ apply to cryptoassets as they would to like-kind exposures, but numerous caveats also apply. These include:

- Tokenized digital assets may be considered HQLA only if they meet all the HQLA requirements; Group 1b and 2 assets may not ever be considered HQLA;
- for inflow/outflow and related NSFR purposes, Group 1 assets are generally treated as like-kind ones;
- standards for Group 2 assets generally treat them as securities. If the bank issues the stablecoin, then liquidity calculations track those for bank liabilities based on the earliest possible call date and encumbrance specifications;
- LCR and NSFR treatment for bank-issued cryptoassets used in wholesale payments or other operational functions is similar to that for like-kind assets, but specifications address various scenarios; and
- supervisors are to apply more conservative standards when warranted by cryptoasset risk. This is likely to be the case when exposures pertain to unregulated entities.

F. Large-Exposure Requirements

These cover cryptoassets that pose credit risk,¹⁰ with these standards clarifying that default risk related to reserve assets that then affects a counterparty must count towards that counterparty. Exposure limits also apply to a bank's exposure to Group 2 cryptoassets as an asset class subject to a new general limit of one percent of Tier 1 capital and a ceiling of no more than two percent. Holdings over

⁸ See **LIQUIDITY17**, *Financial Services Management*, October 1, 2014.

⁹ See **LIQUIDITY32**, *Financial Services Management*, October 27, 2020.

¹⁰ See **CONCENTRATION5**, *Financial Services Management*, April 23, 2014.

one percent are considered 2b and thus subject to more costly RBC, but this now applies only to the amount over the one-percent limit to avoid cliff effects. If the two percent limit is breached, then punitive capital rules would apply to all Group 2 assets.

G. Risk Management and Supervisory Review

Detailed standards are prescribed along with recommended supervisory action both to ensure this is done and to sanction banks when it is not. Supervisors are also given discretion to mandate more stringent standards – e.g., stress testing or scenario analyses. Notably, banks are told to undertake ex ante review of any cryptoasset exposure and ensure it is in line with board-established risk tolerances and other internal controls, with express risk-management strategies for cryptoassets also mandated.