ADAN

L'ASSOCIATION POUR LE DÉVELOPPEMENT DES ACTIFS NUMÉRIQUES

Basel Committee on Banking Supervision second consultation on the prudential treatment of crypto-asset exposures

Adan's consultation response

Septembre 2022

Context

Following a preliminary proposal in June 2021, the Basel Committee on Banking Supervision (BCBS) published a second consultation for its position on the prudential treatment of crypto-asset exposures on 30 June 2022. The paper clearly shows the direction in which the banking sector is heading towards crypto-assets and what this should involve for the market more broadly.

Firstly, crypto-assets are always divided into two groups. The second consultation changed the conditions for classification between these two groups.

1. Group 1 includes those eligible for treatment under the existing Basel framework with some modifications.
2. Group 2 includes "unbacked crypto-assets" and stablecoins with ineffective stabilisation mechanisms, which are subject to a new conservative prudential treatment.

In this latest public consultation document, the Basel Committee on Banking Supervision provides more details on the proposed standard and includes new classification factors such as:

- **Infrastructure risk add-on**: The introduction of an infrastructure risk add-on to risk-weighted assets to address infrastructure risk for all Group 1 crypto-assets.

- **Recognition of hedging of certain Group 2 crypto-assets**: Group 2 crypto-assets that fulfill a specific combination of recognition of hedging criteria (i.e. Group 2a) may be subject to modified versions of the market risk requirements, which enable a reduced degree of recognition of hedging in the determination of a bank's net exposure.

- **Removal of accounting classification link**: the capital requirements that will apply to crypto-assets have been separated from their classification as tangible or intangible assets under accounting standards.

- **Operational risk clarifications**: the proposal on operational risk and resilience was further clarified to delimit more clearly the risks that would be covered by the operational risk framework and those that should instead be considered under the credit and market risk frameworks

- **Details on the application of liquidity rules**: additional details have been added to clarify the application of liquidity risk requirements, including the treatment of crypto-assets liabilities (i.e. crypto-assets issued by the bank).

- **Group 2 exposure limit.** The introduction of an exposure limit will initially limit a bank's total exposures to Group 2 crypto-assets to 1% of Tier 1 capital.

Association's opinion on the Basel Committee's report

First of all, Adan supports the Basel Committee on Banking Supervision's willingness to update its document on banks' exposure to crypto-assets. In a context in which several banking and financial institutions are still hesitant about the development of crypto-assets due to the volatility of some of them and the potential risks they pose to financial stability, Adan would like to make several comments on the modifications made in the document.

NB: The Association's comments are not intended to give a position on the prudential rules set by the Basel Committee (which is not the Association's mission) but rather to address the changes made concerning the criteria for the classification of crypto-assets in groups 1 and 2.

On the recast of the classification conditions for Group 1 and 2 crypto-assets

The proposed framework continues to distinguish between "Group 1" cryptoassets that meet certain classification requirements and "Group 2" cryptoassets, which do not.

Group 1 covers both Group 1a (*tokenised traditional assets*) and Group 1b (*cryptoassets with effective stabilisation mechanisms*). The capital treatment for Group 1 cryptoassets will generally be based on the existing Basel framework (subject to certain additions), while Group 2 will be subject to a 1250% punitive risk weight and an aggregate exposure limit. The wording of the conditions therefore fundamentally affects how the framework will work.

In the first consultation launched by the Basel Committee, the conditions initially proposed were criticised both for their lack of clarity and for having imposed too high a standard on Group 1.

CBBS then revised the requirements in response to these concerns and solicited comments on these amendments. Among other things, the CBBS is considering whether qualification as a Group 1b crypto-asset should require the satisfaction of a "redemption risk test" and a "redemption risk test" or "basis risk test" or, as an alternative, an issuer that is itself prudentially regulated.
Moreover, the updated consultation document mentions that dematerialised securities issued using DLTs or similar technologies are considered to be within the scope of the add-on, while dematerialised securities that use electronic versions of traditional centrally administered registers and databases are not in scope of the Basel standards. Hybrid structures are however not discussed.

Adan's position

Adan strongly supports BCBS's intention to adapt the conditions for the classification of Group 1 and 2 crypto-assets in this new consultation. In Adan's view, the treatment of exposures to crypto-assets should ensure a level playing field for traditional players.
As such, too strict requirements on banks on the prudential treatment of crypto-assets would risk driving them out of this market and thus, limit the massive adoption of this new asset class as well as the market structuring. Adan is thus aware of the necessary balance between preserving financial stability and supporting the digitalisation of finance but considers that

Adan considers that the proposed classification and the related prudential obligations may still have negative effects on the banking sector in its investigation strategy around crypto-assets.
Adan, which advocates open experimentation with this new asset class, considers that some of the rules - notably the ad hoc classification of traditional securities issued in DLT - could limit the banking sector's flexibility, particularly in the context of the imminent implementation of the pilot regime.
Although several positive changes have been made in its current state, it seems that the BCBS text would make DLT experimentation complex for banks, which would deprive them of the benefit of the current regulatory sandbox.
Moreover, a more thorough granularity on the different types of crypto-assets (in particular by distinguishing between application tokens and protocol tokens) could be conducted. While the crypto-asset industry represents over 21,000 tokens, the level of risk associated with non-backed crypto-assets could vary considerably.
As the crypto-asset sector is constantly evolving and diversifying, this binary distinction (coupled with sub-criteria) may become insufficient in the future to accurately capture the exposure risks for banks.

Finally, the statement that dematerialised securities issued using DLTs or similar technologies are considered to fall within the scope of the add-on (a capital surcharge of 2.5% of the exposure), while dematerialised securities using electronic versions of traditional centrally administered registers and databases do not fall under the Basel standards seems disproportionate and does not take into account the opportunities offered by DLTs - which are more secure and more transparent.

On the recognition of the coverage of certain Group 2 crypto-assets

BCBS has accepted that Group 2 crypto-assets that meet a specific set of hedging recognition criteria should be allowed to benefit from modified versions of the market risk requirements that allow a limited degree of hedge recognition in the calculation of a bank's net exposure.

Adan's position

Adan particularly supports this initiative of the BCBS. This inclusion of hedging recognition criteria is a perfect response to concerns raised by the banking industry that certain unsupported crypto-assets in which there is a very liquid and transparent two-way market (such as BTC and ETH) could be effectively hedged, including with related derivatives or exchange-traded products.

About Adan

Adan (Association for the Development of Crypto-Assets) brings together crypto-assets and blockchain professionals in France and Europe. Its members cover many activities: markets, custody, payments, management, analysis tools, project and user support. Adan's mission is to unite the digital asset industry and promote its development in the service of a new digital economy. To this end, the Association has technical expertise in digital assets and maintains a close dialogue with public authorities and industry associations.

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