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Ms. Carolyn Rogers
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland



Re: Discussion paper on designing a prudential treatment for crypto-assets

Dear Ms. Rogers,

The Institute of International Finance (IIF) welcomes the Basel Committee on Banking Supervision (BCBS) discussion paper on designing a prudential treatment for crypto-assets, published on December 12, 2019. With these instruments potentially becoming more sophisticated and widespread in the coming years, there is an opportunity to provide greater clarity for all stakeholders. We support the BCBS for taking a forward-looking view on the evolving financial landscape, and we believe that this discussion paper represents a useful starting point, and a basis to continue with further in-depth analysis on this important emerging topic.

The discussion paper sets out several key risk characteristics, as well as varying activities where private sector banks may hold or trade in crypto-assets, and we believe this could become a useful basis for constructing an initial framework for appropriate prudential treatment. We also believe that there are multiple types of very distinct asset classes that are sometimes incorrectly classified under the singular broad “crypto” banner.

As such, our comments are concentrated on three major themes:

1. Distinguishing the different crypto-asset classes;
2. The need for a risk-based treatment, including the weighting of appropriate risk and activity factors; and
3. Appropriate design of prudential treatment for low-risk crypto-assets.

Distinguishing crypto-asset classes

As a starting point, we see a strong practical need to develop a clear taxonomy, with a well-defined methodology for identifying the various types of instruments across the different crypto asset classes.

The discussion paper does not clearly delineate between a crypto-asset and a technology that simply facilitates exchange of a crypto-asset. Without this clarity, punitive treatment for high-risk crypto-assets, such as bitcoin, may be applied to other assets that exhibit a lower-risk profile, such as stablecoins backed by fiat currency.¹ This could negatively impact innovation. A clear understanding and classification of

¹ One possible option would be to classify digital fiats and similar stablecoins as “digital assets,” distinct from other crypto-assets.

different crypto-asset categories is needed to enable proper regulation and supervision according to their characteristics and risks, as opposed to creating a blanket segment.²

It is important that the terminology remain technology agnostic and focus on the inherent risks of the specific assets. Designing rules that require or encompass the use of certain technologies should be avoided. This is all the more important given the inability to forecast the direction of future developments in underlying technological solutions.

Risk-based treatment

The discussion paper identifies several channels and possible financial and non-financial risk factors arising from crypto-asset exposures. We endorse this focus, and we urge the BCBS to be explicit in utilizing such factors as the basis for a risk-based prudential framework, and to expand and provide more clarity on the sensitivities across the spectrum from low-risk to high-risk crypto-assets.

The IIF also supports the position that the underlying technology should not be considered a risk factor. Based on the principle of technology neutrality, we recommend that, where possible and appropriate, the treatment of crypto-assets should be based on the treatment of the traditional underlying asset. For example, in case of a token linked to segregated underlying assets, we believe that financial institutions should be able to model risks as those of the underlying assets, taking additional operational risks (e.g., legal and technological) into account as appropriate.

Accordingly, the general principles outlined on page eight of the discussion paper correctly emphasize that higher-risk crypto-assets should carefully assessed for new risks arising from their unique features, relative to traditional assets that already are subject to a prudential framework. We agree that the emergence of these instruments does not necessarily require a whole new framework, and should leverage existing prudential treatments. It is similarly important to note that of the 18 types of activities set out on page nine of the discussion paper, many are governed by existing risk controls within private sector banks and aligned to core client business; prudential treatments should (and in some cases already do) reflect this.

It is important to stress that there is not a single driver or determinant of risk, and we see further merit in constructing an appropriate risk-based framework with a matrix view based on activities, products and the risk profile of the particular asset types, to ensure that commensurate treatments apply. Such would enable individual sensitivities or weightings to be attached to each of those activities and risk factors, reflecting graduated scales where appropriate and/or specific qualifying criteria against each of those attributes.

To initiate further thinking, we provide a very high-level indicative example of such a matrix approach in Figure 1.

² If the actual underlying exposure is a hard asset (e.g., Central Bank Digital Currencies), there should be no need for a separate capital treatment. Where a crypto-asset is simply a representation of an underlying asset or claim, any exposure should be prudentially treated as an exposure to the underlying asset or claim.

Figure 1: Indicative Matrix: multiple risk drivers

		Asset or instrument risk profile			
		Lower risk	...	← →	... Higher risk
Higher risk	Key dimensions: Activities, product by risk profile				
... ..					
...				Indicative values, requiring further analysis	...
...					...
... ..					
Lower risk					

This illustration is intended to highlight our recommendation that the BCBS take a matrix approach of targeted risk differentiation, including in the area of “higher-risk” crypto-assets, based on different dimensions of assets and activities, rather than a binary or mono-dimensional approach.

The risk profiles of assets themselves will fall along a spectrum, and may shift over time, while the institution’s associated role, activity, product and service will also be significant drivers of exposure. Developing a matrix that will stand the test of time as digital assets continue to evolve will also be a challenge so we recommend continued engagement with industry in this activity, particularly as the focus expands to the full spectrum of new digital assets.

The consideration of activities should reflect an assessment of the risk differentiation, nature and purpose of exposure.³ It is also stressed that the specific types of risks will vary as they pertain to particular activities.

To consider some example scenarios for some of the different activities noted in the discussion paper:

- Banks owning high-risk crypto-assets directly (e.g., as an investment) would be exposed to market risk, price risk, operational risk (including cyber risk), and legal risk.
- Banks lending to other entities dealing directly with high-risk crypto-assets (e.g. crypto-asset exchanges, fund managers of crypto-asset exchange-traded funds, etc.) would be exposed to credit risk to the entity, operational risk, legal risk, and reputational risk but would not be exposed to the market risk of the crypto-assets unless this risk were so material to the company’s risk that it resulted in a change to their overall credit risk.
- Banks providing custody/wallet services for high-risk crypto-assets would be exposed to operational risk, reputational risk, legal risk.

Additionally, we stress that not all risks are relevant for a prudential framework, for example, reputational and legal risks largely being gating issues rather than prudential risks. The application of a materiality criteria would also help enable private sector banks to experiment and keep pace with innovation.

³ For example, the holding of ether by banks for recording transactions (utility function) should not be penalized with the same high risk prudential treatment as if the holding was for speculative purposes.

We also note that the market scene continues to evolve rapidly, so the lists of identified risks and activities cannot be considered exhaustive and will require regular updating in response to further developments.⁴ The industry stands ready to work with regulators to assess the technology in incremental phases.

Lastly, the IIF maintains that the principle of “same activity, same risk, same treatment” should apply. We encourage the BCBS to utilize and promote the use of current regulations where those are already sufficient to address the risks related to these assets, and to identify if regulation is either absent or requires adjustments. A granular assessment of the current prudential framework should be a prerequisite step before developing additional requirements.

Prudential treatment of low-risk crypto-assets

We note that the discussion paper only provides an example for the treatment of one particular higher-risk crypto-asset scenario.⁵ The prudential treatment of other types of crypto-assets (including lower-risk exposures) also needs to be explored and calibrated, and their risk profiles should be carefully differentiated among the various types of assets in this ecosystem, using classifications that are based on the nature and the economic function of the underlying crypto-asset (e.g., payments, investment, utility).

Such lower-risk assets might start with central bank digital currencies (CBDCs)⁶, followed by tokens issued by a regulated private sector bank (e.g., proposals such as MUFGcoin) or used in counterparty settlement processes between private sector banks (e.g., Finality’s Utility Settlement Coin).⁷ Stablecoins launched by consortiums of large, established global companies could also potentially sit somewhere along the lower end of the risk spectrum, depending on how their reserving process operates and is governed, regulated, and supervised.

We believe it is important that private sector banks are not disadvantaged or disincentivized from holding or transacting in these types of lower-risk crypto-assets. For their ongoing viability and stability in an evolving and increasingly digitized economy, private sector banks need to be able to operate in the currencies and instruments that their customers want to use: in providing customers with depository and custody facilities, in extending credit, and in providing hedging services to manage customers’ risk. If private sector banks were to be subjected to a treatment that was punitive on lower-risk assets, it could contribute to the erosion of what are currently considered “stable” funding sources, adding to some of the financial stability risks that we previously profiled in our December 2018 paper *Asymmetric Disintermediation*.⁸

⁴ For example, the channels listed on page nine of the discussion paper could be complemented by adding a case where there are multiple issuers, where a crypto-asset is issued as a joint initiative of a consortium of private sector banks, perhaps via a Special Purpose Vehicle (SPV).

⁵ As per the discussion paper, high-risk crypto-assets are characterized by the following features: they are digital assets recorded on a DLT platform and secured cryptographically; they are not issued by a jurisdictional authority or another identified issuer; they have no intrinsic value and are not explicitly and directly linked to, or backed by, assets with intrinsic values; and the holdings of the assets do not give rise to a contract between the holder and another identified issuer.

⁶ It is noted that the risk profile of any CBDC will be dependent on the specific design, and the management and creditworthiness of the issuing central bank; consequently, not all CBDCs will necessarily be “low risk.”

⁷ For more information on these types of lower-risk assets and the various considerations around their prudential treatment as well as their potential impact on the future of money and the financial system, please see IIF, *Commercial Bank Coins and Central Bank Digital Currencies*, April 2019, <https://www.iif.com/Publications/ID/3298/Commercial-Bank-Central-Bank-Digital-Currencies-Prudential-Treatments>.

⁸ <https://www.iif.com/Publications/ID/3198/Asymmetric-Disintermediation>.

Consequently, we believe that the calibrations for lower-risk crypto-assets are an important priority. If this discussion paper is to be succeeded by a consultation paper, we urge the BCBS to reflect the sensitivity to multiple drivers (such as the form set out in Figure 1), explore the treatments for low-risk assets in more detail, and develop additional illustrative examples that go beyond merely the high-risk case shown in the discussion paper. We also highly encourage the BCBS to actively follow and engage in discussions on the accounting treatment of crypto-assets, to encourage more alignment between accounting and prudential treatments.

We reiterate our support for the BCBS taking this forward-looking view. We agree that because crypto instruments lack standardization and are immature asset classes undergoing rapid development, there are potential risks and concerns for the financial system. At the same time, we believe the risks depend on the type of crypto instrument and the type of activities executed, and that it is important to differentiate between the varying risk profile that each crypto-asset may exhibit. Not doing so could undeservedly impact lower-risk instruments and their role in innovative financial activity, violate the principle of “same risk, same activity, same treatment,” and cause negative spillovers affecting financial stability and innovation.

The specific nature of the various crypto-asset classes merits deeper assessment of the various instruments and activities, and its continued rapid evolution means that regulation needs to maintain sufficient flexibility, with continuous re-evaluation and agile supervision.

Lastly, we are conscious that the BCBS’s scope is on regulated banking entities, and that many of the participants and potential participants in crypto-assets markets consequently sit outside the prudential perimeter. The dynamic growth and increasing market presence of other entities in areas such as payments presents the potential for them to quickly become market leaders with systemic importance, with implications for financial stability and competition. The IIF therefore encourages the BCBS to collaborate with other agencies to promote a consistent approach across all market actors in the ecosystem.

The IIF looks forward to working with the BCBS and its members on this important topic, and to contribute to the further development of a more substantial risk-based framework. My colleague Conan French (cfrench@iif.com) and I (bcarr@iif.com) stand ready to engage in additional discussions and consultations.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'BCarr', written in a cursive style.

Brad Carr,
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