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The Digital Regulator

The Basel Committee: harsh initial proposal for crypto-asset regulation

Abstract

The Basel Committee on Banking Supervision (BCBS) issued a discussion paper^{link1} (12 December 2019) on the prudential standard for crypto-assets. The goal of this paper is to discuss the design of a prudential framework. It explains the risks characterising crypto-assets and notes the absence of a one-size-fits-all definition of crypto-assets.

In substance, the Committee believes that the lack of standardisation, the rapid development and the high volatility of crypto-assets justify a conservative global prudential standard. This illustrates for fully decentralised crypto-assets such as bitcoin and ether (80% of crypto-assets market capitalisation), in terms of the harshest possible Pillar 1¹ minimum capital requirement (as applied to the worst-rated securitisation tranches), borrowing from its 12 March 2019 statement the Pillars 2 and 3 standards applicable to the broader family of crypto-assets.

The forward-looking attitude of the Committee is commendable. In our view however, the initial direction is misguided. Such standards would stifle financial innovation and confine crypto-assets to an unregulated area. The Committee should acknowledge the complexity involved in formulating a standardised Pillar 1 measure of crypto-asset risk which would be both sufficiently accurate as a means to set regulatory capital and adequate to support financial innovation.

A global standard under Pillar 2 would be better suited, in the circumstances, to reconciling sustainable and beneficial financial innovation with an effective control of crypto-asset risks in the banking system. The prudential framework in place for banking book interest rate risk should serve as inspiration.

The BCBS discussion paper “Designing prudential methods for handling crypto-assets”

The Committee methodically analyses the risks incurred by banks when dealing with crypto-assets and highlights the absence of a one-size-fits-all crypto-assets definition. It illustrates target Pillar 1 capital and liquidity requirements for so-called “high-risk” crypto-assets and refers to its March 2019 statement for Pillars 2 and 3 aspects.

Crypto-assets give rise to traditional risks and carry specific risks.

The BCBS explains that banks dealing with crypto-assets incur – in addition to traditional risks including liquidity, credit, market, operational risk, money laundering / terrorist financing, implementation and reputation risks – specific risks driven by whether a conventional legal entity is involved or not when they are issued, the limited versus unlimited population of users, the mechanical or personal validation protocol, the prevailing legal regime and market data transparency.

The Committee adds that banks could be exposed to crypto-assets risk through a number of channels other than outright exposure, such as by issuing and validating crypto-assets, taking long positions in crypto ETFs, financing third-party investments in crypto-assets, lending and taking crypto-assets as collateral, proprietary and clients-based crypto trading, underwriting, custody, exchange and insurance services, using crypto-assets for internal or inter-bank operational processes.

No one-size-fits-all definition of crypto assets

The Committee observes that the currently available definition of crypto-assets – predicated by the general dependency on cryptography and DLT technology and the absence of physicality – is too general for the purpose of determining requirements for specific crypto-assets. The BCBS recognises that certain crypto-assets can serve economic functions similar to existing asset classes (such as mimicking equity or debt

instruments) and can source their value in a way similar to traditional asset classes (associated cash flows, value of accessible services) and / or can be supply-constrained. The Committee makes clear that the guiding principle “same activity, same risk, same rule” would be applied.

Highest possible Pillar 1 charge for “high-risk” crypto-assets

The BCBS defines “high-risk” crypto-assets in terms of assets that are digital, do not have intrinsic value, are recorded on DLT, are secured cryptographically and are not traceable to an issuer entity in the conventional or legal sense. Bitcoin, ether and other similar assets (an estimated 80% of the crypto-assets market capitalisation as of end 2019) would be in scope. It proposes capital requirements for banking book exposures in terms of full capital deduction (reflecting a 1,250% risk-weighting factor – the highest possible, currently applied only to the worst externally rated securitisations).

Crypto-asset exposures held in the trading book would equally be most conservatively subject to the equivalent of full deduction treatment for market risk and credit valuation adjustment risk, and exposures bearing residual risks would be subject to the relevant add-on. Banks would not be permitted to use the internally-modelled approaches for any crypto-asset exposures.

Crypto-assets would not be eligible to serve as financial collateral for the purpose of the credit risk mitigation framework and would not be eligible as high-quality liquid assets for the purpose of the Liquidity Coverage Ratio and Net Stable Funding Ratio. Finally, exposure to crypto-assets would be included in the leverage ratio exposure measure and would be subject to the large exposure limits set out in the large exposure framework.

Standard Pillars 2 & 3 requirements

Regarding Pillars 2 and 3, the BCBS refers rather to its statement of March 2019, in which it specified the expectations applicable to banks authorised to acquire crypto-asset exposures or provide related services.

These expectations include: assurance that the bank has the relevant expertise to assess crypto-assets risks; implementation of a robust governance and risk management framework for crypto-assets and integration into the overall risk management processes; disclosure of material crypto-asset exposures or related services as part of its regular financial disclosures; prompt supervisory information about actual and planned crypto-asset exposure or activity.

An appraisal of the BCBS discussion paper

With respect to these preliminary, directional views issued for comment, we believe that a Pillar 1 charge is unsuited, in the circumstances, and that a Pillar 2 approach is a better way to reap the benefits of technological innovation in banking and finance in a regulated and controlled way.

A pillar 1 charge is premature. It would stifle innovation and promote unregulated activities

Crypto-assets are an immature asset class, linked to a developing technology poised to revolutionise banking, finance and the broader economy, and provide undisputed benefits, including enhanced efficiency, market liquidity and risk diversification. The Committee should allow these innovations to thrive in a regulated and risk-controlled environment.

It is premature to anticipate at which pace and with what scope the transformation will unfold. It is also too early to foresee when and in what form there will be sufficient stability and maturity in the crypto-markets to support the introduction of a meaningful formulaic Pillar 1 global prudential banking standard.

The Committee should first achieve a full understanding of the additional risk factors and exposure channels currently associated with crypto-assets and clearly isolate the intrinsic risk carried by crypto-assets from the broad operational risk currently surrounding their development (which in part originates from a currently immature and incomplete market infrastructure).

The Pillar 1 standard as currently illustratively proposed would just prevent banks from participating in the crypto-asset market and from offering services vital for the development of such markets – effectively promoting parallel, unregulated, activities and delaying innovation.

Pillar 2 is preferable. It allows reaping the benefits of technological innovation in a controlled way

During the ongoing rapid and intense development phase of crypto-assets, related activities, markets and infrastructure, it is preferable to leverage a more flexible supervisory review process. This process should be complemented by appropriate supervisory dialogue and cooperation, and by issuing qualitative standards (including for DTT / blockchain) for the digitisation processes. A Pillar 2 approach would make it possible to reconcile the need to be sufficiently conservative with the need to grant flexibility and allow further development.

The prudential framework in place for interest rate risk in the banking book should serve as an inspiration. It formulates clear risk management and governance expectations, a detailed (product-based) risk measurement framework, disclosure requirements. It positions capital adequacy within the context of the internal capital adequacy process; it provides supervisory principles for the identification of outliers (including international cooperation) and a standardised risk measurement framework that could be mandated to banks or offered as an option.

Conclusion

The Committee is considering whether to specify a global prudential standard for banks' exposure to crypto-assets and if it decides to specify prudential handling of crypto-assets, it would issue a detailed consultation paper.

In our analysis, we have argued that while the forward-looking stance of the BCBS deserves all praise, the preliminary direction offered for comments and heavily biased towards the

extremely conservative Pillar 1 capital charges is misguided, would prevent banks from participating in the crypto-asset market and from offering services vital for the development of such markets – effectively promoting parallel, unregulated, activities and delaying innovation as well as related benefits.

In the current circumstances, the BCBS should leverage a more flexible supervisory review process (Pillar 2) – for instance inspired by the current banking book interest rate risk framework – to fulfil its conservative needs, while ensuring the required flexibility and making allowance for further development.

¹ The Basel prudential framework rests on three pillars: formulaic minimum capital (risk-based and leverage ratio) & liquidity requirements (Pillar 1), supervisory review process (Pillar 2) and disclosure requirement (Pillar 3).

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