

Federal banking agencies issue guidance on capital treatment of tokenized securities

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Banking organizations must ensure that a tokenized security confers identical legal rights as its non-tokenized counterpart to qualify for the same capital treatment as the non-tokenized form of the security, according to new guidance from the federal banking agencies.

Overview of the guidance

The Office of the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation (collectively, the federal banking agencies) [issued new frequently asked questions](#) on how tokenized securities are treated under the capital rules.¹

- **Defining eligible tokenized security.** The guidance applies to “eligible tokenized securities,” defined as “tokenized securities that, under applicable law, confer legal rights identical to those of the non-tokenized form of the security.” The guidance notes that tokenized securities generally take one of two forms: (1) in some cases, the token is used to represent an interest in a security that has been issued using traditional processes, such as a central securities depository and (2) in other cases, an issuer may issue the security directly on a blockchain. The guidance applies to both tokenization models. However, when a tokenized security does not confer identical legal rights to that same security in a non-tokenized form, it falls outside the scope of the guidance and would not necessarily receive identical treatment under the capital rules.
- **Treatment of eligible tokenized securities.** The guidance states that, under the capital rules, an eligible tokenized security “should be treated in the same manner as the non-tokenized form of the security would be treated.” This means, for example, that if the non-tokenized form of a security would receive a 100% risk weight, an eligible tokenized form of that security would also receive a 100% risk weight. This approach, which we refer to as parity capital treatment, would apply to derivatives referencing an eligible tokenized security as well.
- **Eligible tokenized securities as financial collateral.** The federal banking agencies made clear that eligible tokenized securities that satisfy the definition of “financial collateral” would qualify as financial collateral under the capital rules.
- **The capital rules are technology agnostic.** In sum, the guidance confirms that the capital framework is agnostic towards the technology used to record ownership rights in securities. This means that the use of distributed ledger technologies to issue and transact in securities will not, in and of itself, affect the capital treatment of those instruments. Nor will the design of the blockchain system itself have an impact—e.g., the guidance states that the capital rules do not draw a distinction between permissioned and permissionless blockchains.

Key takeaways

First, implicit in the guidance is that it is permissible for banking organizations to hold tokenized securities as principal and receive tokenized securities as collateral.

Second, the guidance should not be interpreted as permitting parity capital treatment for all tokenized securities. The gating requirement is that an eligible tokenized security must provide *identical* legal rights as the non-tokenized form of the security. Banking organizations should not assume that all tokenized securities confer identical legal rights to those of the security in its non-tokenized form.

Banking organizations considering holding tokenized securities, entering into derivatives referencing tokenized securities or receiving tokenized securities as collateral should consider the following procedural steps before applying parity capital treatment to tokenized security positions:

- **Confirm that the tokenized security satisfies the eligibility definition.** A banking organization looking to apply parity capital treatment should conduct a fact-specific legal analysis to document whether the tokenized security confers identical legal rights as the non-tokenized form of the security.
- **Conduct a specific analysis to recognize a tokenized security as financial collateral.** The guidance emphasizes that banking organizations must satisfy the capital rules' otherwise applicable requirements in order to recognize an eligible tokenized security received as collateral as a credit risk mitigant under the capital rules. A banking organization that has received tokenized securities as collateral for an exposure should ensure that the following conditions are met before recognizing the tokenized securities as financial collateral under the capital rules:
 - **Ensure the tokenized asset meets the definitional requirements of “financial collateral” and the specific type of collateralized transaction.** The definition of “financial collateral” imposes specific requirements on the eligibility of types of assets, such as “investment grade” for debt securities and “publicly traded” for equity and convertible bonds.² In addition, depending on the type of collateralized transaction for which financial collateral is intended to be a credit risk mitigant, the collateral must also be “liquid and readily marketable” or subject to a less favorable treatment if it is “illiquid.”³
 - **Follow the non-tokenized form.** An eligible tokenized security's status as, and type of, financial collateral should follow the status and type of the non-tokenized form of the security. For example, if the non-tokenized form of the security would qualify as financial collateral and receive a 15% haircut under the standardized supervisory market price volatility haircuts,⁴ the banking organization should apply the same haircut to the eligible tokenized form of the security.
 - **Apply the well-founded basis standard for credit risk mitigants.** If a banking organization seeks to recognize an eligible tokenized security that qualifies as financial collateral as a credit risk mitigant,⁵ the banking organization should conduct and document an incremental legal analysis subject to the well-founded basis standard of the capital rules.⁶ This analysis would need to conclude that the banking organization has a perfected, first priority security interest (or, outside of the United States, the legal equivalent thereof) in the eligible tokenized security and that the banking organization's enforcement of its rights in the eligible tokenized security collateral would not be subject to a risk of stay or avoidance (other than narrowly permitted stays such as under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Act) under applicable law in each relevant jurisdiction, including in the event of insolvency of the counterparty.⁷ In other words, banking organizations should update or supplement their existing collateral enforceability analyses to consider whether tokenized securities received as collateral would satisfy these requirements in each relevant jurisdiction.

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¹ 12 C.F.R. Part 1 (OCC), Part 217 (Federal Reserve Board) and Part 324 (FDIC).

² 12 C.F.R. § 217.2 (definition of "financial collateral").

³ See, e.g., 12 C.F.R. § 217.2 (definition of "eligible margin loan" – "liquid and readily marketable debt or equity securities"; definition of "repo-style transaction" – "liquid and readily marketable securities"); 12 C.F.R. § 217.37(c)(3)(iv) (longer assumed holding period and higher supervisory haircuts for netting sets of collateralized transactions with "illiquid collateral"); 12 C.F.R. § 217.132(c)(9)(iv)(A)(2)(iii) (same for netting sets of derivatives with "illiquid collateral" under SA-CCR).

⁴ See, e.g., 12 C.F.R. § 217.37(c)(3).

⁵ Under the capital rules, collateral is generally recognized as a credit risk mitigant under one of two approaches: (1) the collateral haircut approach (a.k.a. "E-C treatment"), which is available for eligible margin loans, repo-style transactions and collateralized derivative contracts or (2) the simple approach (a.k.a. "risk substitution treatment"), which is available for any exposure type. See, e.g., 12 C.F.R. § 217.37(b) (simple approach) and (c) (collateral haircut approach).

⁶ See, e.g., 12 C.F.R. § 217.3 (requiring that banking organizations must "conduct a sufficient legal review to conclude with a well-founded basis," that the transaction meets the definition of an eligible margin loan or repo-style transaction, as applicable, as an operational requirement for recognition of eligible margin loans and repo-style transactions).

⁷ See, e.g., 12 C.F.R. § 217.2 (definitions of "eligible margin loan" and "repo-style transaction").