

Davis Polk

Basel Committee Consultation on Prudential Treatment of Cryptoassets

June 17, 2021

Table of contents

	Page
Background and guiding principles	2
Scope of coverage	4
Proposed classification system	5
Proposed capital treatment	10
Proposed liquidity treatment	15

Background

- The past few years have seen rapid growth in cryptocurrency markets and increased interest in crypto-asset activities among banks worldwide.
- On June 10, 2021, the Basel Committee on Banking Supervision (**BCBS**) published a preliminary [proposal](#) for the prudential treatment of cryptoassets exposures of banks and other institutions subject to the Basel capital framework, noting that it is likely to be part of an “iterative process” of multiple consultations.
- Consistent with its past guidance,* the BCBS expresses the view that these activities have the “potential to raise financial stability concerns and increase risks faced by banks.”
- The consultation:
 - Sets out guiding principles for the prudential treatment of cryptoasset exposures;
 - Proposes a classification system for categories of cryptoassets for purposes of the prudential framework; and
 - Proposes capital and liquidity requirements and supervisory expectations for banks that engage in cryptoasset activities.
- Overall, the consultation would impose significant responsibilities on banks for assessing and monitoring the appropriate classification of cryptoasset exposures and, while generally applying elements of the existing Basel capital framework, adopts a conservative approach to the proposed capital and liquidity requirements applicable to these exposures
- The consultation is open for comment until September 10, 2021. Any final BCBS recommendations would need to be implemented by national prudential regulators, as is the case with the Basel framework more broadly.

* A [March 2019 newsletter](#) and a [December 2019 discussion paper](#) by the BCBS explore these topics and request stakeholder input.

Guiding principles

The consultation's approach is based upon three general principles:

- **Same risk, same activity, same treatment.** Prudential regulation of cryptoassets should be technology neutral and based upon the risks and functions of cryptoassets.
 - There is, however, some tension between the principle of technology neutrality and the approach taken by the consultation.
 - For example, the consultation distinguishes between dematerialized securities, which would be outside the scope of this framework, and tokenized securities, which would be within scope. The difference between the two, as described by the consultation, is that dematerialized securities are recorded on “electronic versions of traditional registers and databases” while tokenized securities are recorded on “distributed ledger or similar technology.”
- **Simplicity.** Given the newness of cryptoassets, the prudential framework focuses on simplicity and the “cautious” treatment of cryptoasset exposures. The consultation recognizes that this approach may need to be revisited as cryptoassets and cryptoasset activities evolve.
 - This principle appears to drive many of the recommendations in the consultation, with a default to more stringent capital and liquidity requirements and supervisory expectations unless cryptoassets and cryptoasset activities meet specific and highly tailored conditions.
- **Minimum standards.** BCBS recommendations are meant to provide minimum standards, with national jurisdictions being free to adopt more stringent requirements in implementing the standards. The consultation points out that this could even include prohibiting banks from having cryptoasset exposures.

Scope of coverage

Definition of cryptoasset: A private digital asset that depends primarily on cryptography and distributed ledger or similar technology.*

Out of scope

- Traditional assets already covered by the Basel capital framework
- Central bank digital currencies
- Any dematerialized securities held on the books and records of a central securities depository or custodian

Within scope

- All other cryptoassets
- Any dematerialized securities held via a distributed ledger
- Non-fungible tokens meeting the definition of cryptoasset
- Decentralized finance (DeFi) instruments meeting the definition of cryptoasset

* See [“Regulation, Supervision and Oversight of ‘Global Stablecoin’ Arrangements,”](#) FSB (Oct. 13, 2020).

Proposed classification system

- The general framework:
 - Banks must classify cryptoassets into Groups 1 and 2 based upon four key conditions.
 - Group 1 is further divided into:
 - Group 1a, **tokenized traditional assets**; and
 - Group 1b, cryptoassets with effective stabilization mechanisms (**qualifying stablecoins**).
 - Group 2, which includes bitcoin, is the general category for all cryptoassets that do not meet the conditions of Group 1.
 - As a result, Group 2 is much broader than bitcoin, which are explicitly referred to in the consultation
- In addition to these conditions, the consultation includes other, more detailed conditions that would also be relevant to the classification of a cryptoasset as Group 1, as summarized in the charts below.

* See [“Regulation, Supervision and Oversight of ‘Global Stablecoin’ Arrangements,”](#) FSB (Oct. 13, 2020).

Proposed classification system

To qualify as Group 1 (a or b), a cryptoasset must meet each of the following four conditions:

A. The cryptoasset either is a tokenized traditional asset or has a stabilization mechanism that is effective at all times in linking its value to an underlying traditional asset or a pool of traditional assets.

Group 1a

- The cryptoasset must be a digital representation of a traditional asset using blockchain or similar technology
- As noted above, dematerialized securities where ownership is recorded through the account of a central securities depository or custodian are out of scope

Group 1b

- To satisfy this condition:
 - A bank must verify ownership rights of any underlying traditional asset upon which the stable value of the cryptoasset is dependent.
 - To determine that a stabilization mechanism is “effective at all times,” a bank must have a monitoring framework to verify that the stabilization mechanism is functioning as intended.
 - The difference in value of the cryptoasset versus that of its underlying traditional asset must not exceed 10bp more than three times over a one-year period; this difference must be monitored daily by the bank. Upon a breach of this threshold, the cryptoasset may only be reassessed when the bank “has demonstrated to the satisfaction of supervisors that the cause of the breach has been addressed and will not reoccur.”
 - The stabilization mechanism must “enable risk management based upon sufficient experience.” New stablecoins would not be classified as Group 1 until a bank can accumulate the necessary experience with the stabilization mechanism.
- Meeting these requirements for stablecoin arrangements—other than those issued by the bank itself or where the arrangement has a specific mechanism to limit price fluctuations—may be difficult.

Proposed classification system

To qualify as Group 1 (a or b), a cryptoasset must meet each of the following four conditions:

B. All rights, obligations and interests arising from cryptoasset arrangements that meet the condition above are clearly defined and legally enforceable in jurisdictions where the asset is issued and redeemed. In addition, the applicable legal framework(s) ensure(s) settlement finality.

- To satisfy this condition:
 - A cryptoasset arrangement must ensure full transferability and settlement finality at all times.
 - A cryptoasset with a stabilization mechanism must ensure full redeemability—that is, the ability to exchange the cryptoasset for cash, bonds, commodities, equities or other traditional assets at all times.
 - Settlement finality in the cryptoasset arrangement should be properly documented so that it is clear when key financial risks are transferred from one party to another, including the point at which transactions are irrevocable.
- Banking organizations would have to conduct legal analyses of settlement finality of cryptoassets in the relevant jurisdictions (including with respect to conflicts of laws and enforceability) to determine whether this condition is satisfied.
 - These analyses likely would address the scope of the applicable legal framework in relevant jurisdictions, particularly for cryptoassets on permissionless systems and cryptoassets where holders are not restricted by geography.

Proposed classification system

To qualify as Group 1 (a or b), a cryptoasset must meet each of the following four conditions:

C. The functions of the cryptoasset and the network on which it operates, including the distributed ledger or similar technology on which it is based, are designed and operated to sufficiently mitigate and manage any material risks.

- This condition includes that:
 - Material risks include those that could impair the transferability, settlement finality or redeemability of the cryptoasset.
 - Entities performing activities associated with these functions must follow robust risk governance and risk control policies. These entities include “operators of the transfer and settlement systems for the crypto asset,” administrators of the stabilization mechanism and custodians of assets underlying the stabilization mechanism.
 - Networks that fulfill this condition would be those where the key aspects are well defined such that all transactions and participants are traceable.
- It is unclear whether a cryptoasset on a permissionless blockchain network could meet these requirements, given that independent validators may be viewed as operators of the system for a cryptoasset recorded on such a blockchain, and traceability of transaction participants may not be possible or possible only pseudonymously.

D. Entities that execute redemptions, transfers, or settlement finality of the cryptoasset are regulated and supervised.

- These entities include “operators of the transfer and settlement systems for the cryptoasset; administrators of the cryptoasset stabilization mechanism and custodians of any underlying assets supporting the stabilization mechanism.”
- As with condition (C), it is not clear that a cryptoasset on a permissionless blockchain network could meet this condition.

Responsibilities for classification

— A bank is responsible for:

- Assessing, including on an ongoing basis, whether a cryptoasset is compliant with the Group 1 classification systems; and
- Demonstrating to supervisors how the cryptoassets fulfill the conditions.

— This includes having in place appropriate risk management policies, procedures, governance, and capabilities to evaluate risks and implement these risk management functions on an ongoing basis.

— Supervisors are responsible for:

- Revising and assessing banks' classification analysis and risk management and measurement approaches; and
- Approving a bank's demonstration of whether a cryptoasset qualifies as Group 1.

— The consultation contemplates coordination among supervisors, including that they “routinely compare and share their supervisory approval criteria.”

- This coordination would be necessary to mitigate the risk of different classifications for similar cryptoassets in different jurisdictions, but may pose unique challenges for cryptoassets given the wide variation in how these assets are classified for various regulatory purposes across jurisdictions.

Proposed capital treatment

	Group 1a (tokenized traditional assets)	Group 1b (qualifying stablecoins)	Group 2 (all other cryptoassets)
Deduction from capital	Cryptoassets would be evaluated for deduction from capital under existing deduction frameworks, including the deduction for assets classified as intangibles under applicable accounting principles		
	Only cryptoassets that are not deducted from capital would be subject to the credit risk and market risk RWA treatments discussed below		
Credit risk RWAs	Generally the same treatment as the underlying traditional asset	For stablecoin exposures where there is an entity (the “redeemer”) that commits to exchange, directly with the holders of the stablecoin, the stablecoin for either an underlying traditional asset or cash equal to the value of an underlying traditional asset, the RWAs for market risk and credit risk equal the sum of two components:*	1,250% risk weight applied to a conservative measure of the exposure amount, determined (subject to a cap for derivatives exposures, see below) as the greater of (a) the absolute value of long position and (b) the absolute value of short position, without giving effect to netting of long and short positions
Market risk RWAs	Generally the same treatment as the underlying traditional asset, but if the tokenized asset has different liquidity characteristics than the underlying traditional asset: <ul style="list-style-type: none"> Tokenized assets may have different market values from their non-tokenized counterparts; and If there is insufficient data to model the impact of these differing liquidity characteristics, the internal models-based approaches to market risk may be unavailable 	<ul style="list-style-type: none"> The RWAs applicable to the underlying traditional assets as if they were held directly by the holder of the stablecoin exposure (based on either the market risk or credit risk treatment of the underlying assets, depending on whether the stablecoin exposure is classified in the trading or banking book); and The value of the stablecoin exposure multiplied by the risk weight applicable to an unsecured loan to the redeemer (effectively, a counterparty credit risk add-on) 	N/A – No distinction between credit risk and market risk; all RWAs reported as credit risk RWAs

* We do not describe the consultation’s proposed capital treatment for stablecoin exposures where stablecoin holders are unable to transact directly with the stablecoin issuer. We are not aware of an existing stablecoin arrangement that uses this structure. There is a strong supervisory push for stablecoin issuers to support a so-called “direct claim.” See, for example, President’s Working Group on Financial Markets, [Statement on Key Regulatory and Supervisory Issues Relevant to Certain Stablecoins](#) (December 2020).

Proposed capital treatment

	Group 1a (tokenized traditional assets)	Group 1b (qualifying stablecoins)	Group 2 (all other cryptoassets)
Operational risk RWAs	Potential Pillar 1 add-on for incremental operational risks associated with cryptoassets, based on one of three approaches: <ul style="list-style-type: none"> • Flat percentage-based operational risk add-on • Variable operational risk add-on based on characteristics of the cryptoasset • Time-based operational risk add-on, decaying over time as the underlying technology becomes more established and conditional on proven performance during stress events 		Not addressed
Credit risk mitigation (including collateralized transactions)	Only recognizable as financial collateral for credit risk mitigation purposes if either (a) the banking organization can show that the volatility in values and holding periods under stress conditions of the tokenized asset are not materially increased compared to the underlying traditional asset or (b) the banking organization increases the haircuts or holding period for the tokenized asset	Not eligible to be recognized as financial collateral for credit risk mitigation purposes	Not eligible to be recognized as financial collateral for credit risk mitigation purposes For repo-style transactions where the banking organization is lending Group 2 cryptoassets, a 25% standardized supervisory haircut will apply

Proposed capital treatment

	Group 1a (tokenized traditional assets)	Group 1b (qualifying stablecoins)	Group 2 (all other cryptoassets)
Other applicable exposure treatments	None	<ul style="list-style-type: none"> If the stablecoin is linked to a pool of underlying assets, rather than a single traditional asset, banking organizations holding the stablecoin should apply the “look-through” standards for equity investments in funds to determine the risk weight applicable to the direct holding of the exposure 	<ul style="list-style-type: none"> For derivatives referencing Group 2 cryptoassets, the exposure amount (to which the 1,250% risk weight is applied) is subject to a cap based on the maximum possible loss on the exposure Counterparty credit risk for derivatives referencing Group 2 cryptoassets is based on the following: <ul style="list-style-type: none"> Potential future exposure (PFE) is equal to 50% of the gross notional amount For purposes of replacement cost (RC) calculation, netting is permitted within netting sets of the same cryptoasset, but netting across different types of cryptoasset is not permitted Cryptoasset exposures may not be recognized as part of any hedging set For Group 2 cryptoasset short positions and exposures that could lead to unlimited losses, supervisors may require a capital add-on if losses could exceed the capital required by the 1,250% risk weight, which would be based on aggregate capital requirements under (1) the FRTB market risk framework (using a 100% risk weight for delta, vega and curvature parameters) and (2) the Basic CVA risk framework

Observations on the proposed capital treatment

— Cryptoassets as collateral

- The consultation states that Group 2 cryptoassets are not eligible collateral for “securities financing transactions and margin loans” and therefore (1) would not be recognizable as collateral in transactions where a banking organization receives such assets as collateral and (2) would receive the highest standardized supervisory haircut of 25% in cases where a banking organization lends such assets to a customer or counterparty against eligible collateral.
- The consultation otherwise provides that Group 1a cryptoassets may be eligible collateral, but only if they meet specified requirements, including that their volatility in value is not materially different under stressed market conditions than the same traditional asset. Group 1b cryptoassets are not eligible collateral.

— Hedging of cryptoassets

- In the context of Group 2 cryptoassets, the consultation states in a footnote that “cryptoasset exposures would not be part of any hedging set,” presumably for the purpose of determining the PFE amount of derivatives under the standardized approach for counterparty credit risk (SA-CCR).
 - It is unclear whether this footnote was intended to apply only to Group 2 cryptoassets or to all cryptoassets, including Group 1 cryptoassets.
- The consultation clarifies in a footnote that, for stablecoin exposures held in the trading book, “the calculation of [RWAs] would depend on the extent to which the market risk arising from the underlying traditional asset has been hedged by the bank” – suggesting that hedging may be recognized for purposes of calculating market risk RWAs for these Group 1b stablecoins and, presumably, Group 1a cryptoassets as well.

Observations on the proposed capital treatment

— Two sources of exposure for some Group 1b stablecoins

- For stablecoins that can be directly redeemed by the holder, the consultation effectively requires the recognition of two separate RWA amounts for:
 - (1) the credit or market risk on the underlying traditional asset (as applicable, depending on the banking or trading book classification of the exposure); and
 - (2) the counterparty credit risk exposure to the redeemer, determined based on the value of the cryptoasset holding, as if the underlying traditional asset were lent to the redeemer (unless the stablecoin is structured to give holders a direct claim on the underlying assets held in a bankruptcy-remote SPV and the banking organization has obtained a supporting legal opinion).

— Treatment of Group 2 cryptoassets may be more conservative than dollar-for-dollar deduction

- The 1,250% risk weight for Group 2 cryptoassets is explained as the equivalent of a dollar-for-dollar capital deduction based upon an 8% total risk-based capital requirement.
- But in practice the capital treatment would generally be even more conservative (aside from the exposure cap for derivatives exposures).
- Many banking organizations – including all U.S. financial holding companies -- are effectively subject to all-in capital requirements, inclusive of applicable buffer requirements, in excess of the 8% minimum total risk-based capital requirement, on top of which banking organizations generally maintain additional buffers as a prudential management or operational matter.
 - For example, for a banking organization managing to a 12% total risk-based capital ratio, a 1,250% risk weight would translate to a \$150 total capital requirement for a \$100 gross long exposure to Group 2 cryptoassets.

Proposed liquidity treatment

	Group 1a (tokenized traditional assets)	Group 1b (qualifying stablecoins)	Group 2 (all other cryptoassets)
LCR – High-quality liquid assets (HQLAs)	<p>Cryptoassets generally would not qualify as eligible HQLAs</p> <p>The BCBS will continue to investigate the prospect of recognizing as HQLAs those cryptoassets that are deemed to be equivalent to traditional assets that themselves qualify for inclusion in HQLA</p>		
Liquidity coverage ratio (LCR) – Outflow and inflow amounts	<p>Any Group 1 cryptoasset on the asset or liability side of a banks’ balance sheet must follow a treatment that takes account of the risks as set out in the LCR standard</p>		<p>Group 2 cryptoassets subject to a 0% inflow for the LCR</p> <p>Group 2 cryptoasset liabilities subject to a 100% outflow</p>
Net stable funding ratio (NSFR)	<p>Any Group 1 cryptoasset on the asset or liability side of a banks’ balance sheet must follow a treatment that takes account of the risks as set out in the NSFR standard</p>		<p>Group 2 cryptoassets subject to a 100% required stable funding factor</p> <p>Group 2 cryptoasset liabilities subject to a 0% available stable funding factor (i.e., liabilities would be assumed to mature in their entirety at the earliest possible date)</p>

Davis Polk contacts

Contacts	Phone	Email
Luigi L. De Ghenghi	+1 212 450 4296	luigi.deghenghi@davispolk.com
Randall D. Guynn	+1 212 450 4239	randall.guynn@davispolk.com
Jai Massari	+1 202 962 7062	jai.massari@davispolk.com
Eric McLaughlin	+1 212 450 4897	eric.mclaughlin@davispolk.com
Andrew Rohrkemper	+1 212 450 3207	andrew.rohrkemper@davispolk.com
Gabriel D. Rosenberg	+1 212 450 4537	gabriel.rosenberg@davispolk.com
Margaret Tahyar	+1 212 450 4379	margaret.tahyar@davispolk.com