

March 13, 2020

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

Re: Basel Committee Discussion Paper: Designing a Prudential Treatment for Crypto-assets (December 2019)

Dear Secretary General Rogers:

The Chamber of Digital Commerce (the “Chamber”) welcomes the opportunity to submit this letter for consideration by the Basel Committee on Banking Supervision (the “Committee”) with respect to its December 2019 discussion paper regarding the prudential treatment for crypto-assets (the “Discussion Paper”).¹ The Chamber is the world’s leading blockchain trade association. Our mission is to promote the acceptance and use of digital assets and blockchain technology, and we are supported by a diverse membership that represents the blockchain industry globally.

Through education, advocacy, and close coordination with policymakers, regulatory agencies, and industry across various jurisdictions, our goal is to develop a pro-growth legal environment that fosters innovation, job creation, and investment with appropriate safety and soundness protections. We represent the world’s leading companies in the blockchain ecosystem, including leading edge software companies, global IT consultancies, financial institutions, insurance companies, law firms, and investment firms. Consequently, the Chamber and its members have a significant interest in blockchain and distributed ledger technology.

I. Introduction

As the Committee correctly identifies in the Discussion Paper, markets in digital assets, cryptocurrencies, and stablecoins remain small.² While prudentially regulated financial institutions are evaluating opportunities to integrate blockchain technology into their operations, to our knowledge only a very small number of these institutions are actively involved in what the Discussion Paper refers to as “high-risk crypto-asset” markets.

¹ See Basel Comm. On Banking Supervision, *Discussion paper Designing a prudential treatment for crypto-assets*, Bank for Int’l Settlements (Dec. 2019), <https://www.bis.org/bcbs/publ/d490.pdf>.

² *Id.*

The Chamber and its member institutions agree with the Committee in recognizing some risks associated with this asset class. Furthermore, the Chamber agrees with the Committee that, at least for certain high-risk crypto-assets, “banks should apply a conservative prudential treatment;” however, we believe that this treatment should be risk-based according to the characteristics of the digital asset and activity as discussed below. A one size fits all approach is not warranted or appropriate as it fails to recognize the differences in the risks associated with various activities in which a bank may engage with regard to these crypto assets.”³ We believe the Committee should apply a framework for the prudential treatment of crypto-assets that is consistent with existing capital frameworks. Because crypto-assets present varying considerations and risks based on their economic function and use by a bank, the Chamber believes it is necessary for the Committee to adopt a sensible taxonomy for crypto-assets that will be an important first step to guide a risk-based approach to prudential treatment.

II. Executive Summary

An appropriate prudential treatment for crypto-assets incorporates the Committee’s guiding principles. However, the Chamber disagrees with the Committee’s proposed prudential treatment and illustrative example for “high risk crypto-assets.” The Committee’s example applies a conservative prudential treatment for all activities related to any “high risk crypto-asset.” While we agree a conservative approach may be warranted for some types of crypto-assets and certain bank activities related to such assets, the variety of applications and characteristics of crypto-assets as well as the different ways in which banks will engage with these assets either directly or indirectly requires a more flexible and tailored approach to address material differences in risk.

Instead, the Chamber encourages the Committee to use the existing prudential framework together with a defined taxonomy to determine appropriate treatment. Under the Chamber’s proposal, the Committee should analyze the risk profile of a crypto-asset through a framework that takes into account: a) the economic function of the crypto-asset and unique attributes of the crypto-asset at issue; and b) the activity in which a bank engages with respect to such crypto-asset. Once the risk profile is properly evaluated, a tailored capital requirement can be determined under a similar approach to the one used for traditional financial assets.

We do not believe that it is necessary to expand the current prudential framework to specifically address crypto-assets, as the existing categories of risk (credit risk, operational risk, and market risk) are sufficient to address activities related to crypto-assets. Our proposed framework for analyzing the appropriate prudential treatment for crypto-assets is guided by the same principles that guided the Committee’s Discussion Paper. First, our proposed framework recognizes that banks have experience engaging in innovative financial activities that have varying degrees of risk and managing those risks under their existing risk management frameworks. It therefore utilizes the principle of “same risk, same activity, same treatment” for crypto-assets that are similar—though not necessarily identical—to traditional asset classes. Second, crypto-assets are an evolving asset and the risks present today will evolve as the market develops. Therefore, the treatment of banks’ involvement with these assets must be agile due to the rapid change in the market.

³ *Id.*

III. Framework for Determining Prudential Treatment of Crypto-Assets

The Chamber urges the Committee to adopt a risk-based framework for evaluating the prudential treatment of crypto-assets. As is the case with traditional assets for which banks and regulators have significant experience calculating capital requirements, a crypto-asset's prudential treatment should be based on its unique risk profile as well as the activity in which the bank is engaged relative to the crypto-asset. In order to assess the risk profile for a crypto-asset, the Chamber believes the Committee should adopt a taxonomy based on the economic function and other key attributes of a crypto-asset (e.g. the issuer type, underlying assets, and redemption model). Then, based on the risk profile of the underlying asset and the activities for which a bank may use or be exposed to such crypto-asset, a prudential treatment can be determined using existing capital guidelines in the same manner used to calculate capital treatment for traditional assets (i.e., credit risk, operational risk, and market risk).

A. Taxonomy: Economic Function and Unique Attributes

The first prong of the framework that the Chamber believes should be used to evaluate the risk profile of crypto-assets examines the economic function and other key attributes of a crypto-asset. As a starting point, we recommend not defining the assets relative to a specific technology (i.e., cryptography), and instead, defining them broadly as “digital assets” (rather than crypto-assets), which is an electronic representation of value. From there, digital assets can be divided into different categories depending on the economic function they serve, the issuing entity, and their structural terms, among other key attributes.

With respect to economic function, the Chamber agrees with the broad categories of crypto-asset economic functions the Committee set forth in the Discussion Paper as a starting point of reference.⁴ The three broad types of economic function are: 1) crypto-assets used commercially for payments and settlement; 2) crypto-assets that represent investments or financial instruments such as a security, commodity, or derivatives contract; and 3) crypto-assets that serve a utility function by providing access to applications, products, and services. As a second step to this taxonomy, the risk profile analysis must also examine each asset on a case-by-case basis, accounting for other key attributes such as the issuer of the asset and the asset's structural terms.

While this is a starting point, we note that the landscape for the potential uses of crypto-assets continually evolves, and thus we recommend the Committee take a principled, flexible approach to address those changing circumstances. Furthermore, in line with the Committee's “simplicity” guiding principle, this taxonomy provides the necessary flexibility to account for the unique structure of various crypto-assets enough to adapt to the evolution of the still nascent crypto-asset markets.

⁴ See *id.*, at 6. In March 2019, the American Bar Association's (“ABA”) Derivatives and Futures Law Committee published a white paper on the regulatory landscape related to digital assets. See Am. Bar Assoc. Derivatives and Futures Law Committee Innovative Digital Products and Processes Subcommittee Jurisdiction Working Group, *Digital and Digitized Assets: Federal and State Jurisdictional Issues*, at 26, AM. BAR ASSOC. (2019). The ABA adopted broad categories of digital assets based on the Swiss Financial Market Supervisory Authority's (“FINMA”) February 2018 guidelines for Initial Coin Offerings, which are similar to the ones the Committee laid out in the Discussion Paper. *Id.*

Although the Chamber’s proposed taxonomy evaluates the economic function and other attributes of a crypto-asset, the Chamber recognizes that there are “hybrid” crypto-assets that fit into more than one broad category of economic function (*i.e.*, could be used for payments and as an investment instrument). The existence of these “hybrids” may require that regulators take a tailored approach to regulation where they draw from multiple regulatory frameworks to ensure that all risks are covered.

B. Activities/Bank Exposure to High-Risk Crypto-Assets

In order to determine the appropriate capital treatment for a crypto-asset exposure, a risk profile of the asset as well as a bank’s activity relative to the asset is necessary. Therefore, the Chamber’s framework incorporates the particular activity for which a bank is using a crypto-asset. The Discussion Paper helpfully laid out a list of potential activities that banks could undertake with respect to crypto-assets and which, therefore would expose banks either directly or indirectly to crypto-assets.⁵ Appendix A below illustrates our analysis based on the same activities outlined in the Discussion Paper of the type of exposure each activity provides the bank participant and the associated prudential treatment for high-risk crypto-assets only. We provide this illustration to show that, even in the Committee’s limited evaluation of a high-risk crypto-asset, different activities that a bank may undertake have materially different risks and this should impact the prudential treatment.

The importance of including the bank’s activity within the framework is illustrated in the following example. The Discussion Paper lists owning crypto-assets directly and owning products with underlying crypto-assets as activities that expose banks to crypto-assets.⁶ If a bank owns a high-risk crypto-asset directly, and also owns exposure to that same asset through a derivatives product like a swap or futures contract, the risk profile of those two particular exposures will be materially different for purposes of calculating an appropriate capital treatment. While the economic function and other key attributes of the asset will be identical, one activity—holding the asset directly—provides the bank with direct exposure to the asset, while the other activity—owning exposure to the asset through a derivatives product—provides the bank with indirect exposure to the asset. Consider another example where a bank is a direct counterparty to a derivatives product referencing the price of a high-risk crypto-asset, but also serving as a futures commission merchant on behalf of a customer trading in the same derivatives product. Again, while the economic function and other key attributes of the asset will be identical, the former activity subjects the bank to price movements in the asset, while the bank is merely serving as an agent on behalf of a customer in the latter activity.

IV. Capital Treatment

Based on the risk profile of a particular crypto-asset paired with the activity in which the bank is engaging, capital requirements should be calculated using the existing capital framework. Here, the Chamber agrees with the Committee’s use of a “same risk, same activity, same treatment” principle to guide its analysis. Given banks’ experience using these guidelines for high-risk asset classes, they are well-positioned to calculate capital requirements for crypto-assets as well. Therefore, the Chamber proposes utilizing existing capital standards in determining the appropriate prudential requirements and supervisory structure for crypto-assets.

⁵ *Discussion Paper*, *supra* note 1, at 9.

⁶ *Id.*

Currently, banks and regulators utilize capital guidelines under the existing framework, comprised of three layers of risk: credit or counterparty risk, operational risk, and market risk. The Discussion Paper lists additional risks that could impact banks exposed to crypto-assets: cyber and operational risks, legal risk (*i.e.*, the legal status of certain crypto-assets), reputational risk, third-party risks (*i.e.*, developers or technology providers), and implementation risk. While the Chamber agrees these risks are relevant to crypto-assets, cyber, third-party, and implementation risks are addressed by operational risk, while reputational and legal risk are gating issues that banks analyze before even committing to holding exposure to a given asset and therefore should not implicate capital requirements.

The Chamber acknowledges that certain crypto-assets—such as high-risk crypto-assets—possess unique attributes that may provide incremental risks.⁷ The Chamber proposes that banks be given the ability to illustrate to their regulators that a certain crypto-asset’s risk profile is analogous to another similar asset’s risk profile to which the bank already holds exposure. If the regulator agrees, such crypto-asset would receive the same capital treatment as the analogous asset. A digitized form of a traditional asset (*i.e.*, a digitized security or derivative product), should receive the same capital treatment as its non-digitized counterpart. In either circumstance, whether a bank is exposed to a high-risk crypto-asset or a crypto-asset akin to a traditional asset, utilizing the current capital framework provides banks with consistency and flexibility as crypto-assets continue to evolve.⁸ If there is no analogous asset that the bank can defend as similar, then direct deduct treatment subject to a maximum loss provision may be appropriate but only in cases where a bank is directly exposed to the full risk of a high-risk asset.

V. Conclusion

While a taxonomy unique to the features and characteristics of crypto-assets is necessary to develop a useful risk profile for the purposes of appropriate prudential treatment, the Chamber urges the Committee to then evaluate the risks involved in various activities in which a bank may engage relative to those assets to determine an appropriate prudential framework utilizing traditional capital guidelines. This will provide banks and regulators a flexible approach to properly calculate an appropriate amount of capital in the face of a rapidly evolving industry.

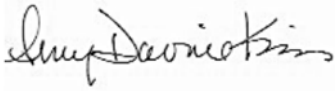
⁷ For example, more complicated risk-weighting algorithms or other methods apply to a wide variety of assets, such as over-the-counter derivatives exposures, guarantees, collateralized transactions, securitization exposures, and exposures to investment funds. These types of algorithms and methods are designed to produce higher risk weights when certain risk parameters are increasing. See Department of the Treasury *et al.*, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III. Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule. Final Rule*, 78 Fed. Reg. 62018, 62181, 62191-98 (Oct. 11, 2013).

⁸ Basel III incorporated an advanced approach to capital adequacy pursuant to which the United States’ largest banking organizations calculate their capital according to their own internal estimates of risk rather than “one size fits all” risk-weight buckets. The Committee devised the advanced approach seeking to “capitalize on the fact that banks are usually better informed about their risk profiles than credit rating agencies or regulators.” Banking Law Manual 2nd Edition: Federal Regulation of Financial Holding Companies, Banks and Thrifts § 6.03 (2019); *see also* Basel Committee on Banking Supervision, *A New Capital Adequacy Framework* 5-6, 13-14, 37-41 (June 1999), *available at* www.bis.org.

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Thank you for your consideration of these issues. We are available to serve as a resource as the Committee continues its evaluation of these issues.

Very truly yours,

A handwritten signature in dark ink, appearing to read "Amy Davine Kim", is positioned above the typed name.

Amy Davine Kim
Chief Policy Officer

Appendix A

The below table evaluates the different activities in which a bank may engage with regard to crypto-assets. It should be noted that this chart is included here for illustration purposes regarding the appropriate regulatory capital risk stripe we believe should be used to calculate regulatory capital. This highlights the differences in risk associated with various activities that a bank may engage in to demonstrate the need for a flexible framework.

Potential Activity	Risk Stripe of Prudential Framework	Exposure Type
Issuing crypto-assets directly	Operational ⁹	Direct
Validating crypto-asset block transactions (<i>e.g.</i> , mining transactions through proof of stake or proof of work)	Operational	Direct
Owning crypto-assets directly (<i>e.g.</i> , as an investment)	Operational Market	Direct
Owning products with underlying crypto-assets (<i>e.g.</i> , taking a long position on an exchange-traded fund)	Operational Market	Indirect
Lending to individuals, corporates, or financial institutions to allow them to invest in crypto-assets	Credit Operational	Indirect
Lending and taking crypto-assets as collateral	Operational Credit	Direct
Lending to other entities dealing directly with crypto-assets (<i>e.g.</i> , crypto-asset exchanges, fund managers of crypto-asset exchange-traded funds, etc.)	Credit Operational	Indirect
Proprietary trading of crypto-assets / crypto-asset derivatives ¹⁰	Operational Market Credit	Direct
Trading crypto-assets / crypto-asset derivatives on behalf of clients	Operational Market Credit	Direct and Indirect

⁹ Cyber risk and implementation risk should be considered a subset of operational risk. *See Discussion Paper, supra* note 1, at 6.

¹⁰ Under the Volcker Rule, U.S. banking entities cannot engage in impermissible proprietary trading.

Clearing crypto-asset futures / crypto-asset derivatives	Operational Credit	Indirect
Underwriting initial coin offerings	Operational Credit	Indirect
Providing custody / wallet services for crypto-assets	Operational	Direct
Where permitted, taking deposits of crypto-assets, or extending loans denominated in crypto-assets	Operational Credit (for extending loans)	Direct
Undertaking securities financing transactions involving crypto-assets	Operational Credit	Direct and Indirect
Exchanging crypto-assets for fiat currency, and vice-versa	Operational Market	Direct
Providing insurance against the theft and/or loss of crypto-assets	Market Credit	Indirect
Using crypto-assets for internal or inter-bank operational processes	Operational	Direct
Acting as a custodian or taking deposits from a reserve backing crypto-assets	Operational	Indirect