

Comments

on the public consultation of the Basel Committee on Banking Supervision on preliminary proposals for the prudential treatment of banks' cryptoasset exposures

Our ref

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Contact: Mr Silvio Andrae

Telephone: +49 30 20225-5437

Fax: +49 30 20225-5404

E-mail: Silvio.Andrae@DSGV.DE

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent almost all German banks.

Coordinator:

German Savings Banks Association
Charlottenstrasse 47 | 10117 Berlin |
Germany

Telephone: +49 30 20225-0

Fax: +49 30 20225-250

www.die-deutsche-kreditwirtschaft.de

Q1. What are your views on the Committee's general principles?

We understand that the Basel Committee is primarily dealing with the regulation of banks. However, we would like to take this opportunity to point out that there must be a uniform global framework for dealing with cryptoassets, including every case that could have consequences for financial stability, regardless of whether a bank or another company is involved. There is a need for regulatory clarity, a consistent cryptoasset taxonomy and standardisation. Moreover, we are advocating prudential requirements that are easy to implement in a rapidly evolving cryptoasset market. Accordingly, non-banks must also be regulated to prevent unwanted evasion into unregulated areas. As part of this, the regulatory regime for banks should also not be too restrictive, especially in the early days. If this is not the case, the supervisors would lose insight into developments on the crypto market, as they would not be able to fall back on the **reports** submitted by banks. In addition, on the basis of their expertise, banks can make a valuable contribution, for instance in the context of **countering money laundering**.

We are proposing the adoption of a **proportionality principle**. The purpose of the prudential requirements is to prevent banks from getting into difficulties because of cryptoassets. The overarching objective is therefore to safeguard financial stability. To do this, the Basel Committee is taking a very conservative approach with regard to Group 2 cryptoassets, for which it is proposing a 1250% risk weight. However, this would prevent banks from gaining experience with cryptoassets such as bitcoin at an early stage. As already mentioned, business with such assets is thus being forced out of the regulated banking sector into unregulated areas. This is counter-productive. To safeguard financial stability and still give banks an opportunity not to be left behind by new technologies, the answer is a proportionality principle under which banks can be invested in Group 2 cryptoassets up to a certain percentage of their total assets without having to apply prohibitively high risk weights. If the exposure exceeds this limit, higher risk weights could apply. The limit should be reviewed regularly and adjusted. In order to take account of the dynamic developments and innovations in this topic area, the prudential requirements should be subjected to a review process in the foreseeable future that should already be scheduled at this point.

This also makes sense in light of the fact that banks often need to hold a certain amount of Group 2 cryptoassets for transfers of Group 1a cryptoassets so they can pay the **transaction fees** ("gas fees"). For example, the EIB has issued a digital bond (Group 1a) on the Ethereum blockchain whose transaction costs are payable in Ether (Group 2).

Over and above this, however, we consider the proposed principles for the supervisory treatment of cryptoassets to be generally appropriate.

We also request that the prudential treatment of cryptoassets should not be linked to the accounting definition of cryptoassets as "intangibles", which is currently still under discussion. Our understanding of the discussion paper is that cryptoassets that have to be deducted from CET 1 under the **accounting rules** cannot fall under the prudential treatment of cryptoassets described in the paper. From our perspective, however, in particular cryptoassets for which there is a market are specifically not "intangibles" since, in contrast to goodwill for example, there is a market value for them. We therefore think it makes sense to apply risk weights instead of a full deduction, irrespective of the classification in the accounting framework.

Q2. What are your views on the Committee's approach to classify cryptoassets through a set of classification conditions? Do you think these conditions and the resulting categories of cryptoassets (Group 1a, 1b and 2) are appropriate? Which existing cryptoassets would likely meet the Group 1 classification conditions?

As a general principle, we can understand the proposed classification and the differences in the prudential treatment. As proposed, cryptoassets that are merely a digital form of a traditional asset and that grant the owners the same rights as traditional assets should be treated as traditional assets. We consider the necessary classification into Groups 1a, 1b and 2 to be correct in principle, although we think Group 2 should be further subdivided, as the approach applied to Group 2 is too conservative and not risk-sensitive.

In our view, it does not make sense to treat a **stablecoin** that has a stable pool of assets, but which falls into Group 2, for example because of an intra-year **fluctuation in value of 11 bp** instead of the allowed 10 bp, in the same way as a crypto currency without a collateral pool that has just been created by an unknown company. We assume that many stablecoins will not meet the condition of a maximum fluctuation of 10 bp.

This is also the case particularly because the condition linked to classification as a Group 1 asset, i.e. that either a traditional asset is tokenised or a stablecoin is used, quickly leads to classification as a Group 2 asset for new business models if the cryptoasset relates to a new (traditional) asset class, even if the risks are not higher. In light of the dynamic development of the market, we therefore welcome the fact that the Basel Committee is striving for continuous further development of the regulatory regime.

Considering the condition for classification as a Group 1 cryptoasset set out in paragraph 2 on page 5 of the Consultative Document ("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.") it should be clarified, in our opinion, that a clear contractual arrangement is sufficient.

We would also welcome the creation of a (non-exhaustive) list of examples of cryptoassets that fall under Group 1a/1b. These could then serve as a reference point for classifying instruments.

Q3. What are your views on the classification conditions? Are there any elements of these conditions that should be added, clarified or removed in order to:

- ensure full transferability, settlement finality, and/or redeemability;**
- limit regulatory arbitrage, cliff effects and market fragmentation; and**
- take account of new and emerging cryptoassets?**

As described above, we consider a limit of a 10 bp fluctuation in the value of the pool of a Group 1b stablecoin to be too conservative. Instead of classifying the asset in Group 2, together with the associated cliff effect, consideration could be given, for example, to a risk weight multiplier that adequately reflects the level of fluctuation if the threshold is exceeded.

In principle, classification should also be possible for a group of cryptoassets with similar characteristics, instead of at the single-asset level.

Q4. For the first classification condition, is there an alternative methodology to assess the effectiveness of the stabilisation mechanism of Group 1b cryptoassets? Would this proposed methodology be consistent with ensuring the effectiveness of the stabilisation mechanism while also being practical?

From our point of view, it is almost impossible to fulfil the condition "*Banks must also verify the ownership rights of any underlying traditional asset from which the stable value of the cryptoasset is dependent upon. In the case of underlying physical assets, they must verify that these assets are stored and managed appropriately. This monitoring framework must function regardless of the cryptoasset issuer.*", or only with great difficulty, as the banks would have hardly any control over the "supply chain" behind the assets. In addition, banks would be the only potential investor in the asset class that would have to face such a "burden of proof", leading to level playing field questions. We are therefore asking for this requirement to be deleted.

Q5. For the third classification condition, (i) would risk governance and risk control practices for Group 1 and Group 2 cryptoassets differ; and (ii) are there alternatives to the required risk governance and risk control practices that would ensure that material risks of the network are sufficiently mitigated and managed?

The risk control mechanisms are likely to differ for Group 1 and Group 2 crypto assets. Ultimately, it must be ensured for Group 1 that there is a legal connection between the underlying asset and the token. In the case of a Group 2 cryptoasset, such as bitcoin, this aspect does not apply. A further subdivision needs to be made even within Group 2, as described above.

Q6. For the fourth classification condition, (i) to what extent would the regulation and supervision of entities that execute redemptions, transfers, or settlement finality of the cryptoasset reduce risk in cryptoasset exposures held by banks; (ii) which entities should/ should not be in scope of regulation or supervision? For instance, are there entities involved in the transfer and settlement systems of cryptoassets (such as nodes, operators and/or validators) that should be excluded from the condition of required regulation and supervision?

Q7. Do you consider the responsibilities of banks and supervisors to be clear and appropriate? Are there any other responsibilities for banks or supervisors that the Committee should consider?

In our view, the responsibilities of banks and supervisors are generally understandable. We are assuming that new control mechanisms will have to be introduced at the banks to ensure this.

We welcome the fact that, in the case of the same cryptoassets being classified as Group 1 by different banks, supervisors should rely on their previous assessment. This is all the more important because supervisory decisions should be taken as quickly as possible.

In addition, consideration should be given to **publishing cryptoassets** that have already been assessed and **"grouped"** in their relevant jurisdictions so that banks can invest in the cryptoasset without any significant assessment effort by the bank and supervisors. Finally, it is worth noting that a different classification of the same assets by different banks would also be problematic from the perspective of a level playing field.

Q8. Are there ways in which the increased operational risk relating to cryptoassets (relative to traditional assets) can be measured? How should a pillar 1 add-on be designed to capture additional operational risks arising from exposures to cryptoassets?

We do not feel that it is appropriate to generally assume any increased operational risk relating to cryptoassets and to capture this with flat capital add-ons. Ultimately, Group 1a cryptoassets are primarily created as cryptoassets to reduce operational risk associated with settlement. In light of this, we reject the idea of a flat add-on based on the exposure amount and rather tend towards a "calculation" of a variable add-on or charge based on the specific characteristics of the cryptoasset. The existence of any operational risk should always be assessed on a case-by-case basis. It should therefore also at least be possible to set the operational risk add-on to zero if there are no additional risks compared with traditional assets.

In addition, the idea of further reducing the calculated add-on after a certain period could be considered if experience shows that the cryptoasset has proven to be resilient against possible external influences, such as cyberattacks.

It remains to be seen whether it makes sense to adapt the current Pillar 1 **operational risk** framework for cryptoassets and thus make the prudential requirements more complex, or whether it makes more sense to **address** any risks resulting from the technology that have not yet materialised in a loss event **via Pillar 2**.

Q9. Are there further aspects of the credit risk and market risk requirements that could benefit from additional guidance on how they should apply to Group 1a cryptoassets?

The exclusion of cryptoassets involving additional counterparty credit risk from tokenised traditional assets should either be removed or at least differentiated ("The above criteria are also not met by cryptoassets that through their specific construction involve additional counterparty credit risks relative to traditional assets.").

Q10. Do you have any views on the Committee's current thinking on the capital requirements for Group 1b cryptoassets?

To ensure a level playing field, non-bank issuers of stablecoins such as Tether, for which the stablecoins are only allegedly 100% collateralised by USD or other fiat currencies, or whose collateralisation is not made fully transparent by the issuer, should be treated as strictly as corresponding issues or constructs by banks. As Tether is the main liquidity provider in the bitcoin market, although the stablecoin Tether is largely "collateralized" by commercial paper, financial stability and liquidity risks should also be taken into

consideration. The regulatory arrangements should therefore pay appropriate attention to the actual collateralisation of stablecoins, and the measurement of capital requirements should depend on the type of stablecoin under consideration. "**Overcollateralization**", in the sense of a pool whose value significantly exceeds the claims against the redeemer, should be favourably considered in the context of calculating the risk weight that would be assigned to the redeemer in the case of an unsecured loan.

We are also in favour of the ability to use certain **stablecoins as collateral**, especially if it is ensured that the claim is legally enforceable and the assets in the pool are insolvency-proof.

Q11. What further aspects of the credit risk and market risk requirements could benefit from additional guidance on how they should apply to Group 1b cryptoassets?

Q12. Do you think the proposed capital treatment of Group 2 cryptoassets, including the application of a 1250% risk weight instead of deducting the asset from capital (for the reasons explained above), appropriately reflects the unique risks inherent in these assets?

We would like to point out that we are not in favour of an application of a 1250% risk weight for high-risk cryptoassets in general. Although this is by now practically the easiest way to cover potential risks from cryptoassets, it does not take into account their different design options. What we would like to see is a more differentiated approach looking for equivalent use cases among current asset classes.

This applies in particular to tokenised traditional assets and stablecoins that have just fallen short of the conditions for being grouped into Group 1a and 1b. As already described in the answer to question 2, it does not seem rational to treat a stablecoin that fluctuates slightly more in value, for example, in the same way as a less established cryptocurrency.

Especially for established high-risk cryptoassets like bitcoin, we also consider the proposed application of a 1250% risk weight to be too harsh. The key question is whether the cryptoasset will have any value in the event of its liquidation. It is true that the value of e.g. Bitcoin is highly volatile. Given that it has been in existence for over ten years, however, it must be considered to have more value than less established cryptoassets. We would suggest evaluating recoverability with the help of historical data. Instead of a risk weight of 1250%, one approach could be to compare certain high-risk cryptoassets with risky or volatile assets already available on the market. In this case, the risk weights are much lower (between 300-400%). This would be in line with the Basel framework where a 400% risk weight is assigned to speculative unlisted equity exposures. In other respects, this risk weight would also be assigned if the joint venture were to issue or be invested in cryptoassets. Any regulation of cryptoassets should, in any event, include a review clause so that the regulation can be reassessed and adjusted in a timely manner. This is absolutely essential in such a new and rapidly developing area.

We would also like to point out that it is unusual not to make a distinction between the trading and non-trading books. It makes a difference whether banks hold cryptoassets in the trading book, e.g. because they act as market makers for their clients and, in this case, determine the P&L daily and hedge risks, or whether they have the cryptoassets in the non-trading book, e.g. so they can pay transaction costs for Group 1a cryptoassets.

Q13. Are there alternative approaches that the Committee should consider that are simple, conservative and easy to implement? For exposures in the trading book, would it be appropriate to permit recognition of hedging via the application of a modified version of the standardised approach to market risk?

If there are exposures relating to the same cryptoassets, **hedging** should be possible, via both traditional financial and insurance instruments and instruments related to cryptoassets. The risk weight of individual cryptoassets should be applied to the net exposure resulting from netting all long and short positions in that cryptoasset, rather than selecting the maximum of long or short positions. The reason is that the latter would not adequately reflect the actual net exposure.

In other respects, see our response to Q12.

Q14. Do you have any views on the Committee's current thinking regarding the leverage ratio, large exposures framework and liquidity ratio requirements? Are there further aspects of these requirements that could benefit from additional guidance?

We believe that generally excluding cryptoassets from HQLA makes no sense, including with regard to possible future developments. Instead, we propose transferring and adapting the existing standards to this new asset class. We suggest allowing **Group 1a** cryptoassets at least to be classified as **eligible HQLA** assets if they share the same characteristics as traditional assets and qualify as HQLA.

Q15. Do you have any views on the responsibilities of banks? Are there any other responsibilities or aspects that should be covered by banks for the purposes of the supervisory review?

We believe that the responsibilities outlined in section 1.2 are comprehensive and reflect banks' risk management practices with respect to asset classes in general.

The suitable assumption of risks is one of the banks' economic responsibilities. The many requirements imposed on the management of all material risks, both in principle and concrete – from the risk inventory all the way down to validation – are comprehensively laid down. Supervisory authorities regularly obtain a detailed overview of the adequacy of risk management and the risk, capital and liquidity position as part of the **SREP**. In light of this, the requirement that banks should additionally (proactively) inform the supervisory authorities about the extent of their cryptoasset exposures and manage them strategically and operationally appears to be unnecessary. This information should be reserved for assessment in the SREP. In other respects, these requirements apply in a similar way to all risks.

In particular, monitoring the underlying DLT technology requires a high level of specialist knowledge at the banks. The question therefore arises as to whether ISO standards should be introduced for DLT so that the assessment effort for the banks is reduced.

Q16. Do you have any views on the responsibilities of supervisors? Are there any other responses that could be considered by supervisors when conducting supervisory review?

Q17. Do you have any views on the adjustments to minimum Pillar 1 capital requirements to capture additional credit and/or market risk? Are there any other potential modifications that supervisors may need to consider?

Risk mitigation measures, such as insuring risks associated with cryptoassets, are not discussed in the Consultative Document, but should also be considered when calculating the prudential treatment of cryptoassets.

Q18. Do you have any views on the potential design of disclosure requirements?