ABI Associazione Bancaria Italiana

Basel Committee consultation on prudential treatment of crypto-asset exposures

ABI Response

September 9th, 2021

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

ABI considers the definition of a prudential treatment as outlined by the Basel Committee a fundamental component for a crypto-assets regulatory framework that could contribute to mitigating the related risks and put those new instruments under a regulated environment. ABI also believes that monitoring this market and its development is essential to identify an appropriate set of rules.

We agree with the general principles mentioned ("Same risk, same activity, same treatment", "Simplicity"). Proportionality is also one of the key principles of prudential framework and should therefore be considered also for crypto-assets. The regulatory framework should be appropriately defined to address the different situations in a way that is proportionate to the actual risks and complexity.

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?

A crypto-asset that provides equivalent economic functions and poses the same risks compared with a "traditional asset" should be subject to the same capital, liquidity and other requirements as the traditional asset. ABI therefore basically agrees on the BCBS approach that the prudential treatment of crypto-asset exposures should be defined taking as a starting point the treatment applied to traditional asset, while a specific charge might be considered, where needed, to account for additional risk profiles that arise due to the peculiarities of such exposures.

ABI supports the Basel Committee's risk-based approach in defining crypto-asset categories. However, the Association wants to emphasise that some crypto-assets have not equivalent in the traditional world (i.e. Hybrid crypto-assets), so for some specific use cases it will be needed to develop a specific discipline.

We believe it is useful to clearly identify traditional financial instruments eligible for inclusion in the Group 1 category. This is also necessary in order to create a clear separation between tokenizable financial instruments and other crypto-assets that may have similar financial characteristics. However, for this approach to be more comprehensive, it would be highly desirable that the categories identified for prudential purposes are, to the extent possible, consistent with the categories of crypto assets that are being defined in the relevant legislation, since work in this regard is underway in some jurisdictions, like the EU. This is to allow banks to understand with legal certainty the correct prudential treatment to be applied.

The consultation wording provides for the application of the most conservative treatment as the default approach for every instrument, leaving the burden of evaluation on banks to exclude a crypto-asset from this category. This approach seems too broad and penalises businesses that rely on such exposures. Specific and

better calibrated definitions, such as those that will be introduced by MiCA Regulation at the European level or those suggested by FATF at the international level, could be used to identify additional subsets of instruments in order to simplify the evaluation process and thus favour a less severe treatment.

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

When responsibility to assess a crypto-asset to be considered within Group 1 falls on banks, the conditions of classification must be clear and unambiguous. They should be based on objective criteria and not on conditions that cannot be measured. To this end, the difficulty of measuring whether a network on which a crypto-asset is based is adequate enough not to compromise transferability, redeemability and settlement finality is pointed out. This complexity is enlarged by the variety of existing technologies and the uniqueness of each of them, which make it even more complex to identify the level at which condition are considered "sufficient" (*"The functions of the crypto-asset 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.")* to fit all alternatives.

Having said that, without a clear and objective classification requirement (such as the first classification condition on the stability of a stablecoin arrangement), classification "fragmentation" could occur and thus undermine one of the general principles that has guided the supervisory framework.

> 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?

We consider important the provision of an unambiguous criterion of evaluation for the fulfilment of the first classification condition. A stablecoin arrangement which has a daily difference in value that exceed three times 10 bp of the value of the underlying traditional asset cannot be considered as Group 1.

For information purposes only, it should be noted that in a working paper on stablecoins and stability mechanisms (Bullmann et al. (2019)), has been shown that over a three-year period the annualised volatility of the most popular stablecoins was at least 10%. It would be useful to determine whether the vast majority of stablecoin available on the market would be able to meet the first classification condition.

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?

Within the DLT/Blockchain family there can be many different configurations. Many of them are recent and in a continuous state of evolution. As pointed out above, we believe it is necessary to identify objective and clear requirements for the fulfilment of the classification conditions. ABI stresses the need for an approach that is as technologically neutral as possible, even though within this family of platforms. A future-proof approach would make it possible to avoid continuous and different evaluations that may require excessive and maybe inconsistent effort over time.

The validation mechanism and the distinction between permissionless and permissioned DLT play a crucial role in the quantification of different risks. For instance, in permissionless, fully decentralised blockchains, without the intervention of any service providers it is more difficult to mitigate AML/CFT, operational, ICT and cyber-risks. We would also add that in permissionless blockchains it would be much more difficult or in some cases impossible to identify clear responsibility and accountability.

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?

ABI denotes an excessive effort for banks in assessing the adequacy of a crypto-asset and its network to be classified within Group 1. In particular, the second and the third classification condition require a costly compliance effort. Assessing each crypto-asset to which a bank is exposed and continuously monitoring the entities that are responsible for its core activities would be complicated and, in many cases, difficult to assess.

ABI believes that the assessment of classification eligibility is very challenging. We suggest a reconsideration of the responsibilities for measuring and monitoring classification conditions that are placed on banks. The burden of compliance may discourage banks from exposing itself to a particular crypto-asset that may have the same risk as an equivalent traditional instrument.

As mentioned above (please see answer to Q2), we deem it is important to identify a subset of less risky instruments for which more simplified evaluation processes can be envisaged.

In addition, a mechanism that grants that banks are not required to seek approval for Group 1 status could be envisaged for assets that have been otherwise approved for other banks within a given jurisdiction. In any case, the BCBS or any other international authorities should maintain a public record/list of approved Group 1 cryptoassets qualified as eligible to ensure transparency and level playing field across jurisdictions. Having said that, a bank remain responsible for the continuous monitoring of the crypto-assets meeting the eligibility requirements as well as the assessment of the underlying risks.

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?

Calibrating a fair and proportionate capital requirement that can mitigate operational risk is very complicated especially in a framework based on standardised methods (AMA approaches no longer present in Basel 3 final). Crypto-assets have some unique characteristics and therefore they entail operational risks that cannot be transferred from the traditional world.

With regard to the Committee's preliminary proposals, we do not agree with the approach whereby capital requirements can be expected to decrease over time. The time variable does not always have a positive impact on the robustness of the network, and it is not always possible to assess it in a uniform manner (e.g., blockchain forks).

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?

In line with the first general principle, ABI believes it is appropriate to apply the same prudential treatment to a crypto-asset that has the same economic functions and pose the same risks as an asset in the traditional world. As far as the credit risk is concerned, the technology itself does not give any different creditworthiness to the issuer, unless there is an automatic redeemability mechanism that trigger an on-chain reserve liquidation.

It is worth noting the recent example of the EIB's recent bond emission on a permissionless blockchain. Fitch assigned an AAA rating to the bond because it found that blockchain technology does not add additional credit risk to that of a traditional issue.

A further element to be pointed out refers to the possibility that a tokenised traditional asset may exist simultaneously with the equivalent asset based on traditional technology. In the case of a unique and exclusive tokenised asset, there is no difference in terms of credit and market risk and therefore the approach outlined is consistent. Conversely, if the tokenized asset had a twin in the traditional world, then the difference in liquidity (assuming lower liquidity in the distributed market) could

also pose unexpected risks. But this could occur also in the opposite situation: liquidity could flow into a distributed system, bringing more risk to the traditional market.

As of today, the vast majority of tokenisation initiatives of financial instruments based on distributed ledger technology are focused on the issuance and placement activity and usually involve limited post-trading processes. In this sense, we believe it is important to monitor the implication of post-trading activities (when such services will be developed on a large scale), in order to assess the impact in term of capital treatment of unsettled transactions and failed trades (within credit risk) of a tokenised security more precisely.

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

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?

A group 2 crypto-asset could potentially cause a total loss of investment. We therefore consider it useful to provide a conservative treatment.

However, such an approach could hinder certain initiatives of banks that rely on such exposure as for example liquidity provider activities as there is no distinction between banking book and trading book, hedging is not recognised, and the netting of long and short position is not allowed. To this end, we think that a more accommodating prudential treatment could be envisaged, as an exception, for those institutions that intend to set up such operations. Anyway, for the purpose of determining the exposure, the effects of possible hedging and netting should be taken into account.

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?

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?

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?

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?

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