

A NEW STEP TOWARDS THE RECOGNITION OF THE CRYPTO-ASSETS MARKET BY INTERNATIONAL STANDARD SETTERS

Consultation of the Basel Committee on the prudential treatment of banks' exposure to crypto-assets

An institutionalisation dynamic on the crypto-assets market is underway.

While an increasing number of banks are developing or planning to develop activities related to crypto-assets, the Basel Committee has just initiated a consultation on the appropriateness and terms and conditions for their prudential treatment. This consultation is an opportunity for banks to contribute to the establishment of international standards to ensure the sustainable and robust development of their activities in relation to crypto-assets.

On 12 December 2019, the Basel Committee, an international body bringing together the prudential regulators of the world's major financial jurisdictions, published a consultation paper¹ on **designing a prudential treatment for crypto-assets**. This consultation is a strong signal of the recognition of the existence of banking activities in the realm of crypto-assets.

It is part of a **broader work programme set up by the Basel Committee** to monitor the evolution of the crypto-assets market and its impact on traditional banking players. In March 2019, the Basel Committee publicly issued a first set of recommendations² for banks investing in or developing activities related to crypto-assets. These included the importance for banks to apply appropriate due diligence to assess new types of risks associated with crypto-assets; to have appropriate governance and risk management policies; and to be transparent about the risks incurred, both as regards their clients and supervisory authorities.

In its latest publication, the Basel Committee also details the characteristics and risks associated with crypto-assets and solicits stakeholders on the **specifics of a possible prudential treatment of banks' exposure to crypto-assets**. The deadline for responding to the consultation is **13 March 2020**.

A decisive step in the international regulatory consideration of crypto-assets

The publication of this consultation by the Basel Committee sends a **strong signal to the market and in particular to banks** as part of the development of their crypto-asset activities. While the Basel Committee had not remained silent on the subject, by fully integrating it into its risk mapping for several years, it had not, strictly speaking, begun any standard-setting work on crypto-assets. This has now been addressed through this consultation, which **bodes well for future regulatory initiatives** aimed at clarifying the prudential treatment of banks' exposure to the crypto-assets market.

As a reminder, the Basel Committee on Banking Supervision is a forum for cooperation in banking supervision, made up of representatives of the central banks and prudential authorities of the world's major financial jurisdictions. It is responsible for strengthening the soundness of the global financial system and ensuring effective prudential supervision. In this context, its main task is to set international standards for the harmonised regulation and supervision of internationally important banks.

While the market share of crypto-assets remains modest compared with that of the financial system, the Basel Committee believes that, considering their strong growth, crypto-assets could raise concerns about financial stability and increase the risks to which banks are exposed.

What kind of crypto-assets are targeted by the Basel Committee?

In its consultation paper, the Basel Committee takes care to clarify the concept of "crypto-assets". As instruments that can be used as a means of payment, a source of investment or a prerequisite to access a current or future product or service, crypto-assets are multi-taskers. The Basel Committee points out that no single definition has

¹ Basel Committee, "[Designing a prudential treatment for crypto-assets](#)", 12 December 2019.

² Basel Committee, "[Statement on crypto-assets](#)", 13 March 2019.

yet been agreed. Referring to the definition proposed by the Financial Stability Board (³), **the Basel Committee adopts a very broad definition of the concept of crypto-assets** based on their nature (digital/virtual), their reliance on cryptography and their use of distributed ledger technology. However, it expressly wished to exclude from this scope any central bank digital currencies⁴.

The fate of stablecoins, described in the consultation document as crypto-assets that aim to reduce the volatility of crypto-asset markets or offer repayment guarantees, is more uncertain. The consultation document does not exclude their inclusion in the scope of the analysis: *"the responses to this paper will inform the Committee's development of a prudential treatment for crypto-assets at large, including for crypto-assets that are issued by regulated financial institutions, or that make use of stabilisation tools"*.⁵

How are banks exposed to crypto-assets?

The consultation document specifies the **types of risks associated with crypto-assets to which banks could be exposed**. These include "traditional" financial risks applicable to other asset classes such as liquidity, market and counterparty risks. The Basel Committee also mentions risks specific to crypto-assets, of a non-financial nature, such as **(i)** cyber and operational risks; **(ii)** risks related to the uncertainty of the legal framework applicable to this new category of assets; **(iii)** reputation risks; and **(iv)** risks related to "implementation" (which stem from banks' difficulty in implementing changes to their in-house systems and controls to process crypto-assets).

The consultation document aims to clarify the ways in which banks may, directly or indirectly, be exposed to crypto-assets. **A non-exhaustive list of transmission channels is thus established**⁶, which includes:

- (i) issuing crypto-assets directly;
- (ii) owning crypto-assets directly (e.g. as an investment);
- (iii) lending and taking crypto-assets as collateral;
- (iv) proprietary trading of crypto-assets;
- (v) providing custody / wallet services for crypto-assets;
- (vi) exchanging crypto-assets for fiat currency, and vice-versa;
- (vii) using crypto-assets for internal or inter-bank internal processes;
- (viii) acting as a custodian or taking from a reserve backing crypto-assets.

Questioning the application of specific prudential treatment to take into account the risks associated with banks' exposure to crypto-assets

To cover the risks to which they are exposed, banks must have an appropriate level of capital to ensure the robustness of their activities. The current regulations do not specify the prudential treatment of crypto-assets, i.e. **how the risks associated with crypto-assets should be taken into account by banks when calculating their own funds and liquidity ratios**.

In its consultation paper, the Basel Committee proposes to illustrate its approach with an example of **increasing capital requirements and revising the calculation of liquidity ratios (LCR⁷ and NSFR⁸)** when banks are exposed to "high-risk crypto-assets".

³ "A type of private asset that depends primarily on cryptography and distributed ledger or similar technology as part of their perceived or inherent value", Financial Stability Board, Crypto-asset: Work underway, regulatory approaches and potential gaps, 31 May 2019, p. 10.

⁴ Basel Committee, "[Designing a prudential treatment for crypto-assets](#)", 12 December 2019 (p.1).

⁵ Ibid. (p.1).

⁶ Ibid. (p.9).

⁷ *Liquidity Coverage Ratio* (LCR).

⁸ *Net Stable Funding Ratio* (NSFR)

In addition to “high-risk crypto-assets”, the Basel Committee is also considering applying specific prudential treatment to banks that would be exposed to other types of crypto-assets with specific risk profiles. In particular, **(i) crypto-assets that would be used for intra and interbank settlement purposes; and (ii) crypto-assets that use stabilisation tools linked to other assets.**

Pending the outcome of this consultation, **the Basel Committee recommends that banks** that hold or conduct activities related to crypto-assets **adopt a conservative approach** to how they assess and take into account the risks associated with this asset class.



This consultation by the Basel Committee heralds the start of a move to institutionalise the crypto-assets market. Indeed, the activities and services that banks are currently structuring in the field of crypto-assets will eventually require precise answers as to the prudential regime to which they will be subject.

This consultation therefore marks a key step in international regulatory thinking and, above all, represents an opportunity for banks to put forward their proposals for the prudential treatment of these new activities.

On the basis of the responses received to its consultation, the Basel Committee may decide to establish specific prudential treatment standards for crypto-assets. In this case, it would publish a draft applicable framework specifying the terms and conditions for calculating this treatment, which will be subject to further public consultation. This will provide an international minimum standard for international banks.

The approach initiated by the Basel Committee should thus enable banks to develop their new activities in the field of crypto-assets in a clear and robust regulatory environment by anticipating the prudential treatment that may be required of them.

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