# WFE Response: Prudential Treatment of Crypto-asset Exposures
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## Background

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent the operators of over 250 market infrastructures, spread across the Asia-Pacific region (37%), EMEA (43%) and the Americas (20%), with everything from local entities in emerging markets to international groups based in major financial centres. In total, member exchanges trade over $100 trillion in shares a year and are home to some 60,000 companies, with an aggregate market capitalisation of around $120 trillion. The 50 distinct central counterparty (CCP) clearing services (both vertically integrated and stand-alone) collectively ensure that traders put up $1 trillion of resources to back their risk positions.

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for all sorts of investors and companies wishing to invest, raise capital and manage financial risk.

Founded in 1961, the WFE seeks outcomes that maximise financial stability, consumer confidence and economic growth. We also engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play an internationally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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# WFE Response: BCBS consults on draft standards for the prudential treatment of crypto-asset exposures


**Summary**

- Distributed ledger technology (DLT) has the potential to improve financial services provision, even if there are some inappropriate market practices currently taking place.
- The WFE supports a technology-neutral approach to regulation. Crypto-assets should be subject to the "same activity, same risk, same rules" principle.
- The prudential framework should promote the trading of assets on regulated platforms, ie, acknowledging that risks are reduced when entities that are already regulated and licensed offer these services.
- The Group 2 exposure limit (relating to coins other than stablecoins and derivatives thereon) lacks justification and ought to be raised or removed. If the Committee wants to keep the exposure limit it should be amended to permit netting benefits, among other things.
- The infrastructure risk add-on goes against the principles which the Committee is seeking to achieve, ie, tech neutrality and 'same risk, same rules,' and should be revisited.
- Where applicable, Basel's rules should encourage clearing, as it benefits market by delivering stable infrastructure, standardised processes, and powerful risk management.
- The prudential framework should promote hedging by bringing rules on hedging of 2a assets be more in line with current market principles.


**Introduction**

The WFE appreciates the opportunity to respond to the Basel Committee on Banking Supervision's second consultation on the prudential treatment of crypto-asset exposures. The Federation welcomes the Basel Committee's continued focus on designing a prudential framework for crypto-assets. We appreciate the regulatory certainty that this should provide, particularly given the pace of evolution and client demand for crypto-assets.

For the purposes of this response, we have used the BCBS's definition of crypto-assets. However, as will become clear below, we do not necessarily think this definition is helpful. By defining tokenised and non-tokenised traditional assets as crypto-assets there is a danger of conflating the risks more commonly associated with unbacked crypto-currencies to securities and other products which merely utilise DLT to deliver a traditional product.

**Comments on the proposal**

The underlying technology for crypto-assets, distributed ledger technology (DLT), holds promise to make it possible to deliver financial services more quickly, securely and at lower cost. This is true across payments, financing, trade processing and other capital markets activities. That type of economic efficiency would lead to tangible benefits for the real economy. It is critical, from a public policy perspective, that these benefits can be delivered by regulated financial institutions within a regulated environment. These efficiencies should be able to be realized across various products and services, including the use of crypto-assets, with the same safety and sound tools that the Basel Committee has introduced in the current capital and liquidity framework.

This is not to say that the sector is without risks. The unregulated status of many providers of crypto-assets has attracted some inappropriate market practices. However, allowing a) fully authorised exchanges and clearing houses and b) banks to support digital assets is a prudent way to further develop and incorporate risk management into the broader ecosystem. Hence, while the regulatory framework for crypto-assets is being developed, regulated banks should not be unnecessarily restricted from participating in crypto-asset markets, particularly when using fully regulated exchanges and CCPs. In fact, the embedding of a regulatory framework would be facilitated more efficiently through the active participation of regulated exchanges, CCPs and banks throughout the development process.

The proposed approach set forth in this second consultation fails to deliver a technology neutral approach to prudential treatment of crypto-assets. In particular, the proposal penalises tokenised traditional assets as compared with traditional assets, by applying an infrastructure risk add-on the former. We believe that a singular operational risk add-on charge only for DLT-based crypto-assets, as contemplated by the consultation, is inconsistent and unnecessary, particularly when the DLT is managed by an authorised exchange/CCP, which must and does take into account such risks. Moreover, achieving a technology-neutral approach to crypto-asset regulation is the stated aim of the Financial Stability Board (FSB), International Organisation of Securities Commissions (IOSCO) as well as the Basel Committee itself.

The proposal also fails to identify the largest source of risk associated with crypto-assets. Moving from electronically held traditional assets to DLT-based traditional assets is much like the move from paper share certificates to electronic certificates. Whilst there are risks associated with the operation of any technology, this is not the key problem with crypto-assets. The real source of risk in the crypto-asset space is due to the unregulated nature of many of these products and the platforms on which they trade. We note that, during the 'COVID markets' of 2020, the operational resilience challenges that arose were in the wider ecosystem, rather than at exchanges and CCPs, as highlighted by the July 2022 IOSCO report on the topic.[1]

In contrast to crypto trading platforms, regulated exchanges ensure transparency and disclosure, which leads to sufficient liquidity and, as relevant, disclosure of risks. All exchanges scrutinise products on their exchanges and are subject to regulation that includes systems and controls to prevent abusive trading and to protect the integrity of price formation. Exchanges are also generally subject to prudential rules that require them to hold financial resources to meet their operational costs. Finally, their governance and management are usually subject to tests which ensure they are fit and proper to manage an exchange. Therefore, crypto-assets traded on regulated exchanges should not be treated in the same way as their unregulated counterparts.

**RECOMMENDATION 1:** Treat all crypto-assets that are traded on regulated exchanges the same as their traditional counterparts.

*The Group 2 exposure limit*

The exposure limit of 1% of a bank's tier 1 capital lacks justification. The proposed methodology has no precedent in financial market regulation when comparing it to other relatively volatile asset classes. Even in the wake of the 2008 financial crisis, this sort of policy was not proposed, despite the urgency of corrective measures at the time.

An overly conservative exposure limit is more likely to stifle the maturing of the marketplace rather than allow for healthy growth. The 1% threshold should be raised meaningfully to allow banks to support clearing of exchange-traded crypto-assets given that it is emerging in a fully regulated manner.

As we are generally not in favor of the introduction of such exposure limits, we suggest that the Basel Committee undertake to assess how different jurisdictions develop their own adaptations or interpretations of the limit, given

[1] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD706.pdf

the wide spectrum of crypto-asset-based hubs and micro-economies that have emerged in recent years in financial centres around the globe.[2]

Moreover, the overall exposure limit for group 2 assets should be limited to those that are not traded on exchanges. As the Committee notes, it is proposing an exposure limit for all Group 2 assets outside of the large exposure rules because "the large exposure rules of the Basel Framework are not designed to capture large exposures to an asset type, but to individual counterparties or groups of connected counterparties. This would imply, for example, no large exposure limits on crypto-asset where there is no counterparty, such as Bitcoin." However, exchange-traded derivatives on crypto-assets have counterparties in the same manner as exchange-traded derivatives on non-crypto-assets. Thus, the exposure limit for Group 2 assets should not apply to traditional exchange-traded, centrally cleared derivatives with crypto-asset underlyings.

At the very least, the exposure limit should exclude exposures arising from client cleared transactions (ie, transactions that are centrally cleared for a client by a direct participant in the clearing system). Bank-affiliated clearing firms are critical aspects of the exchange-traded, centrally cleared ecosystem. The prudential framework for crypto-assets is best placed if it enables clearing firms to support clearing of crypto-assets.

Furthermore, applying the exposure limit without netting benefits actively discourages the management of risk in group 2 crypto-asset exposures. This is not a prudentially beneficial decision as it fails to recognise and encourage behaviour that leads to reduction in real exposures, as compared with the gross amounts. In a centrally cleared world, this reduction is legally sound and enforceable and, via multilateral netting, reduces exposures more than is possible in the bilateral world.

**RECOMMENDATION 2:** Raise or remove the Group 2 exposure limit

**RECOMMENDATION 3:** If BCBS continues to take the view that an exposure limit is required, it should be amended so that:

- BCBS assess how different jurisdictions develop their own adaptations of the limit;
- the overall exposure limit for group 2 assets should be limited to those that are not traded on regulated exchanges;
- the exposure limit should exclude exposures arising from client cleared transactions;
- the exposure limit is applied with netting benefits;
- clarify that exposure limits are not applicable to crypto-asset custody providers.

*The infrastructure risk add-on*

The infrastructure risk add-on goes against the principle of technology neutrality as no comparable capital add-ons are applied on other technologies used within banks. Every technology bears an intrinsic risk, which has to be managed appropriately, but this form of treatment of the technology is not justified. The existing regulatory tools are sufficient to manage this risk.

A blanket 2.5% add-on also does not capture the important technological and conceptual differences between eg, single-chain crypto-assets, multi-chain crypto-assets, crypto-assets issued by central authorities, and crypto-assets on permissioned/permissionless blockchains, amongst others. Finally, an add-on that is independent of who ensures

[2] In the event that BCBS considers that an exposure limit remains, it should be made clear that exposure limits are not applicable to crypto-asset custody providers.

the infrastructure quality does not give an adequate incentive to infrastructure users/developers to prioritise the stability and reliability of the infrastructure.

As noted above, the proposal penalises tokenised traditional assets as compared with traditional assets, by applying this infrastructure risk add-on to the former. A singular operational risk add-on charge only for DLT-based crypto-assets, as contemplated by the consultation, is inconsistent and unnecessary, particularly when managed by an authorised exchange/CCP, which must and does take into account such risks.

**RECOMMENDATION 4:** Remove the infrastructure risk add on for products traded on regulated venues.

*Treatment of cleared products*

Clearing is not always relevant to crypto-assets as some products trade in a way where settlement is achieved immediately. Nevertheless, where crypto-assets follow a more traditional settlement cycle clearing should be encouraged. Clearing benefits markets by delivering a stable infrastructure, standardised processes, and powerful risk management, including multilateral netting. Where applicable, this should be supported and not disincentivised, a view held by the BCBS in their prior publications[3].

**RECOMMENDATION 5:** Group 2 exposure limits arising from client clearing should not be included in the group 2 exposure quantification.

*Hedging of Group 2a assets and current market principles*

We urge the Basel Committee to fully recognise hedging of Group 2 crypto-assets in the prudential framework; otherwise, underlying exposures would be significantly overstated. Overstating underlying exposures would fail to deliver the correct risk-sensitivity. In the case of directional exposure to illiquid Group 2 crypto-assets that are more difficult to hedge and where there is a less established price history or derivatives market, a more conservative approach using the proposed 1250% risk weight and recognising limited hedging and netting benefits can be used. In other cases, with sufficient depth of liquidity in the underlying position and more established controls on market functions, banks should be able to recognise market risk hedging, collateralisation arrangements and counterparty netting of group 2 crypto-assets.

**RECOMMENDATION 6:** Rules on hedging of 2a assets should be more in line with current market principles, namely:

a) Physically settled contracts should be eligible for hedging recognition in the same way that cash-settled contracts are eligible.
b) Hedging should be recognised for contracts with different maturity dates
c) Hedging should be recognised across contracts listed by different exchanges.

[3] https://www.bis.org/bcbs/publ/d467.htm