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Basel Committee's "final" crypto exposure standards not the final word, practitioners say

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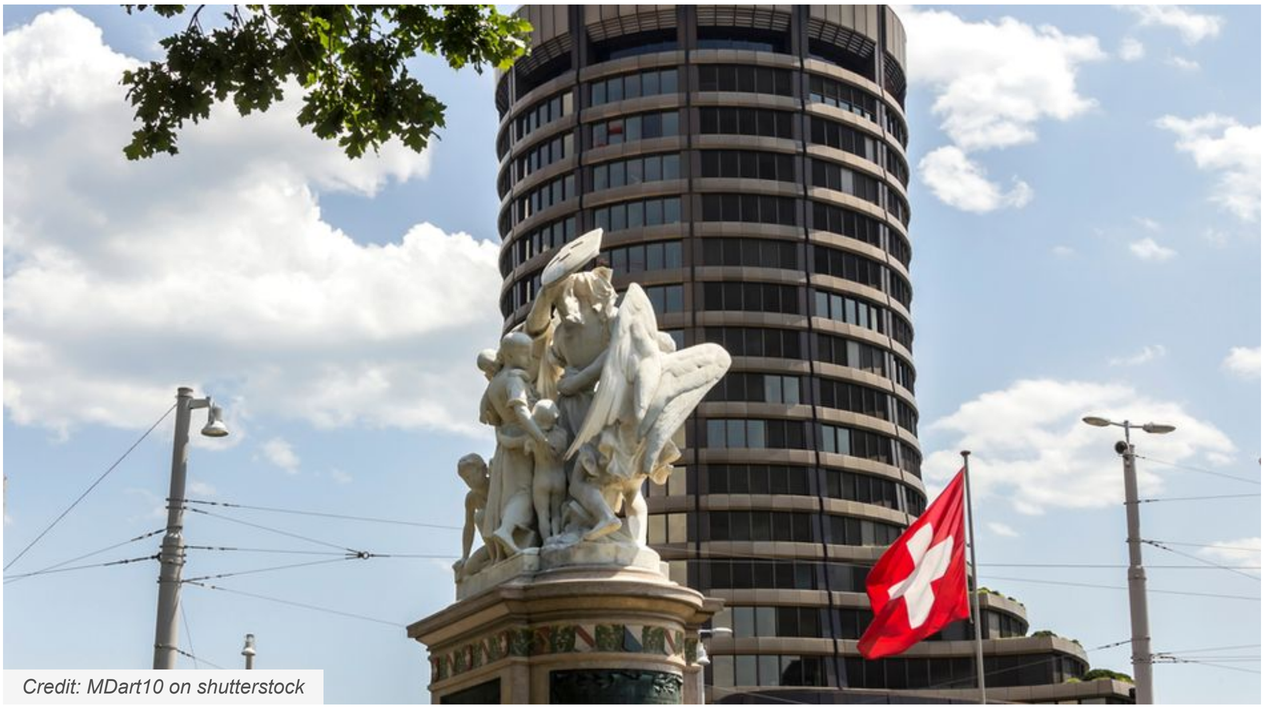

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The Basel Committee has released its long-awaited new prudential standard for banks with crypto exposures, but practitioners predict the committee will have to revisit the standard before long as new products develop.

The Basel Committee on Banking Supervision released its finalised **prudential treatment** for banks' exposures to crypto assets on 16 December. The committee's oversight body, the Group of Central Bank Governors and Heads of Supervision (GHOS), has endorsed its implementation.

The final publication of the document follows a consultation which took place in June 2022.

In the document, the committee recommends a "conservative" prudential treatment for unbacked crypto assets and stablecoins with ineffective stabilisation mechanisms.

The new BCBS standard splits crypto-assets into two groups with differing levels of conservatism.

The first group includes tokenised traditional assets – which it labels "Group 1a" – and also stablecoins and crypto assets with effective stabilisation mechanisms, which it labels Group 1b. Assets in the first group will be subject to capital requirements based on the risk weights of underlying exposures, as set out in the existing Basel Framework.

By contrast, the BCBS standard devises a new conservative capital treatment for Group 2 crypto-assets, which include those that fail to meet any of the classification conditions of Group 1, as well as any unbacked crypto-assets.

Covington & Burling partner **Michael Nonaka**, co-chair of the firm's financial services group in Washington, DC says the endorsement by GHOS of a regulatory capital standard for banks' crypto holdings is an important and timely step forward for digital asset regulation.

"Prudential regulatory capital requirements are a critical precondition to the banking industry providing digital asset services, and local implementation processes will reflect the committee's consultations to date as well as supervisors' experiences and responses to the high-profile bankruptcies that have occurred this year," Nonaka says.

Joseph Castelluccio, a partner at Mayer Brown in New York, tells GBRR: "Given that the report's detailed approach to classifications, and the numerous tests that must be satisfied on an ongoing basis to qualify for Group 1, all stablecoins – not just those with 'ineffective stabilization mechanisms' – are subject to a form of conservative treatment under the recommendations".

He adds that the committee's focus on stablecoins is directionally consistent with the view held by some US legislators, that updated regulation of stablecoins as a subset of crypto assets, or digital assets more generally, may be more achievable in the near term than a broader, more omnibus attempt to overhaul digital assets regulation.

Castelluccio also draws attention to how the "effectiveness" of stabilisation mechanisms, one of the criteria for inclusion in Group 1, would be assessed and proven, as national regulators consider how to implement those elements of the report.

"Over the past year – following the collapse of Terra Luna and more recently the bankruptcies of several high-profile exchanges – there has been increased attention on Proof of Reserves (PoR) and a call in the market for institutions to voluntarily provide their PoRs – including those not currently subject to banking regulations," Castelluccio says.

However, not all PoRs carry the same weight or provide the same assurance, he notes.

"Several of the tests described in the report could contribute to a standardisation of acceptable PoR tests in the market – even for entities not regulated as banks," Castelluccio says.

Changes after the second consultation

Matthew Bisanz, another Mayer Brown partner, at the firm's DC office, says that while market participants may have requested wider ranging changes from the consultation, the eventual revisions were "only modest" as is "often the case".

One change following the consultation concerns the basis risk test for crypto-assets.

Following the consultation, the committee abandoned its plan to implement a basis risk test for crypto assets with stabilisation mechanisms, intended to ensure that the holder of a crypto-asset can sell it in the market for an amount that closely tracks its PEG value.

Instead, the final standard will require stablecoins to be supervised and regulated by a supervisory authority that applies prudential capital and liquidity requirements.

Additionally, the committee is axing a planned requirement for banks to assess their crypto assets against the classification conditions and seek prior supervisory approval to finalise the classification, which stakeholders successfully argued would be "unnecessarily burdensome".

Instead, in the final standard banks would be required to notify supervisors of classification decisions and supervisors would have the power to override these decisions if they disagree with a bank's assessment.

"Some in the crypto industry may be concerned with the strict nature of some aspects of the BCBS prudential standard," Bisanz says.

He notes, however, that national regulators and legislatures may deviate from the standard when implementing it.

"As we have seen with the Basel Endgame initiative, the adoption or translation process can take a long time," Bisanz says, adding: "therefore, we expect the focus to move from somewhat quickly shaping a global standard to lengthy engagement with national-level officials."

Lastly, he notes that aspects of the BCBS prudential standard seem to target or respond to issues of the moment, such as stablecoins.

"The crypto industry is rapidly iterating new products every day, and therefore, I expect that BCBS may need to revisit this standard more frequently than it has other prudential documents," Bisanz says.

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