

September 30, 2022

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland



Japanese Bankers Association

JBA comments on the BCBS Consultative Document: “*Second consultation on the prudential treatment of cryptoasset exposures*”

Dear Basel Committee members:

The Japanese Bankers Association¹ (JBA) appreciates the opportunity to provide our comments on the Basel Committee on Banking Supervision’s (BCBS) Consultative Document: “Second consultation on the prudential treatment of cryptoasset exposures” (hereafter the “Proposal”) released on June 30, 2022.

General comments

The JBA supports the BCBS’s development of the prudential treatment of cryptoasset exposures from the first consultative document in light of the current rapid changes in the situation regarding cryptoassets. The JBA is also supportive of some changes, such as the recognition of hedging of certain Group 2 cryptoassets and removal of the accounting classification link.

On the other hand, while the JBA understands that the growth of cryptoassets and related services has the potential to raise financial stability concerns and increase risks faced by banks, these prudential treatments including the quantitative criteria on hedge recognition of Group 2 cryptoassets should be provisional and be iteratively revised and updated, given that the cryptoasset ecosystem has been evolving rapidly in recent years and various products related to cryptoassets have emerged with different risk characteristics. As appropriate quantitative threshold levels will vary because of the rapid expansion of the cryptoasset market and the development of the cryptoasset ecosystem, consideration should be given to making the framework simpler and more flexible at this point in time, such as a holistic regulatory approach, including Pillar 2.

In addition, as noted in the GHOS statement dated September 13, 2022², members reiterated the importance of designing a robust and prudent regulatory framework for banks’ exposures to cryptoassets that promotes responsible innovation while preserving financial stability. In this regard, the Proposal, particularly the infrastructure risk add-on and complex classification conditions, could unduly restrict businesses on cryptoassets at banks, thus stifling innovation for cryptoassets and DLT of banks compared with other industries.

For example, DLT platform for issuance and distribution of security token is being considered by some

¹ The Japanese Bankers Association is the leading trade association for banks, bank holding companies and bankers associations in Japan. As of September 30, 2022, JBA has 114 Full Members (banks), 3 Bank Holding Company Members (bank holding companies), 77 Associate Members (banks & bank holding companies), 58 Special Members (regionally-based bankers associations) and one Sub-Associate Member for a total of 253 members.

² <https://www.bis.org/press/p220913.htm>

Japanese banks. This service is expected not only to improve the security and efficiency of securities settlement infrastructures, but also to enhance customer convenience by reducing settlement risk through shorter settlement cycle than existing infrastructures, reducing administrative costs and remittance fees and securitizing smaller lot of assets. The treatments in the Proposal, such as the infrastructure risk add-on, may discourage financial institutions from developing new and useful businesses, as well as rule out possibility of conducting such useful businesses. This could hinder responsible innovation.

The BCBS should design regulations that strike a balance between financial stability and responsible innovation, taking into account the views of a wide range of stakeholders and in line with the above intent of the regulations.

We have repeatedly stressed that the principle of “same risk, same activity, same treatment” is essential. As we stressed in our response to the discussion paper³ and the first consultative document⁴, we believe that *“[e]ven if the banking system is shielded from risks of cryptoassets by the restrictive and conservative prudential treatments, it does not necessarily ensure global financial stability as a whole. If crypto-assets are held or transacted widely outside the banking system in the future, bank-only regulations can deteriorate global financial stability rather than ensure it”*.

Fintechs and Bigtechs have already started providing financial services related to cryptoassets and their impact on the financial system is growing. In addition, non-banks are emerging, and the shadow banking issue has risen. Under these circumstances, imposing regulations only on banks will enable the use of cryptoassets through non-regulated firms, which will not reduce the risks to financial stability.

If regulations are under consideration for cryptoassets, Fintechs, Bigtechs, and non-banks should also be included in the scope, not only banks. Therefore, discussions should not be taking place only at BCBS, but also through globally open forums, such as the FSB and G20. As for the private sector, we would like to see dialogs starting or continuing with various stakeholders, such as Fintechs and Bigtechs.

Removal of the infrastructure risk add-on

We do not believe that the infrastructure risk add-on is suitable for all DLT types and therefore should not be applied evenly.

The risks that DLT-based products may face depend more on the integrity of the organization, such as risk management or systems in place to prevent embezzlement, than on technical aspects. Therefore, we believe it is more prudent to supervise the responsibilities and risk management of the DLT operators to mitigate risks. If the DLT operators are composed of multiple entities, it would be unclear where responsibilities lie to deal with issues that may occur, and we believe that clarification of such responsibilities and supervision is needed.

³ <https://www.zenginkyo.or.jp/fileadmin/res/en/news/news200313.pdf>

⁴ <https://www.zenginkyo.or.jp/fileadmin/res/en/news/news210910.pdf>

Even in cases where the DLT is run by a single entity, we believe that it would be better to manage the integrity of the DLT operator through risk management supervision to mitigate risks, as incidents where funds have been embezzled or stolen through hacking are known.

We do not believe that evenly applying the infrastructure risk add-on for all DLT types would be effective even if the technical risks are taken into consideration as the degree of risks varies depending on how the DLT product was built.

To meet the Group 1 cryptoasset classification conditions, all rights, obligations and interests arising from the cryptoasset arrangement are legally enforceable and the Group 1 cryptoasset requires that entities execute redemptions, transfers, storage or settlement finality of the cryptoasset, or manage or invest reserve assets. Therefore, as described in the Proposal, it is highly unlikely that any cryptoassets based on permissionless blockchains will be able to meet the classification conditions to be included in the Group 1 cryptoasset and we describe permissioned DLT as follows.

As a consequence of the Group 1 cryptoasset classification conditions, a high level of security is required, thus the system must be built using a secure software that meets such conditions and it will not matter if an existing database or the DLT is used since there is little difference in security.

For example, to ensure finality in the system, there will be a need to use a DLT that is equipped with mechanisms to ensure such finality in place.

Some DLTs with such mechanisms use existing database products that are broadly used worldwide to record ledgers and also widely used software to integrate data across multiple databases. Although there are some components that are newly created for the DLT, such as the function to execute smart contracts and the connection between database products and software, the main components of the DLT are the database products and software that are broadly used worldwide and considered to be highly secure, and no other technologies that would compromise security are introduced.

Hence, in order to meet the Group 1 cryptoasset classification conditions, there is a need to use a secure DLT built with databases and software that are broadly used worldwide, and since the components of the DLT are almost the same as existing databases products, there is no significant difference in security compared to existing database products.

In addition, as noted in General comments, the infrastructure risk add-on may stifle responsible innovation. For example, if all financial institutions participating in the above DLT platform were subject to the infrastructure risk add-on, the burden would be greater than the benefit of participating in the platform, and as a result, this could discourage financial institutions from developing new and useful businesses as well as starting such businesses. From this perspective, the infrastructure risk add-on is unnecessary.

Further revisions on the classification conditions

We support the alternative to the redemption risk test and basis risk test proposed in 60.17. Rather than leaving it to holders to conduct and verify these tests, it is more effective and preferable to ensure the soundness of issuers through supervision and regulation by a supervisor. Also, from the viewpoint of holders, confirming that the issuer is subject to regulation is sufficient, thereby reducing the burden.

Assuming that SCO 60.17 is realized, we would like to request that the classification conditions of cryptoassets as described in the Proposal be revised in light of practical feasibility and clarification as follows.

- The redemption risk test requires in 60.13 (1) that *[t]he value of the reserve assets (net all non-cryptoasset claims on these assets) must at all times, including during periods of extreme stress, equal or exceed the aggregate peg value of all outstanding cryptoassets*, but the timing and the frequency of this confirmation is unclear and should be clarified.
- Classification condition 2 requires that *“[a]ll rights, obligations and interests arising from the cryptoasset arrangement are clearly defined and legally enforceable in all the jurisdictions where the asset is issued and redeemed”*. This could be read as requiring that this condition be confirmed in all the jurisdiction in which the cryptoasset is distributed, but that is not practical. Therefore, the condition should be satisfied as long as the reserve assets of the cryptoasset is secured in the respective jurisdictions in which the cryptoasset is issued, not redeemed.
- We recommend further discussions and development of global common definitions regarding transferability, settlement finality, and/or redeemability stipulated in the classification condition 2 as these definitions are generally closely related to statutory, common, or case laws in each jurisdiction and their international consistency is not necessarily assured. Without common or harmonized definitions, each jurisdiction may set their own definitions and standards, which may result in classifying a cryptoasset into different categories (for instance, Group 1b in jurisdiction A may be Group 2a in jurisdiction B). We believe that internationally shared definitions and standards are needed to avoid potential concentration of cryptoasset trading in jurisdictions with cryptoassets classified in low-risk groups by their definitions. Otherwise, the consequent concentration of cryptoasset-related risks in certain jurisdictions may increase the risk of financial stability due to regulatory fragmentation.

Scope of cryptoassets

The scope of cryptoassets in the Proposal is limited and the treatment in the following cases is unclear. We would like to request clarification and propose these treatments as follows.

- *Other tokenised traditional assets*: While bonds, loans, claims on banks, equities, derivatives and commodities are listed as tokenised traditional assets, the description should be more comprehensive since other assets such as real estate, aircraft, and ships may be commercialized as security tokens using DLT in the future.

- *Positions held for STO services:* We recognize that some companies use the STO scheme for their funding. In the Proposal, it seems that there are no descriptions about STO and the group as which STO is classified is not clear. However, the fundamental risk of STO is similar to the traditional assets because issuers have similar responsibilities and duties with securities. Therefore, we would like STO to be classified into Group 1a.

- *Non-Fungible Tokens (NFTs):* The first consultative document in footnote 5 on page 2 states that “[d]ecentralised Finance (DeFi) instruments or Non-Fungible Tokens (NFTs) meeting the definition of cryptoassets are considered to be within the scope of this paper,” however there is no mention of NFTs in the Proposal. NFTs have drawn attention in recent years, but as the actual value and risk of NFTs are not fully evaluated yet, we believe that it is premature to include them in the prudential regulatory framework at this time. A thorough analysis should be conducted to weigh the risks before considering a response from the perspective of prudential regulation.

Disclosure requirements

We agree to the idea that periodic disclosures of material cryptoassets are necessary as SCO 60.134 states. However, we believe that “materiality” includes several aspects such as company strategy, company revenue, impact on financial system due to size of exposure. Therefore, the definition of “material” should be clarified.

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We thank the BCBS again for the opportunity to comment on the Proposal and hope our comments will contribute to further consideration in the BCBS.

Yours faithfully,

Japanese Bankers Association