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

Japanese Bankers Association

JBA Comments on the BCBS Discussion paper: *"Designing a prudential treatment for crypto-assets"*

Dear Basel Committee members:

The Japanese Bankers Association[1] (the JBA) appreciates the opportunity to provide comments on the Basel Committee on Banking Supervision's (the BCBS) Discussion paper: "*Designing a prudential treatment for crypto-assets*"[2] (the DP).

I. General Comments

The JBA welcomes the DP, which covers a number of important aspects on crypto-asset features and risks as well as a wide range of prudential regulatory issues. Given the rapidly evolving nature of the crypto-asset ecosystem and related risks, the process taken by the BCBS, that is to publish the DP as a starting point and seek a wide range of views of stakeholders for further considerations, is suitable and appropriate.

Given that crypto-assets are an immature asset class and their behavior in a time of stress has yet to be fully tested as described in the DP, the JBA is able to understand the BCBS's view that exposures to crypto-assets, especially to high-risk crypto-assets, need to be subject to a conservative prudential treatment at this juncture. The JBA acknowledges that there remains skepticism over the value of crypto-assets and its sustainability, particularly towards those types of crypto-assets that have no intrinsic value.

Nonetheless, the JBA believes that such conservative treatment, including the definition of high-risk crypto-assets, should be provisional if it is to be incorporated into prudential standards. While the sustainability of the value of crypto-assets is uncertain at this juncture, it is also a fact that there is an observed value traded in the market; it cannot be denied that in the future, the value of crypto-assets is stabilized and sustainably underpinned by solid demand for certain purposes, such as settlements. Provided that track records observed in the market through the cycle are sufficiently available, more sophisticated risk measurements may become applicable. It is, therefore, recommended that the BCBS explicitly notes that the treatments will be reviewed along with technological advances and on-going developments in crypto-asset markets.

The following sections provide details of the points that should be considered in designing a prudential treatment for crypto-assets.

II. Regulatory approaches and measures

- Potential regulatory approaches and measures to protect banking systems against risks of crypto-assets are not necessarily limited to capital and liquidity requirements. In addition to the prudential treatments, there are various other possible options, such as (i) limiting the total amount of exposures to crypto-assets to below prudentially acceptable levels; (ii) enhancing supervisory review or Pillar 2 framework, as noted in the

[1] The Japanese Bankers Association (JBA) is a premier financial organization whose members consist of banks, bank holding companies and bankers associations in Japan. As of January 1st, 2020, JBA has 117 Full Members (banks), 3 Bank Holding Company Members (bank holding companies), 74 Associate Members (banks & bank holding company), 58 Special Members (regionally-based bankers associations) and 1 Sub-Associate Member for a total of 253 members.

[2] https://www.bis.org/bcbs/publ/d490.htm

BCBS's March 2019 newsletter; and (iii) prohibiting banks or banking groups from acquiring or holding such exposures. Some jurisdictions, including Japan[3], have already implemented or proposed such measures.

- The JBA supports the BCBS's view that jurisdictions that currently prohibit their banks from having any exposures to crypto-assets would be deemed compliant with any potential global prudential standard. However, where the exposures to crypto-assets are restricted to below a prudentially acceptable level by virtue of banking regulations of a jurisdiction, an additional layer of conservative prudential treatment of crypto-assets will effectively overlap and be overly punitive. As long as the exposures to crypto-assets are prudently managed and limited to below a prudentially acceptable level, a conservative prudential treatment is not logically warranted. If the BCBS is to set forth prudential minimum requirements to crypto-assets, those interactions between regulations need to be carefully considered.

- Further, the accounting treatments for crypto-assets have yet to be established internationally. Since the relationship between accounting and prudential treatments is mutually dependent, we believe the prudential treatment of crypto-assets and its development timeline need to be aligned with those for accounting standards, if the BCBS is going to develop a prudential minimum requirement.

III. Definition of crypto-assets

General definition of crypto-assets

- As described in the DP, there is no single or generally-recognized definition of crypto-assets at present. If different definitions were to be adopted by jurisdictions, then the prudential treatments would become inconsistent and fragmented across jurisdictions, which not only leads to uneven level playing fields but also raises concerns of regulatory arbitrage.

- The JBA believes that it is particularly crucial to set a globally consistent and harmonized definition of crypto-assets, given that virtually-traded crypto-assets have global characteristics in nature. As a first step, it is recommended that a "stocktake" be conducted for the definitions that currently exist in jurisdictions,[4] including those for accounting, tax and legal treatment purposes, prior to developing prudential regulations.

- Regarding the key features of crypto-assets discussed in page 5 of the DP, all transactions and data recorded using the distributed ledger technology (DLT) appear to be deemed as crypto-assets, even those data and transactions that are merely recorded using the DLT instead of other hardware for various reasons. While the JBA agrees that three features provided in the DP, *digital / virtual nature, reliance on cryptography and use of distributed ledger technology* are key features of crypto-assets, the JBA disagrees that data or transactions merely recorded using the DLT are deemed as crypt-assets. It should be noted that the three features are neither exhaustive nor mutually exclusive with key features of other data or transactions recorded using the DLT.

Definition of *"high-risk crypto-assets"*

- The prudential treatments of high-risk crypto-assets provided in the DP are effectively prohibitive. It is therefore necessary to carefully define *"high-risk crypto-assets"* that are subject to conservative prudential treatments, so that such conservative prudential regulations do not impede future innovation or fail to capture unanticipated types of high-risk crypto-assets.

[3] In Japan, the revision to the supervisory guidelines has been proposed regarding holdings of crypto-assets by a banking group. The summary of the revision is as follows; as general requirements, it requires banking groups to ensure that the acquisition of crypto-assets by a banking group to be a minimum and, whenever the banking group acquires, holds or disposes crypto-assets, the banking group is required to have sufficient internal risk control so that any risks related to crypto-assets would neither impede its banking business nor result in significant losses to the banking group. Specifically, the banking group is required to: (i) identify, assess, and reduce risks of crypto-assets considering those features and characteristics; (ii) put in place effective AML/CFT measures; (iii) ensure financial soundness (the amount of crypto-assets are required to be a minimum and investments in crypto-assets by the banking group are prohibited), and (iv) put in place effective cyber security measures against threats.

[4] For instance, the definition of "crypto-assets" in Japan does not include the DLT feature as defined in the Payment Services Act; *"property value (limited to that which is recorded on an electronic device or any other object by electronic means, and excluding the Japanese currency, foreign currencies, and Currency-Denominated Assets) which can be used in relation to unspecified persons for the purpose of paying consideration for the purchase or leasing of goods or the receipt of provision of services and can also be purchased from and sold to unspecified persons acting as counterparties, and which can be transferred by means of an electronic data processing system"*.

- In the DP, the following is suggested to characterize high-risk crypto-assets: *they are digital assets that are recorded on a distributed ledger technology platform and are secured cryptographically*. It is true as an observed fact that most existing crypto-assets in the current market have the DLT feature. It would, however, be technically possible to create crypto-assets that are traded on the cloud platform instead. Given that the DLT feature does not automatically link to higher prudential risks, further consideration should be given. The JBA believes that it would be better to set the definition of high-risk crypto-assets technologically neutral to the extent possible.

- The feature *"they are <u>not issued by</u> a jurisdictional authority or another <u>identified issuer</u>"* is not clear. The JBA has interpreted this to mean that if there is no entity to fulfill accountability or responsibility for a given set of crypto-assets, then they are considered to be high-risk, and seeks clarification from the BCBS.

Other types of crypto-assets

- The JBA is supportive of the BCBS's view that certain types of crypto-assets referred to as *"stablecoins"* warrant further assessment and elaboration before designing their prudential treatment. The JBA also agrees with the view that certain forms of digital currencies referred to as *"central bank digital currencies"* are outside the scope of the DP and need to be discussed separately as to their prudential treatment.

- In addition, the following cases should be excluded from the scope of the prudential treatment of crypto-assets, or at least, their prudential treatment should be carefully calibrated.

  - *Crypto-assets used for internal operational processes or intra- and inter-bank settlements, which are fully backed by fiat currency:* their risks are effectively identical to a bank's deposits, at least from the perspective of prudential treatments, although they may entail operational system-related risks.

  - *Crypto-assets held for custodian services or taken as deposits:* These should be considered from the perspective of risks of fulfillment of obligation as custodians to their customers, such as risk of operational continuity and cyber risk, rather than from the perspective of prudential risk.

  - *Lending to individuals, corporates or financial institutions to allow them to invest in crypto-assets:* It should be clarified that lending related to crypto-assets regarding (v) on page 9 of the DP is limited to those truly associated with investments in crypto-assets, and that it does not mean lending in general to customers who incidentally hold crypto-assets or are holding them in their own accounts, because it is simply not practical to investigate whether each borrower holds such assets or not.

IV. Risk-based approach

- The JBA is supportive of the general principle of "*same risk, same activity, same treatment*", which is unquestionably important from the perspective of not only ensuring fair competition, avoiding regulatory arbitrage and not hindering innovation, but also aligning regulatory treatments with risks arising from underlying assets and related business by a risk-based approach.

- This principle needs to be applied in designing a prudential treatment for crypto-assets. Restrictive prudential treatment should not be applied to all crypto-assets simply because they are "crypto-assets", and if warranted, certain crypto-assets should be treated as equivalent to traditional financial instruments. For example, there could be types of crypt-assets that have or are linked with underlying assets. If their structure is similar to beneficial interest in trust, accordingly they should be treated in the same way as similar traditional asset-backed securities[5].

[5] Likewise, as noted in the report issued by the International Monetary Fund (IMF) in January 2020, the quality of underlying assets should be reflected in prudential treatment of exposures, given crypto-assets like Stablecoin that have safe and reliable underlying assets. More specifically, crypto-assets backed by a fiat currency deposited in the central bank's deposit account (Like USC: Utility Settlement Coin) should be treated as HQLA, as central bank deposits. The IMF report states that *"The risk mitigation provided by collateral should only be reflected in the prudential treatment of exposures if robust safeguards are in place, such as prudential regulation and supervision covering the ownership and availability of the collateral by the financial*

- Banking groups' exposures to crypto-assets may include those to which it is not appropriate to uniformly apply the proposed conservative prudential regulations. For example:

    - *Positions held for STO services:* Where a bank acquires or holds crypto-assets on behalf of issuers or investors for a very short period of time (e.g. a few days) solely for the purpose of providing Security Token Offering (STO) services, such as receiving payments from or paying dividends to investors, the bank does not bear any risks related to asset value and its fluctuations, because the bank's responsibility is merely to pass those crypto-assets to issuers or investors in units of value used in the crypto-assets.

    - *Liability positions:* If the same crypto-assets are held on both the asset and liability sides, exposures bearing risks of loss or depreciation of the crypto-assets is the net amount of assets and liabilities. If prudential regulations exampled in the DP are applied to gross exposures, it may not reflect actual risks and will result in excessively conservative treatments.

    - *Hedged positions:* Where the value of crypto-assets is hedged or guaranteed by a third party, the risk of loss of value of the crypto-assets is virtually the same as the credit risk to the third party. Thus, it may be appropriate to treat such case within the scope of the Basel credit risk framework.

    - *Structural risk mitigation:* Where a banking group has a subsidiary engaging in business related to crypto-assets with crypto-asset exposures, the maximum loss the banking group could bear is theoretically limited to the total amount invested in the subsidiary, absent any step-in commitments to support the subsidiary. In this case, it is worth considering limiting the crypto-asset exposures to the total amount of internal equity investments in the subsidiary for the purpose of risk calculations.

V. Regulatory framework for Non-banks

- Based on the principle of "*same risk, same activity, same treatment*", if prudential regulations for crypto-assets are applied to banks, simultaneously the comparable prudential standards (e.g. capital deduction from net asset requirements) should be applied to non-bank players. The JBA recognizes that this would be outside the scope of the BCBS's mandate and thus requires collaborative work with other international standard-setting bodies (e.g. the Financial Stability Board). It is, however, crucial not just for ensuring fair competition and preventing regulatory arbitrage, but for global financial stability.

- Even if the banking system is shielded from risks of crypto-assets 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.

    - If crypto-assets become disruptive to conventional banking services, the restrictive and prohibitive regulatory approach only to the banking sector will not make sense at all to ensure financial stability;

    - It induces emergence of an unregulated shadow banking system (crypto-assets ecosystem), and makes it more difficult for financial authorities to monitor vulnerabilities of the crypto-assets market and the financial system more widely; and

    - Failures of such shadow banking system will eventually destabilize the entire financial system including the banking system, directly and indirectly through such as settlement chains or risk contagion effects.

- While the DP states "*<u>a robust regulatory framework would require</u> effective regulations and standards related to crypto-asset exchanges and platforms, and other service providers involved in the ecosystem,*" the JBA reiterates that the "<u>competent authorities must ensure</u>" this, given the above risks. If the BCBS is of the view that there is no imminent financial stability concern over crypto-assets and thus prudential standards to

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regulator or the central bank." Prior to establishing such requirements, clear and globally harmonized standards are also needed.

non-bank players at present, it is not also logically warranted to introduce prudential regulations to banks.

(End)