Bank of International Settlements/ Basel Committee
Centralbahnplatz 2
4051 Basel, Switzerland

Submitted via www.bis.org

FIA EPTA response to the second Basel Committee Consultative Document "Prudential treatment of crypto asset exposures"

Amsterdam, 30 September 2022

Dear Sir, Madam,

The FIA European Principal Traders Association (FIA EPTA) welcomes the opportunity to comment on the second Basel Committee Consultative Document "Prudential treatment of crypto asset exposures", dated June 2022 (CD-CAE). While the Consultative Document and regulations mainly focus on banks, FIA EPTA members expect those may have an indirect application in some jurisdictions to investment firms, for example, via the RtM framework under IFR (K-NPR) in the EU. FIA EPTA also commented on the previous Consultative Document of June 2021.

FIA EPTA represents 24 independent European Principal Trading Firms (PTFs) which deal on own account, using their own capital for their own risk, to provide liquidity and immediate risk-transfer in exchange-traded and centrally-cleared markets for a wide range of financial instruments, including equities, bonds, options, futures, ETFs and crypto assets. Our members are important sources of liquidity and stability for end investors and markets across Europe. FIA EPTA members are becoming a part of the digital/crypto assets space, using their existing knowledge to improve the liquidity in these products and in the development of technology. FIA EPTA's members are based in the UK, the Czech Republic, Germany, Ireland and the Netherlands.

Our members are independent market makers and providers of liquidity and risk transfer on trading venues and end investors across Europe. Market making and liquidity provision (also referred to as principal trading or dealing on own account) is a distinct activity that is undertaken by non-systemic investment firms rather than banks, in a highly dispersed and varied ecosystem of independent Principal Trading Firms. These firms operate innovatively and competitively; leading to a vibrant, dynamic and diverse ecosystem which massively reduces interconnectedness and increases substitutability. This fundamentally reduces systemic risk whilst improving market quality and lowering costs for retail and institutional investors alike.

Crypto assets have a range of characteristics. Some serve as payment tokens or coins, while others are manifestations of currently tradable, regulated, financial instruments. FIA EPTA members see great potential and societal benefit in security tokens that serve as a tradeable digital asset, comprising an exposure in underlying traditional assets. We also see viable traditional instruments that provide investors with exposure in underlying digital assets. Digital assets and distributed ledger technology (DLT) platforms will substantially improve the transparency of information, automation, distribution and liquidity. The adoption of crypto assets will expand beyond the first niche application of cryptocurrencies, with DLT removing many sources of inefficiency in the financial markets.

The feedback on the first Consultative Document has led to changes in the proposed prudential treatment. FIA EPTA members welcome this open attitude of the Basel Committee as we have reached a pivotal moment for the adoption of innovative technologies that will improve capital markets by verifiable and transparent information, higher efficiency of clearing and settlement and more liquidity.

Regarding the scope of the proposed framework, FIA EPTA members believe that the CD-CAE refers to 'banks' undertaking certain activities related to crypto assets. This means that the proposed approach should not be applied to investment firms. In some jurisdictions, however, there is a belief that the scope of the proposed framework should be extended. FIA EPTA members believe an extended scope of the proposed framework would be a change of the Basel Committee view, which we believe should be explicitly agreed upon. Generally, extending the scope to investment firms trading for own account does not reflect the actual risks of crypto assets for these firms, nor would it strengthen the functioning and contributions to pricing by (regulated) market making activities.

FIA EPTA members are convinced that the remained general principle '**Same risk, same activity, same treatment**' is essential in designing a balanced supervisory regime for crypto assets exposures. FIA EPTA members made a similar comment in the previous Consultative Document. Unfortunately, we believe that the elaboration of this general principle in the CD-CAE is still inconsistent. Investment firms trading on their "own account" have a much lower risk profile than banks. Consistent use of the general principle, although reversed (different, risk, different activity, different treatment), would support an appropriate regime for these types of investment firms.

Focusing on the proposed changes in the CD-CAE compared to the previous Consultative Document, FIA EPTA members supports the development of the specific standards text for inclusion in the Basel Framework in the form of a new chapter. The **refinement of the classification conditions**, leading up to the redemption risk and basis risk tests might tackle some concerns raised previously. However, the 'narrowly passed' risk add-on seems to be overly burdensome in preventing the quality of the outcome of the basis test, erodes confidence in the basis risk test and might create less transparency and trust in the stablecoins in Group 1.

The use of permissionless blockchain on itself should not be detrimental to be excluded in Group 1 and the peg-to-market difference in the basis risk test should be relative to market volatility over the same period. Otherwise, a short period of spikes in a period of 12 months could cloud the outcome of the basis test. Disqualifying permission-less blockchains from Group 1 would effectively mean that all major stablecoins (who are all on the Ethereum blockchain) would be excluded. These instruments play an important role in the crypto-infrastructure and their exclusion would be systematically detrimental. Therefore, we believe an adjustment of SCO 60.14 would be appropriate.

The **infrastructure risk add-on** to risk-weighted assets (RWA) for all Group 1 crypto assets has not been requested by the market as the infrastructure risk of the group of crypto assets because the use of DLT is limited and well identified in the market. There is no need for additional covering besides market-driven risk mitigating actions. This might only diminish the trading opportunities in these Group 1 crypto assets.

One of FIA EPTA members' comments in 2021 focused on **capitalizing net positions** in crypto assets. This is appropriate, as market makers provide liquidity, trading with the price differences between the different types of crypto ETPs on the different types of trading venues while keeping the net exposures in the crypto assets flat. Although the new proposal by the Basel Committee is helping market makers to execute their functions, it is still insufficient to rise to ultimate market efficiency. Especially the SCO 60.60 under 2, stating the reference to highly liquid underlying ETF/ETN, is too restrictive. With this requirement, many well-established crypto assets are excluded. FIA EPTA members would suggest creating at least appropriate scale of liquidity levels which would be acceptable for this requirement diverged to the crypto asset, derivative or underlying ETF/ETN.

Although now framed as a **100% capital charge** for Group 2 crypto assets, the risk weight of 1250% remains the basis assumption in the CD-CAE. As also raised by many market participants in response to the previous Consultative Document this assumption should be re-assessed and aligned with current Basel Framework risk weights for other, equivalent, assets, as it is not proportionate to the underlying risk and does not reflect the overall impact of crypto assets on the global financial markets and of crypto assets that are matured, established, traded on liquid markets and have internal governance controls.

In addition, FIA EPTA members expect that there will not be enough clearing capacity; which will have negative consequences for market participants trying to trade these products as part of the regulated framework and often for risk mitigation purposes. This will mean that most likely they will engage in other ways with these activities, for example in bilateral and unregulated trading.

In terms of market and credit risk, the risk weight for crypto assets as stated above; should be calculated equally as either the asset class 'equity' or 'commodity' within the Basel framework depending on the characteristics of the crypto asset. Over the years, several regulators have expressed their opinions regarding the classification.

The US Securities and Exchange Commission (SEC) by its chair's testimony in front of the Banking Committee in the US Senate presented the view that crypto assets should mostly be seen as equity.[1] In an enforcement action by the US Commodities Futures Trading Commission (CFTC) in 2015, crypto assets have been properly defined as commodities under the US Commodity Exchange Act (CEA).[2] The CEA's text defines commodity generally and categorically 'not by type, grade, quality, brand, producer, manufacturer or form'. The CFTC considers Bitcoin and Ether as commodities because they can be freely traded on traditional asset markets as well as cryptocurrency exchanges. The Bank of England Prudential Regulation Authority echoes this approach, stating that firms may look to the commodity framework to inform appropriate diversification and hedging methodologies.[3]

We agree with these regulators that the characteristics of the crypto assets primarily define its classification. Consequently, considering the many characteristics of crypto assets is essential for a sound regulatory framework. Commonly, crypto assets use cryptography, peer-to-peer networks and a DLT to create, verify and secure transactions. Crypto assets can have different functions and characteristics: they may be used as a medium of exchange; a way to store value; or for other business purposes, like investment, or any expression of interest (like fan-coins).

For operational risk, an add-on should be considered which would not exceed the risk weight of existing risk weight calculations for other asset classes. This is particularly important as the advanced modelling approach (AMA) has been replaced by the new standardized approach (SMA) under Basel II. There is limited discretion for banks and other firms to use AMA models for the purposes of the internal capital adequacy assessment (ICAAP) or similar processes. The new SMA approach does not appropriately account for digital assets as it is based on more traditional banking business models. In addition, the SMA utilizes a combination of a rudimentary Business Indicator Component (BIC) and an indicator incorporating the firm's loss history; this does not incorporate any of idiosyncrasies of the digital asset class or its underlying technologies.

The most concerning new proposal in FIA EPTA members' view, is the CD-CAE, the provisional **exposure limit of 1% of Tier 1 capital**. According to SCO60.122, a financial institution's exposure to Group 2 crypto assets should be limited to 1% of the institution's Tier 1 capital. And according to SCO60.124, this exposure should be measured as the sum of all individual gross long and short positions. The CD-CAE does not provide any rationale or justification for this low maximum exposure limit, which FIA EPTA members feel will prevent many established institutions from entering the market for crypto assets. As an example – an institution with EUR 1 billion in Tier 1 capital would already reach its exposure limit with EUR 5 million in long positions in crypto assets, hedged with EUR 5 million in short positions in related instruments, ultimately going flat on its real market exposure.

[1] https://www.banking.senate.gov/imo/media/doc/Gensler%20Testimony%209-15-22.pdf, Chairman Gensler also stated this in a speech on September 8, 2022; https://www.sec.gov/news/speech/gensler-sec-speaks-090822#_ftn2.
[2] In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29.
[3] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2022/march/existing-or-planned-exposure-to-cryptoassets.pdf?la=en&hash=9C23154F16580082C3DD6437B4C3352591A0F946.

FIA EPTA members believe that this exposure limit will prevent many institutions from entering the market for crypto assets at all. We feel however that the participation of established financial institutions in the market for crypto assets is exactly what this market needs for it to become a more mature market where regulated firms and institutions play a large role. This would increase stability in the market and will create better self-steering risk mitigating market practices. Regulators should support this development of the crypto asset market instead of ending an era of innovation by preventing established financial intuitions to assist in building a mature market showing societal benefits. FIA EPTA members also believe that the addition of "…indirect holding (i.e. those via investment funds…)" on the scope of this exposure limit is too limiting. Many financial institutions take an equity stake in FinTech start-ups or building innovative DLTs. FIA EPTA members are concerned, that this role in the ecosystem of enabling innovation should not be captured by the CD-CAE.

Consequently, FIA EPTA members would suggest withdrawing this proposal for an exposure limit. If under very specific reasoning and circumstances, such a limit must be set, we would suggest significantly increasing the maximum exposure to crypto assets that institutions can enter into, via a higher maximum exposure limit and better recognition of the risk-reducing effects of hedging. Alternatively, an exemption for PTFs which deal on own account, don't have clients and work with a much smaller balance sheet, would also address the problem of the overly burdensome and detrimental exposure limit for PTFs.

We would welcome the opportunity to provide further background to the Basel Committee on the issues raised in our response.

FIA EPTA
FIA European Principal Traders Association