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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
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Consultative Document – Prudential Treatment of Crypto-Asset Exposures

Dear Sir/ Madam:

State Street Corporation ("State Street") welcomes the opportunity to comment on the consultative document issued by the Basel Committee on Banking Supervision ("Basel Committee") regarding the development of a prudential framework for bank exposures to crypto-assets.[1] The Basel Committee's work reflects the rapid growth of interest in crypto-assets within the financial industry and therefore the need to define a regulatory approach for these assets that helps promote responsible innovation within the banking sector, while also addressing potential new risks and their implications for financial stability. We appreciate and support the Basel Committee's efforts, and we agree that the development of a prudential framework for crypto-assets is likely to require an iterative process that is open to change over time as experience with the underlying technology and industry use cases grow.

Headquartered in Boston, Massachusetts, State Street is a global custody bank which specializes in the provision of financial services to institutional investor clients. This includes investment servicing, investment management, data and analytics, and investment research and trading. With $42.6 trillion in assets under custody and administration and $3.9 trillion in assets under management, State Street operates in more than 100 geographic markets.[2] State Street is organized as a United States ("US") bank holding company, with operations conducted

[1] https://www.bis.org/bcbs/publ/d519.pdf
[2] As of June 30, 2021.

through several entities, primarily its wholly-owned state-chartered insured depository institution subsidiary, State Street Bank and Trust Company. While our primary prudential regulators are therefore the Massachusetts Division of Banks and the US Federal Reserve System, we are subject to oversight by numerous banking regulators in the various jurisdictions in which we operate.

Global custody banks, such as State Street, employ a highly specialized business model focused on the provision of financial services to institutional investor clients. These clients, which include asset owners, asset managers and official sector institutions, contract with custody banks to ensure the proper safekeeping of their investment assets, as well as the provision of a broad range of related financial services. This includes access to the global settlement infrastructure in order to complete the purchase or sale of investment securities; various asset administration functions, such as the processing of income and other interest payments, corporate action events, tax reclamations and client subscriptions and redemptions; and the provision of banking services, notably access to deposit accounts used to facilitate day-to-day transactional activities. The importance of financial services to custody banks can be seen in the large amount of revenue that they derive from fee-related activities. For instance, in Q2 2021, fee revenue comprised 83% of State Street's total revenue.

Furthermore, custody banks have balance sheets which are constructed differently than other banks with retail, commercial and investment banking operations. Specifically, the custody bank balance sheet is liability driven and expands not through asset growth, but through the organic development of client servicing relationships that, over time, translate into increased volumes of stable deposits. These deposits, rather than various sources of wholesale funding, comprise the largest part of the custody banks' liabilities. For instance, as of Q2 2021, client deposits made up more than 75% of State Street's total liabilities. In turn, these stable deposits are used to purchase large and well-diversified portfolios of investment assets which generate conservative amounts of net interest revenue. Importantly, custody banks acquire deposit liabilities as a direct result of the financial services which they provide. In other words, the cash deposits that come on to the custody bank balance sheet are driven by customer-related needs and not by the custody banks' financing decisions.

We appreciate the opportunity to offer our views on the Basel Committee's consultative document informed by our role as a custodial entity, a role that is widely understood by the market and by the regulatory community as providing important benefits for the safety of client assets and the stability of the financial system. Below we offer a series of observations on the Basel Committee's approach to the prudential treatment of crypto-assets, followed by a set of recommendations regarding the capital treatment of such assets, designed to both clarify and strengthen the intended approach. Our policy observations and recommendations can be summarized as follows:

- The Basel Committee should consider including an additional guiding principle in its approach to the development of a prudential framework for crypto-assets, which is

adherence, to the fullest extent possible, to the standards and methodologies which apply in the existing capital framework;

- The Basel Committee should clarify the differences in the risk profile of Group 1a (tokenized traditional assets) and Group 1b assets (crypto-assets with stabilization mechanisms, or "stable-coins"); it should also develop a more granular and risk-sensitive approach to the treatment of Group 2 assets;
- The Basel Committee should clarify the classification conditions which apply to Group 1 assets, notably the concepts of 'effective at all times' and 'ongoing assessment'; it should also eliminate the need for prior supervisory approval for the designation of Group 1 assets;
- The Basel Committee should confirm that certain due diligence requirements of banks can be undertaken on the basis of appropriately defined categories of Group 1a assets and via the use of industry forums, utilities, consortiums and other similar initiatives; it should also acknowledge the ability of banks to rely on relevant third-party expertise;
- The Basel Committee should clarify that it is permissible for banks to use existing governance and risk-management structures to identify, assess and manage the risk resulting from their crypto-asset activities;
- The Basel Committee should reject the implementation of an operational risk capital surcharge for Group 1 assets; it should also clarify that step-in risk is not present when banks offer custody and administrative services for both tokenized traditional assets (Group 1a) and stable-coin arrangements (Group 1b);
- The Basel Committee should permit the treatment of tokenized assets that are representations of traditional assets which qualify as high-quality liquid assets ("HQLA") to also count as HQLA, subject to the presence of a mechanism to seamlessly convert the tokenized asset into its HQLA equivalent; and
- The Basel Committee should revise its approach to Group 2 assets in order to permit banks to support certain clearly defined trading activities on behalf of their clients, including the purchase or sale of crypto-assets on an agency basis.

It is important to emphasize, as a threshold matter, that prudential standards represent only one of the elements which define the regulatory framework for crypto-assets, and that bank participation in crypto-asset activities is also dependent upon the clarification of key regulatory matters outside of the capital framework. This includes, for instance, consistent guidance from regulators, within and among national jurisdictions, regarding the appropriate classification of various types of crypto-assets, which have at times been categorized as commodities, derivatives, securities and currency, designations with important implications for the ability of banks to support client facing activities.

DESIGN OF THE PRUDENTIAL FRAMEWORK FOR CRYPTO-ASSETS

Guiding Principles

The Basel Committee highlights in the introductory section of the consultative document several general principles which have guided the development of its approach to the prudential treatment of crypto-assets. This includes the application of the concept of technology neutrality, based on adherence to the core principle of 'same risk, same activity, same treatment.'[3] We strongly endorse this approach which we view as essential to the development of a prudential framework that appropriately addresses the regulatory and technological challenges posed by crypto-assets, while also supporting responsible innovation and the maintenance of a level-playing field among market participants. Furthermore, we strongly agree that key processes related to crypto-assets, such as the transfer of assets, the processing of redemptions and the settlement of transactions, should be undertaken by entities which are subject to appropriate regulation and supervisory oversight. This includes, in particular, the administration of stable-coin arrangements, which require transparency and oversight over the processes and controls used to safeguard the underlying assets, the existence of strong valuation capabilities and the seamless processing of day-to-day transactional activities.

In order, however, to better define the Basel Committee's approach to crypto-assets and to reduce unnecessary complexity, we recommend the adoption of an additional guiding principle, which is the use to the fullest extent possible, of standards and methodologies found in the existing capital framework. For instance, we note that the Basel Committee's suggestion that Group 1 crypto-asset activities may warrant an additional operational risk charge is inconsistent with the design of the new standardized measurement approach for operational risk which was finalized in December 2017 and which is still pending adoption in various national jurisdictions globally.[4] Similarly, we see no objective reason why the Fundamental Review of the Trading Book ("FRTB"), adopted by the Basel Committee in January 2016, should not be used as the basis for defining an appropriately granular approach for the trading of crypto-assets by banks on behalf of their clients, at least for certain Group 2 assets with well-defined structural features and the presence of strong market liquidity.[5]

Categorization of Crypto-Assets

The Basel Committee's consultative document recognizes, at a high-level, that there are differences in the risk profile of various types of crypto-assets based upon their structure and use case, and therefore proposes the implementation of two broad categories of exposures with differing prudential requirements. The first category of exposures (Group 1 assets), is in turn, broken down into two subcategories; (i) tokenized traditional assets (Group 1a), which are

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[3] Basel Committee Consultative Document, d519; page 2.
[4] 'Basel III: Finalizing Post-Crisis Reforms', Basel Committee on Banking Supervision, December 2017.
[5] 'Minimum Capital Requirements for Market Risk,' Basel Committee on Banking Supervision, January 2016.

digital versions of traditional assets that use cryptography, distributed ledger technology ("DLT") or other similar technology to record ownership of the asset rather than through the account of a central securities depository ("CSD"), and (ii) crypto-assets with stabilization mechanisms (Group 2a), or 'stable-coins', which are crypto-assets with dedicated pools of underlying traditional assets used to 'peg' or otherwise support the value of the crypto-assets. While the consultative document reflects an appropriate understating of the broad characteristics of Group 1a and Group 1b assets, we believe that it would be useful for the Basel Committee to more clearly distinguish between the risk profile of tokenized traditional assets and stable-coin arrangements. For instance, tokenized traditional assets, which represent, in effect, simply a different way of recording ownership of an asset using new technology, do not face the same operational complexities as stable-coin arrangements which are highly dependent upon the mechanism used to link the value of the crypto-assets to the underlying traditional assets. This complexity is heightened by the fact that there is currently no consensus industry standard on how stabilization mechanisms should be structured. Similarly, concerns regarding the transfer, redemption and settlement of crypto-assets are likely to be more pronounced with stable-coin arrangements than with tokenized traditional assets. As a practical matter, this means that the risk-management processes and controls which apply to Group 1a assets are likely to be different and less intensive than those which apply to Group 1b assets, a distinction that should be recognized in the Basel Committee's approach.

Furthermore, in order to promote responsible innovation, we also believe that the Basel Committee must adopt a more granular approach to the treatment of Group 2 assets which, as currently defined, incorporates any crypto-asset that otherwise fails to meet the narrow conditions specified for designation as either a Group 1a or a Group 1b asset. Crypto-assets which are categorized as Group 2 assets are subject to a highly punitive risk weight of 1250% which has the practical effect of making it impossible for a bank to support even basic client-facing trading activity, such as the purchase or sale of crypto-assets on an agency basis.

In our view, greater granularity in the treatment of Group 2 assets could be achieved by dividing such assets into two- or more- sub-categories of exposures, with differing prudential requirements based on factors which demonstrate the presence of a robust and liquid two-way market. This includes, for instance, the overall market capitalization of the crypto-asset, average trading volumes and sufficient depth of book. This also includes the presence of financial structures that permit the hedging of risk for that asset, such as the existence of a futures market. Furthermore, the Basel Committee could condition the more favorable treatment of certain Group 2 assets based upon the presence of structural features which are similar to those which apply to Group 1 assets. This includes, in particular, the existence of suitable anti-money laundering protocols, adequate controls over the potential loss or misuse of data, and appropriate operational risk capabilities and controls.

Using this construct, the first sub-category (Group 2a) would comprise, for example, Bitcoin, Ether and potentially certain stable-coin mechanisms that would not otherwise qualify for treatment as Group 1b assets, while the second sub-category (Group 2b) would comprise all other types of Group 2 assets, including those with novel terms or structures. To avoid the

potential for a sharp 'cliff effect' in the capital treatment of such assets, an appropriate mechanism should be established to manage the transition of assets between sub-categories, based on their defined standards and characteristics, notably in the case of a downgrade from Group 2a status to Group 2b.

Classification Conditions

The Basel Committee lays out in Section 1.1 of the consultative document a lengthy and highly prescriptive list of requirements that must be met for a crypto-asset to be categorized as a Group 1 asset. This includes broadly defined requirements which address the structure of the crypto-asset; the legal rights, obligations and interests that relate to such assets; the design of risk management processes and controls; and the structure of the DLT platform or other similar technology that supports the crypto-asset. While we recognize the Basel Committee's desire to proceed with caution in the development of a prudential framework for a still nascent category of assets, we believe that the conditions laid out in the consultative document are unnecessarily onerous, and as a practical matter, will have the effect of substantially limiting the ability of banks to support responsible innovation and the reasonable needs of their clients.

For instance, the consultative document specifies that a stable-coin mechanism must maintain, 'at all times', parity in the value of its crypto-assets relative to the underlying assets, with the further requirement that there be no more than three instances of divergences in the value of such assets of greater than 10 basis points over a one-year horizon. Moreover, to the extent that this condition is not met, 'the stabilization mechanism will no longer be deemed effective', resulting in the recategorization of the stable-coin mechanism as a Group 2 asset until such time as the bank can 'demonstrate to the satisfaction of the supervisor that the cause of the breach has been addressed and will not reoccur.'[6] While it's not clear from the consultative document how the Basel Committee determined the appropriateness of the 10 basis point standard, in practice this approach creates a substantial 'cliff effect', wherein a bank may suddenly incur a cost-prohibitive capital charge for its exposures to a stable-coin mechanism even due to temporary instances of market volatility, without recourse.

As another example, the consultative document does not provide any guidance on the practical meaning of the term 'ongoing assessment', nor does it condition the requirement to ensure settlement finality 'at all times' to prevailing market conventions and practices. Similarly, the requirement for banks to 'sufficiently mitigate and manage any material risk' is highly subjective, thereby creating broad uncertainty as to what is required of banks to reasonably ensure compliance with the specified classification conditions. As such, we recommend that the Basel Committee carefully reassess and refine the proposed conditions for classification as a Group 1 asset in order to ensure that they are clearly defined and appropriate to the management of the underlying risk.

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[6] Basel Committee Consultative Document, d519, page 4.

Furthermore, in order to reduce regulatory complexity and mitigate the potential emergence of market fragmentation, we strongly urge the Basel Committee to reconsider the requirement for prior supervisory approval for the designation of Group 1 assets, adopting instead a more conventional approach in which banks make their own classification determinations, subject to supervisory oversight and review.

Due Diligence Requirements

The Basel Committee emphasizes throughout the consultative document a rigorous series of due diligence and monitoring obligations that banks must meet when engaging in crypto-asset related activities. This includes the ongoing assessment of whether each Group 1 crypto-asset remains compliant with the classification conditions set forth in Section 1.1 and the demonstration of that compliance to the satisfaction of the appropriate supervisory authority.

As a general matter, we agree that it is the responsibility of banks to understand the structure, purpose and use of crypto-asset related products and services, and to carefully assess the underlying risks. In the case of Group 1a assets, this includes adequate due diligence to ensure that the tokenized version of the asset conveys the same legal and economic rights as those conveyed by the traditional asset. We also agree that banks should not assume the qualification of a tokenized asset based simply on the characteristics of the underlying traditional asset, and that banks must also analyze, as necessary, whether the tokenized traditional asset meets the preconditions for recognition as eligible collateral.

We would, however, urge the Basel Committee to clarify that it may, in certain cases, be appropriate for banks to conduct their due diligence obligations on the basis of discrete categories of Group 1a assets rather than on an asset-by-asset basis. For example, the ability to group due diligence-related obligations would, in our view, be appropriate for a series of tokenized traditional assets (e.g. all equity securities of companies in the Dow Jones Industrial Average) with the same underlying legal and economic construct issued on the same DLT platform.

More broadly, we agree that banks are responsible for ensuring the reliability of the technology, systems and applications that underpin crypto-assets. This includes the presence of an appropriate consensus mechanism, suitable controls over access to the underlying cryptographic keys/ assets, sufficient computing capabilities and strong control parameters for node operators. In this respect, we agree that permissioned-based DLT systems offer the greatest means of control over crypto-assets and are therefore most appropriate as the basis for products and services offered by banks.

In order, however, to best support the efficient use of industry resources, we urge the Basel Committee to clarify that due diligence obligations regarding DLT platforms and other relevant technology systems can be met by banks using common industry forums, utilities, consortiums or other similar arrangements, designed to develop and share common standards and practices. Similarly, the Basel Committee should clarify that banks can rely for their due

diligence obligations on third-parties that will inevitably emerge with highly-specialized expertise in various crypto-asset related matters that is best organized and maintained through centralized service providers.

Governance and Risk Management Controls

The Basel Committee emphasizes in Section 5.1 of the consultative document that banks must maintain appropriate governance arrangements, as well as internal processes and controls, to effectively manage the risk that results from their exposure to crypto-assets on an ongoing basis. While we fully endorse this approach, we note that at times, the consultative document can be read as requiring firms to establish a separate governance and control framework that is specific to its crypto-asset exposures. We do not believe that this is necessary. Indeed, while we recognize that there are risks which are unique to crypto-assets, we believe that these risk can effectively be managed using existing governance and risk management processes and controls. This includes the ability to identify, assess and manage risk attributable to the underlying DLT platform or other similar technology, potential new or additional types of operational or cyber-risk, and heightened risk attributable to money laundering and other financial crimes. We therefore recommend that the Basel Committee clarify in the final version of its standards, that it isn't necessary for banks to establish a separate governance and control framework for the management of crypto-asset related exposures, provided that existing risk management structure can be deployed to the same effect.

CAPITAL AND LIQUIDITY REQUIREMENTS FOR CRYPTO-ASSETS

Operational Risk Capital

The Basel Committee emphasizes in the consultative document its concern that crypto-assets have the potential to pose heightened levels of operational risk, which it believes can be addressed via the application of an additional pillar 1 capital charge. This is reflected in the assertion that capital requirements for Group 1 assets should be 'at least equivalent to those of traditional assets with further consideration of capital add-ons.'[7] We believe that this concern is substantially overstated when it comes to exposures that result from the provision of custody-related services for both Group 1a and Group 1b assets and should therefore be reconsidered.

Indeed, in the case of tokenized traditional assets, provided that the underlying DLT platform is sound and that the tokenized version of the traditional asset conveys the same economic and legal rights (conditions that must be met for treatment as a Group 1 asset), the risk of greater operational risk is minimal. In fact, in many ways tokenized traditional assets will reduce the risks that result from current inefficiencies in the post-trade landscape stemming from the need to continuously reconcile information among the various entities involved in a transaction. This

[7] Basel Committee Consultative Document, d519; page 3.

results from the ability of all entities using a DLT platform to share a common representation of the relevant asset throughout its lifecycle, from trading to settlement, to safekeeping, and to ongoing administration.

In the case of stable-coin mechanisms, while we agree that there are important legal and operational considerations that must be addressed prior to their use as financial assets, including the careful articulation of each party's respective rights and obligations and the implementation of processes to ensure the safety of the underlying assets and the timely execution of redemptions, these considerations are not substantively different that those which exist today when offering custody services to various pooled investment assets, such as exchange traded funds. This is in fact one of the reasons why we strongly support the Basel Committee's view that entities which support key transactional processes for crypto-assets must be subject to appropriate regulation and supervisory oversight.

As such, we strongly recommend that the Basel Committee affirm that the default treatment for Group 1 assets is the use of the existing capital framework without the application of any additional operational risk charge, except in narrow and highly fact-dependent circumstances where supervisors determine that the bank lacks the capacity to adequately manage the underlying risk exposure.

Step-in Risk

The Basel Committee emphasizes its concern in the consultative document that regardless of the underlying legal rights, obligations and interests which the ownership of crypto-assets entail, banks may in practice feel obligated to step-in and assume economic responsibility for Group 1 assets held by investors or clients in order to protect the bank's reputation. While we recognize the potential for step-in risk in narrow cases where a bank acts an issuer or sponsor for a novel crypto-asset exposure with limited transparency, we do not believe that any such risk exists in cases where a bank is hired to provide custody-related services for crypto-assets. This is true regardless of whether the custody bank is charged with the safekeeping and administration of tokenized traditional assets on behalf of its clients, or whether it is responsible for the administration of a stable-coin mechanism including the transfer of assets, the movement of cash, the processing of subscriptions and redemptions, and the settlement of transactions. We therefore strongly recommend that the Basel Committee clarify its concerns regarding the potential for step-in risk in Group 1 assets, and that in any event, it specifically affirm that the default assumption in cases where a bank provides custody services for Group 1 assets is the use of the existing capital framework without any additional charge for step-in risk.

High-Quality Liquid Assets

The Basel Committee takes the highly conservative position in the consultative document that while it will continue to explore the matter, for the time being no crypto-asset should be permitted to qualify for treatment as HQLA for the purposes of meeting the liquidity requirements in the Basel III accord. This includes tokenized versions of traditional assets that

otherwise qualify for treatment as a HQLA. While we understand the Basel Committee's desire to proceed with a certain measure of caution, we believe that this approach is unnecessarily restrictive and that it will in practice create inefficiencies in the market that will slow the development of responsible innovation and unnecessarily fragment market liquidity. Instead and consistent with the core principle of 'same risk, same activity, same treatment', we believe that the Basel Committee should permit tokenized versions of traditional assets that are categorized as HQLA to also count as HQLA, provided that the underlying DLT platform is sound, that the tokenized version of the traditional asset conveys the same economic and legal rights and that a mechanism exists through which the bank is able to seamlessly monetize the tokenized version of the asset into the underlying traditional asset.

Group 2 Assets

As noted in our earlier observations, the Basel Committee envisions that all crypto-assets that fail to meet the specified conditions for categorization as Group 1 assets will be treated as Group 2 assets subject to a punitive risk weight of 1250%. This has the practical effect of making it impossible for banks to offer even basic trading services for Group 2 assets on behalf of their clients, such as the purchase or sale of crypto-assets on an agency basis. In order to address the clear limitations of this approach, we believe that it is essential for the Basel Committee to develop a standard for Group 2 assets that differentiates between basic categories of exposures and that also maintains the current distinction in the capital framework between trading book and banking book assets.

For instance and as previously noted, the Basel Committee should strongly consider the creation of two - or more - sub-categories of Group 2 assets, defined on the basis of various factors which demonstrates the structural robustness of the asset and the presence of a liquid two-way market. The first sub-category (Group 2a) would be comprised of well-established and more liquid crypto-asset structures, such as Bitcoin and Ether, and would be subject to a proportional risk weight of 400%, which is analogous to the existing treatment for speculative unlisted equities. The second sub-category (Group 2b) would be comprised of all other more novel and less liquid structures, and would be subject to a risk weight of 1250%.

Furthermore, banks should be permitted to make us of existing methodologies for the assessment of their exposures, including the FRTB for market risk, and in the case of derivatives exposures, the standardized approach for counterparty credit risk. Similarly, banks should be permitted to recognize the effect of initial margin collected from their counterparties, to net transactions that reference the same underlying asset and to engage in hedging activities to manage their risk. Finally, the Basel Committee should lay the foundation for the development of central clearing capabilities for certain types of crypto-assets by signaling the potential for an appropriately reduced capital charge over time.

STATE STREET.

CONCLUSION

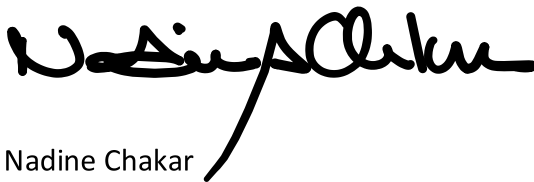
Thank you once again for the opportunity to comment on the important matters raised within the consultative document. To summarize, while State Street supports the Basel Committee's efforts to develop a framework for the prudential treatment of crypto-assets, and its emphasis on an iterative process that evolves as experience with the underlying technology and industry use cases grow, we believe that there are several areas where the intended approach should be clarified or revised.

In terms of design features, this includes: the adoption of an additional general principle of adherence to the fullest extent possible to existing standards and methodologies in the capital framework for global banks; a more precise articulation of the differences which exist in the risk profile of Group 1a (tokenized traditional assets) and Group 1b (stable-coins) assets; greater granularity in the treatment of Group 2 assets; refinement of the classification conditions for Group 1 assets, including the elimination of the supervisory approval process; clarification of various due diligence obligations to improve the deployment of industry resources; and confirmation of the ability to use existing governance and risk management processes to manage crypto-asset related exposures.

In terms of the capital and liquidity treatment of crypto-assets, we strongly oppose the potential implementation of an additional operational risk charge for Group 1 assets, and we also urge confirmation that step-in risk is not present when a bank provides custody and asset administration services for either tokenized traditional assets or stable-coin arrangements. Furthermore, we recommend that the Basel Committee permit Group 1a assets that are digital versions of traditional HQLA to also qualify as HQLA subject to certain conditions, and we strongly urge substantive changes to the capital framework for Group 2 assets to permit banks to support certain trading activities on behalf of their clients, such as the purchase or sale of crypto-assets on an agency basis.

Please feel free to contact me at nchakar@statestreet.com should you wish to discuss the contents of this submission in greater detail. We welcome the opportunity to further engage with the Basel Committee on this topic, notably on matters regarding the custody and administration of crypto-assets, and we stand ready to provide whatever assistance may be appropriate.

Sincerely,



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