coinbase

To:
Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel, Switzerland

28 March 2024

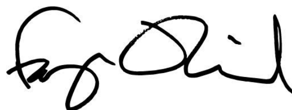
Re: Cryptoasset Standard Amendments

Coinbase Global, Inc. (together with its subsidiaries, **Coinbase**) appreciates the opportunity to respond to this consultation by the Basel Committee on Banking Supervision (the **Committee**) on proposed amendments to its previously published standard on banks' exposures to cryptoassets (**cryptoasset standard**).

Banks play critical roles in the financial system – not only to allocate credit and promote economic growth, but also to operate parts of the technological infrastructure of financial services. Technology is always evolving; standing still is not an option. For this reason, we believe both banks and the crypto ecosystem stand to benefit from banks making greater use of blockchain technology and engaging more fully in cryptoasset markets. Realizing these benefits will depend on striking the right balance between innovation and prudence.

We appreciate the Committee's continued consideration of these issues and its willingness to update the cryptoasset standard as the market develops. We look forward to continuing to work with and discuss these issues with the Committee.

Yours sincerely,



Faryar Shirzad
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Introduction

Blockchain technology has the potential to provide significant improvements to our financial architecture, increasing resilience, lowering costs and making processes more efficient. It is critical that banks, as the core of today's financial system, be permitted to help shape the development and adoption of this technology. Their level of participation should be driven by economic fundamentals – the financial and commercial feasibility of cryptoasset-related activities – with the role of bank regulators to ensure that their activities are conducted in a safe and sound manner, without making these activities permissible in theory but impossible in practice

We are disappointed that the Committee continues to employ an approach to bank capital requirements for cryptoassets that we believe to be fundamentally flawed and inconsistent with past practice of the Committee. Many of the requirements are not based on the risk of these assets to a bank, but rather reflect other policy objectives which the Committee normally does not incorporate in capital requirements, as we explain in detail, below. In addition, if the Committee does retain the current overall approach, we have more detailed suggestions on specific topics.

Capital should be proportionate to the risks for a bank in holding an asset

The Committee has correctly committed to tying risk weights for capital calculations to the level of underlying risk to a bank of holding an asset. This includes pushing back against the many ways in which various stakeholders have called for modifying capital requirements based on the societal value of certain activities. We agree that capital requirements are generally an inferior policy tool for promoting desirable social activities and discouraging undesirable ones as compared to the many other tools available, such as direct regulation of the activities, tax policy choices, subsidies or penalties, guarantees, and public-private partnerships.

Further, basing capital requirements on criteria other than risk levels may undermine risk management practices at banks by diminishing the importance of risk calculations. Each time the Committee promotes or accepts such distortions, it does harm in the specific instance and also opens the door wider to further introductions of political considerations into risk management. It also could encourage further re-examination of the Committee's international role, as it has been generally understood until now that the Committee's mandate is not to set social policy. There are other international bodies, including the Financial Stability Board (**FSB**) and the Committee on Payments and Market Infrastructure (**CPMI**), with remits more appropriate to dealing with some of the issues on which the Committee is implicitly setting policy in these standards.

The Committee's choices demonstrate a desire to severely limit the holding, and therefore use, of stablecoins by banks. If that is the Committee's desire, and if it is within its remit,

then it should do so transparently and through a different means than by setting capital standards that bear little relationship to the actual risk levels for banks holding these stablecoins.

The distorting impacts of the massive cliff effects in the standards

An overarching problem in the consultation, carried over from the earlier standard, relates to the use of a blanket 1250% risk weight for all cryptoassets that do not fall into Group 1a or 1b. This produces a massive cliff effect that penalizes assets which are very similar to those in 1a or 1b, but fail to meet the precise criteria. Jumping from a risk weight of 100%, or significantly less, for a stablecoin that qualifies for 1b treatment, to 1250% for one that barely misses qualification, is analogous to mandating the death penalty for a parking ticket or other minor infraction.

Most basically, as we pointed out in our response to the earlier consultation, it is easy to construct examples of tokens designed to be stablecoins which would fail the specific tests to qualify for Group 1b treatment while presenting virtually the same level of risks to banks holding these tokens as do stablecoins that qualify. As an extreme example, imagine a token that maintained 99% of its reserve assets in insured deposits at high-quality banks, but invested the other 1% in assets not qualifying for the 1b test. Forcing banks to hold capital based on a 1250% risk weight would mean they had capital of at least the total target value of the tokens, despite the near certainty of recovering at least 99% of that amount. (In practice, as discussed below, the capital levels would generally be significantly higher than 100% of the total target value.)

The Committee historically has tried to avoid approaches that focus on “form over substance,” instead striving to match capital requirements to the underlying economic risks to a bank. There may be times when it makes sense for the Committee to go by the form of an asset as a matter of necessity (lack of data to distinguish in any greater depth, for example) or convenience (for instance, when it is not worth the Committee’s time to examine an asset category on a more granular basis), but these exceptions do not apply here.

A final high-level point is that there is literally no risk-related logic that justifies applying a cap on holdings of Group 2 assets of 1% of Tier 1 capital while also applying capital requirements that will always be at least at the level of the maximum theoretically possible loss and, in almost all cases, will be even higher still. These capital levels more than cover the potential loss, meaning that there will effectively be a net release of capital if the Group 2 assets became worthless. Again, we believe this requirement demonstrates that the Committee has pursued extraneous policy objectives while purporting to be setting capital requirements based on risk levels.

Specific violations of the principle of capital requirements following risk levels

There are other ways in which the conditions for Group 1b treatment violate the principle of focusing on the level of risk for a bank holding the asset, rather than other policy goals which are outside the Committee's remit.

For example, there are dual criteria related to the stability of the peg of a stablecoin to its target value. We agree that it is reasonable to include a requirement that the financial assets backing a stablecoin should be sufficient to provide for redemption at the target value in a short period even under stressed conditions. However, we do not believe there is a good reason to require that the market value does not fluctuate outside of a narrow range. Given the ability to directly redeem the stablecoin at the target value within a short period, a bank would have only a very short-term liquidity risk, rather than a credit risk meriting a 1250% risk weight.

We acknowledge that some have argued that the statistical test represents a way of capturing market intelligence on the credibility of the redemption promise. However, we believe this is much better dealt with directly through the rules on the reserve assets. There are too many instances, including in the very safe US Treasury and UK Gilts markets, where market prices have temporarily moved a considerable distance from underlying economic values. All in all, if the Committee is planning to establish Pillar 1 capital requirements for liquidity risks, this seems an odd place to start and would certainly not warrant such an extreme risk weight.

Before leaving the topic of the many ways of triggering the cliff effect and ending up with a 1250% risk weight, we feel compelled to point out once again that a 1250% risk weight is not remotely justifiable without at least a cap on the requirement equal to the maximum possible loss to the bank if the asset became worthless. In practice, most banks, often due to other regulatory requirements, have capital requirements at least equal to 12% of risk weighted assets (RWA). This means they would be allocating capital to these digital assets of at least 150%[1] of the amount they could lose even at the theoretical maximum loss. A truly risk-based analysis would show most cryptoassets warrant capital requirements substantially below the theoretical maximum loss, as we laid out analytically in our responses to both the Committee's first and second consultations on its standard. However, even if the Committee takes an extreme view, there is no argument that more capital is needed than the theoretical maximum loss. Placing a cap on the capital requirements of 100% of the value of the asset on the bank's balance sheet would be very easy to implement and to understand, therefore we continue to see no reason not to make this revision.

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[1] If an asset gets 1250% risk weight, under a 12% capital / RWA, this asset gets 150% (1250%*12%) of its total value as capital requirement. A bank subject to such requirements would need to hold $1.5 million in capital against a $1 million exposure to a Group 2 cryptoasset.

Tokens on permissionless networks should be eligible for Group 1 treatment

We are also strongly disappointed that the Committee remains unwilling to allow tokens using permissionless networks to qualify for treatment as Group 1 assets. The great majority of stablecoin assets are currently in permissionless networks because of the many advantages offered by those networks. Research and development in the blockchain space is overwhelmingly focused on permissionless networks, giving a strong indication of where future innovation and commercial development will occur.

It is unclear why the Committee is convinced that a permissioned system produces less risk to asset values than a permissionless one. A permissioned system could be set up by a central institution that put a low priority on risk mitigation or it could be run badly for other reasons, including a desire to hold down costs. There could certainly be bad permissionless systems, but the transparency they grant to the entire world provides the benefits of many eyes watching how it operates. Even if the Committee is convinced that permissionless systems are inherently riskier, applying the death penalty of the 1250% risk weight to bank holdings of stablecoins on these networks is vastly disproportionate to the risk differentials that might exist between permissionless and permissioned systems.

It would be helpful for the Committee to show the analysis whereby it determined that a very high risk weight is justified for permissionless systems. Given the vast amount of time the Committee and its staff have now spent on digital assets, we do not believe it is reasonable to simply argue that the Committee is more comfortable with certain types of activities, defined quite narrowly, and that anything outside of this box should be hit with punitive capital requirements that will effectively keep banks out of this area of innovation.

Other responses to specific points

One of the Committee's questions was whether, and if so under which conditions, stablecoins that use securities financing transactions (**SFTs**) should be included in Group 1b. We believe stablecoins that use SFTs should be allowed in Group 1b with certain conditions listed below, which are consistent with bank liquidity requirements as laid out by the Committee. We believe that with these conditions, SFTs would meet the core principles of reserve assets as outlined in section 2.1 of the consultation paper, while providing an easier option than outright sale to liquidate a reserve asset in some market conditions.

In addition to the key requirements that are listed for specific SFT types below, we believe all SFTs should:

- Utilize high-quality collateral consistent with the standards specified in section 2.1 under the heading "credit quality," including claims on or guaranteed by sovereigns and central banks with high credit quality; and
- Be short-term, in line with section 2.1 under the heading "maturity."

Cash borrowed via a repurchase transaction should be allowed, as these transactions enable high-quality reserve assets to be liquidated efficiently. The consultation paper expresses concern that this "would allow the stablecoin to leverage itself and might artificially inflate stablecoin reserves." However, this problem can be easily addressed by permitting a stablecoin issuer to count only the market value of its unencumbered assets as part of the stablecoin reserves.

Securities lent through a repurchase transaction collateralized by other securities should be allowed for completeness, but, again, only the market value of the unencumbered securities should count towards reserves, to ensure that outstanding stablecoins remain fully backed at all times.

Similarly, cash lent through reverse repurchase transactions should be allowed, subject to the same standards of collateral quality specified above. In practice, overnight reverse repos over-collateralized by highly rated sovereign debt securities are very safe exposures, so there is no reason to discourage them.

Conclusion

The financial system and the real economy are best served when financial institutions are permitted to take on risks within well-defined parameters. For this reason, the Committee's remit has always been anchored to banks' safety and soundness, a mandate that is broad and important but not indefinite. We welcome efforts by the Committee to strike a balance that both supports innovation within the banking system and improves the cryptoasset ecosystem as well.