



Governors and Heads of Supervision endorse global bank prudential standard for cryptoassets and work programme of Basel Committee

The Group of Central Bank Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee on Banking Supervision, endorsed a global prudential standard for banks exposures to cryptoassets which is to be implemented by 1 January 2025. The text of the new standard will comprise a new chapter of the Basel Framework (SCO60) and it will provide the guidelines for prudential treatment of banks' exposures to tokenised traditional assets, unbacked cryptoassets and stablecoins. The legislative text outlines the classification rules banks must follow when categorizing crypto assets, addresses managing the risks stemming from new digital infrastructure, and sets limits on banks exposures.

As banks have become increasingly exposed to cryptoassets, recent volatility and events have emphasised the need for prudential regulation for cryptoassets. The GHOS will continue to monitor key issues including the role of banks as stablecoin issuers, custodians of cryptoassets and other potential interconnectedness between traditional banks and the cryptoassets market.

The GHOS endorsed work programme for 2023-24 also includes a forward-looking approach to identifying and assessing emerging risks and vulnerabilities to the global banking system, of which cryptoassets play a key part. Market participants can therefore expect cryptoassets to remain a key part of the GHOS agenda, with relevant regulations to follow.

What should management consider

Management should carefully review the new standards and consider them in line with their strategy on crypto assets. Although 1 January 2025 is nearly 2 years away, the uptick in the industry's take-up of crypto assets would mean that most firms would have exposures to such assets by the implementation date; this means that boards should be cautious about regulatory implications prior to the implementation of strategies.

The Future Regulation of Unbacked Cryptoassets in the UK

A report from UK Finance highlights the opportunities surrounding unbacked cryptoassets (i.e., those that are not fully-backed by fiat currencies or high-quality liquid assets) and the associated technology while discussing how regulation should be designed and shaped to maximise these opportunities. The report examines the regulatory considerations in line with the FCA's operational objectives: consumer protection, market integrity and effective competition. It analyses the deployment of unbacked cryptoassets via use cases of trading, custody and payments, while considering:

1. The risks and harms regulators are trying to address
2. The tools used to address similar risks in traditional finance
3. The challenges and opportunities encountered when applying these tools to cryptoassets
4. The risks raised by the crypto asset ecosystem

The report considers key cross-sectional requirements to align proposals with the FCA's objectives, namely the consumer duty, financial and operational resilience, financial crime, governance, and risk management.

What management should consider

It is clear that regulators are incredibly concerned about the financial stability implications of unbacked crypto assets on firms' balance sheets. It is interesting to note that UK finance draws a clear (and tangible) link between crypto and a number of areas where financial regulation exists. This hints at the possibility that regulators could investigate exposures to (and handling of) crypto assets through the lenses of existing legislation, potentially before specific regulation on crypto is introduced. Management should carefully review the use cases below.

Use case one: Trading

The trading case describes the facilitation or execution of an exchange involving unbacked cryptoassets, either for fiat or other cryptoassets. The three methods discussed for trading include:

1. Using a self-hosted wallet through a decentralised exchange
2. Trading unbacked cryptoassets through an intermediary
3. Peer-to-peer trading using a centralised facilitator

In regard to consumer protection, when trading cryptoassets, retail customers are interacting directly with the exchange, rather than through an intermediary as would be the case in traditional finance. These nuances change the requirement in regulation. For example, traditional intermediaries must make an assessment of a customer's risk profile and investment needs and offer products and services accordingly. The FCA is beginning to integrate this message into cryptoassets, requiring advertising to be "fair, clear and not misleading". The new Markets in Crypto Assets regulation (MiCA) introduces a similar requirement in assessing the suitability of cryptoassets for customers based on knowledge, investment objectives and ability to absorb losses. Although such requirements may limit the products that can be offered to investors, it is crucial to ensure customers have sufficient knowledge about the products they are investing in.

The volatile nature of crypto markets also requires strong price transparency to ensure consumers have up-to-date and accurate prices. In traditional financial markets, the MiFID II regulation requires exchanges and intermediaries to report their trades to data reporting service providers. This affords up-to-date pricing for consumers and allows them to see where to find the best price for an asset. The OECD's statutory reporting requirements were updated for the Crypto-Asset Reporting Framework and Amendments to the Common Reporting Standards which require the following to be reported:

1. Exchanges between relevant cryptoasset and fiat currencies
2. Exchanges between one or more forms of relevant cryptoassets
3. Transfers of relevant cryptoassets

UK Finance suggest the regulatory definitions to be widened and further leveraged to achieve greater price transparency in crypto markets.

In summary the trading use case shows how existing regulations may be extended and modified to cover cryptoassets depending on their definition. Trading of cryptoassets will need to be defined as a regulated activity, requiring firms to comply with the FCA Principles of Business. The FCA can bring the digital representation of traditional financial assets (which move on blockchain) under the CASS, MiFID and MAE regimes.

Use case two: Custody

The topic of custody was a key point of discussion during the recent FCA Crypto Sprint. The report defines custody as “the safekeeping of a private key on behalf of self or others”, where the private key refers to the cryptographic key that represents ownership and/or control by providing the user with the access to transact. The types of custody can vary:

- Personal custody: the case where there is no third-party services. Consumers have direct access to their assets and full control. This can be either hardware or software wallets with no intermediary. These wallets however are very difficult to regulate.
- Full and minority control as custodian: custodial wallets offering varying levels of control. Some providers have partial control, allowing them to execute, transfer and sign transactions, but the providers would not have full control without the customers private key to enable the transactions release.

In the case of a custodian, the FCA Crypto Sprint group suggested the extension of the CASS rules as a basis for covering cryptoassets. The four fundamental principles to CASS are:

1. Identification of client assets: a custodian should be able to identify where they hold client assets in their business..
2. Segregation and safeguarding: according to CASS regulations, client assets are to be held separately from the custodians own assets, usually with segregated client accounts. This could be easily achieved by cryptoasset custodians holding client assets in a separate wallet.
3. Reconciliation: the CASS regulations require regular reconciliation of the custodians’ records. The nature of the blockchain technology, renders this requirement futile.
4. Registration and legal title: any assets belonging to a client must be labelled and registered as belonging to the client

Despite the complexities, the CASS rules provide a sound basis from which to build regulation for the custody of cryptoassets.

Use case three: Payments

The report defines a payment as the transfer of digital assets from one party to another in exchange for a good or service.

The UK Payment Services Regulations (PSRs) and e-Money Regulations (EMRs) impose capital, safeguarding, outsourcing, accounting and audit requirements on intermediaries. Payment and e-money firms must also be authorised by the FCA and comply with AML/CFT regulations as well as those relating to operational risk. The government are in the process of amending the PSRs and EMRs to bring stablecoins into scope through the Financial Services and Market Bill. As these payment firms must be FCA regulated they will also fall under the new Consumer Duty, bringing consumer outcomes to the forefront of the FCA’s objectives.

Under the PSRs and EMRs firms are also required to safeguard client assets by placing them in a separate account or by applying appropriate insurance, though the volatile prices can make sourcing such insurance difficult.

The PSRs and EMRs therefore provide a good level of regulation in cases where payments are being made using cryptoassets and will continue to be reviewed and updated in line with changes in the cryptoasset space.

Beyond the three use cases, UK Finance additionally consider Decentralised Finance (DeFi), underlying Distributed Ledger Technology (DLT) and staking.

DeFi used DLT to remove a centralised party in various financial transactions using smart contracts. This gives more control to individuals and less reliance on third parties. DeFi can be used for buying or selling, loans or payments in a peer-to-peer fashion. Although the use of smart contracts removes the need for a central party it does put governance needs on to the developers of the blockchain being used, Regulation therefore remains important in identifying those responsible for governance and holding them suitably accountable. Regulators are considering an approach which would allow them to directly interact with the distributed network and therefore provide oversight in real time by

viewing the blockchain itself. This would provide strong oversight but would require significant investment and training from regulators to operate efficiently. Other proposals include codes of conduct, with regular reviews and updates. A recent report from the European Union Commission on DeFi Policy Considerations proposes a voluntary compliance framework¹. This allows users and blockchains to voluntarily comply in exchange for forms of public support.

When it comes to the underlying DLT technology, the benefits are widely agreed. However, the use of DLT presents several challenges with regard to regulation. Ledgers can be private, vulnerable to cyber risks and in some cases are becoming too-big-to-fail. The Basel committee's consultation on the prudential treatment of cryptoassets², alludes to regulatory flexibility to add risk weighted add on according to factors such as size and age of the ledger. The IMF have also highlighted the ESG risks associated with the high energy consumption of certain DLT. When MiCA comes into force in 2024 it will require cryptoassets to disclose their carbon footprint. This demonstrates the EUs commitment to its ESG goals, extending them to DLT.

Staking refers to a way of earning rewards for holding a cryptoasset, as a form of interest. Staking can be done as a validator on a proof-of-stake blockchain, where the participant earns rewards for supporting the operation of the blockchain. Participants usually earn newly minted blocks as a reward. This is an important part of proof-of-stake networks as it incentivises participants to act in the interest of the wider system. Staking as an entity occurs when token holders lend their tokens within the DeFi ecosystem. Staking in this way is inherently riskier than staking as a validator, an essential role to operate the ledger.

In conclusion, there has been significant progress in the regulation of cryptoassets, and the intention of major regulatory bodies to advance in this space is clear. The first steps have been made with regulations such as MiCA and EMRs. As well as specific regulation regulators will extend traditional regulations like CASS and MiFID to include cryptoassets. This will undoubtedly require input and resources from exchanges, payment platforms and traditional financial institutions providing cryptoasset products. However, the use of the Crypto Sprint events and working groups shows the intention of regulators, especially those in the UK, to work closely with the market in designing cryptoasset regulations such that the benefits of DLT can be maximised and breathing space provided to harness innovation and potential.

EBA launches call for interest for two expert groups and a call for input to advise on its work under the recast Funds Transfers Regulation

The European Banking Authority (EBA) issued a call for interest to join two of its Technical Expert Groups. The first is cryptoassets service providers and anti-money laundering and countering financing of terrorism. This group will provide financial crime expertise in relation to cryptoasset services providers. The anonymity of cryptoassets, difficulty in confirming the source of funds, speed of cross border transactions and lack of current regulation makes cryptoassets a key area of risk for AML and CFT purposes.

The second group is on restrictive measures regimes. This group will focus on systems and controls institutions can put in place to comply with wider financial sanctions. Again, this could be difficult given the anonymity of cryptoassets.

What management should consider

Both Technical Expert Groups demonstrate a clear intention to bring cryptoassets into the scope of more traditional financial regulations and the desire of the EBA to bring in experts of the field where necessary to ensure regulation is effective and in line with wider objectives, both regulatory and financial. There is no specific action for firms to take, but developments should be closely followed in the context of changing regulation.

¹: [Decentralized Finance: information frictions and public policies \(europa.eu\)](https://ec.europa.eu/economy_finance/centralized-finance-information-frictions-and-public-policies_en)

² [Press release: Basel Committee publishes second consultation document on the prudential treatment of banks' cryptoasset exposures \(bis.org\)](https://www.bis.org/press/pr20220902.htm)

The FSB proposes framework for the international regulation of crypto-asset activities

The recent turbulence in the market has highlighted several key risks including problems with business models, maturity and liquidity mismatches and over leveraging. The collapse of FTX and contagion like effects have also shown how there can be too-big-to-fail risks in the cryptoasset space which threaten the entire market. These risks have been amplified by the lack of regulation in the market and lack of consumer protection leading to widespread losses. Despite the clear need for legislation, the FSB acknowledges the potential in the technology and the importance of shaping regulation such that this potential can be harnessed.

The FSB identifies several challenges in designing regulation for cryptoassets. The first is the significant lack of data and information. Cryptoassets mostly fall outside of reporting requirements hence monitoring and preventing vulnerabilities becomes difficult from an oversight perspective. The level of interconnectedness between the crypto market and the traditional financial market is unclear and shall play a key part in the design of future regulations. The FSB further identifies the need for consistency in regulation across borders and sectors as cryptoasset firms often offer services that come under a range of regulatory regimes. Due to the range of activities that cryptoasset firms engage in, the FSB suggests regulation which is cumulative, such that it becomes more stringent the more activities a single firm is engaged in.

The second risk is the policy initiatives at international and jurisdictional levels. Some jurisdictions are designing specific regulations to address the cryptoasset space, where others are amending existing regulations to bring cryptoassets into scope. The FSB is reviewing how existing international standards can apply to cryptoassets, including stablecoins.

The FSB's proposed approach for a comprehensive regulatory framework is based on the underlying principle of "same activity, same risk, same regulation". Therefore the regulation should promote the comprehensiveness and greater international consistency of regulatory and supervisory approaches to cryptoasset markets. Secondly, the FSB recommend the revision to the High-Level Recommendations for Global Stablecoin Arrangements (GSC)³. The recommendations include guidance to strengthen the governance framework by defining the responsibilities of participants in the cryptoasset market. The recommendations also discuss the reliance on algorithms and arbitrage activities as stabilisation mechanisms for stablecoins.

Considering the above recommendations, it is clear the FSB identifies the risks posed by cryptoassets to wider financial stability as genuine and serious. Hence regulation should be "comprehensive and globally coordinated", and it should target stablecoins which now feed into the wider cryptoasset market. The FSB also commits to continued monitoring of developments and risks in the cryptoasset market and for final recommendations to be delivered by year end 2025.

What management should consider

The key point that we feel that Management should think about is the one on data and information. With so much decentralised work that is currently being undertaken on this topic, the inherent risk around data ownership and integrity is high. This chimes with a lot of regulatory noise on data in general, meaning that this will automatically carry heightened significance in any forth-coming regulation, and therefore it is important for firms to ensure that they are comfortably positioned in the context of data quality.

The FSB Chair sets out ongoing work to strengthen financial resilience amidst growing financial stability challenges

The FSB published a letter to G20 finance ministers and central bank governors from its chair, Klaas Knot.

³ [FSB publishes high-level recommendations for regulation, supervision and oversight of "global stablecoin" arrangements - Financial Stability Board](#)

The letter discusses the global financial challenges including rising interest rates and heightened inflation levels. Against this backdrop, Mr Knot discusses the progress in the regulation of cryptoassets.

The recent volatility in cryptoasset markets and the so called 'crypto winter' has reinforced the FSB's identification of the risks the market poses to wider financial stability and the need for regulation. Mr Knot calls for a comprehensive and robust international framework to "identify, monitor and address" risks from cryptoassets. The letter discusses the recommendations for the revision to the Global Stablecoin Arrangements (GSCs), which include guidance on strengthening the governance framework, as discussed above. As the chair of the FSB, Mr Knot deliberates the importance of understanding macroeconomic developments, including cross-border implications and need for global supervision.

In 2020, the leaders of the G20 endorsed the Roadmap for Enhancing Cross-border Payments⁴. This roadmap looked to address the frictions that cross-border payments face and harness the potential benefits presented by cryptoassets that could be faster, cheaper and more transparent. Mr Knot discussed how this roadmap has reached an inflection point, with substantial foundations and analysis in place. He believes now is an important time to build on this and deliver practical projects to enhance payment arrangements across the G20. The latest FSB report on the roadmap proposes increased collaboration between the public and private sector to harness these benefits and accelerate progress on these next steps.

Cyber poses one of the key risks to the cryptoasset market as instances of cyber attacks increase in frequency and sophistication around the world. Mr Knot identifies the increased interconnectedness of the financial system as a particular risk, and notes that cyber-attacks within crypto markets will possibly have impacts across the wider financial system. As such the FSB have submitted a consultive report which proposes common terminology and incident reporting to be introduced.

Finally, Mr Knot discusses the potential climate risks associated with cryptoassets. He discusses how cryptoassets could be included in the scope of climate related disclosures such as the FSB's Task Force on Climate-related Financial Disclosures (TCFD). A TCFD report is the basis of a publication by the International Sustainability Standards Board discussing both sustainability and climate related financial disclosures, due early 2023.

In conclusion Mr Knot discusses several key risks presented by the cryptoasset market, namely cross border payments, cyber risks and climate related risks. In light of these risks and wider financial instability, Mr Knot, speaking on behalf of the FSB as a whole, reminds us of the need for regulation of cryptoassets and the potential risks to financial stability as cryptoassets become increasingly intertwined with the traditional financial system.

What management should consider

Not anything in particular. However, it is interesting to note that some of the themes that Mr Knot speaks about resonates with the "same activity, same risk, same regulation" and "comprehensive and globally coordinated" themes that is pertinent in the FSB article from above. There is perhaps room for speculation here that there might be national as well as international regulations on crypto.

Crypto-assets and their risks for financial stability

In an article from the European Securities and Market Authority, authors share the risks present in the market for crypto-assets and the interlinkages with the traditional markets.

The structural risks in cryptoasset markets opens the analysis. Many cryptoassets have no tangible value, hence allowing for their markets to be highly speculative. This has been coupled with aggressive marketing, and consumers not fully understanding the complex products they invest in.

⁴ [G20 Roadmap for Enhancing Cross-border Payments: Consolidated progress report for 2022 - Financial Stability Board \(fsb.org\)](#)

The result has been extremely volatile markets, furthered by high levels of leverage being offered by some exchanges.

Another risk is the pseudonymity in cryptoasset markets and lack of transparency of data. Although the ledger itself is public, there is not sufficient information to make any assessment of an individual's creditworthiness. Wallets are labelled with an individual public key made up from a combination of letters and numbers. Any individual can have one or many wallets, so it is impossible to know an individual's aggregate exposure and again therefore make any accurate assessment of creditworthiness.

A risk that is native to Distributed Ledger Technology is the risk of so called 51% attacks. This occurs where an individual or group of miners are able to take control of more than 50% of the networks mining hash rate, a measure of the networks power. Once a group has a controlling share of the hashing power, they are able to alter the blockchain itself, and since they control the network, they can accept the change. From here it is possible to reverse the chain and double spend coins, although reversing actual transactions would be very difficult. Blockchains are also inherently vulnerable to network congestion risk, which can bring a blockchain to a stop and damage the value of tokens and reputation of the chain.

Attention should be paid to these risks as the cryptoasset market becomes increasingly interconnected with traditional financial markets. Growing numbers of both retail and institutional investors are entering the industry. It becomes problematic if an investor has a net-asset holding in cryptoassets but has net-liabilities in fiat currency. The existing volatility in cryptoasset markets could limit the investors ability to meet liabilities in fiat, therefore creating a spill over from the cryptoasset market to real markets. Increasing amounts of investors are also gaining indirect exposures through derivatives and exchange traded products and funds (ETPs and ETFs), like the ProShares Bitcoin Strategy ETF⁵, the first SEC regulated Bitcoin ETF of its kind in the US. This mitigates the risk to investors as they gain exposure without having to hold any product but can lead to significant losses from increasingly complex financial products. Still, this is a clear move to accepting cryptoassets into traditional financial market offerings.

The article goes on to discuss the recent attention given to stablecoins, like the reserve-backed ones that are pegged to a fiat currency. In theory one token is issued with each deposit, such that a store of reserves exist equal in actual value to the number of tokens in circulation. However, there is no disclosure requirements for stablecoins and so some doubts have been raised as to the actual value of reserves. Some stablecoins, including Tether the largest of its kind, have started voluntary disclosures of their reserves. It became clear that these reserves had massive exposures to treasury bonds, various loans and corporate bonds and even other digital tokens⁶. Once again this exposes linkages between the cryptoasset market and the traditional financial market. If these reserves needed to be liquidated quickly, it could lead to liquidity pressures and fire sales, causing spill over effects into traditional financial markets.

Applying ESMA's five principal risk monitoring framework to the cryptoasset market:

1. Liquidity risk

Liquidity risk in the context of cryptoasset markets is referring to congestion on the blockchain and the lack of minimum liquidity requirements for exchanges. ESMA opines liquid risk to remain stable with no clear reason for deterioration in the near term.

2. Market risk

The Association highlights concentration in a few major cryptoassets, as well as the increasing use of leverage as the main market risk vulnerabilities. While the recent sell-off and de-leveraging may have eased this pressure, ESMA still labels it as high risk with a stable outlook in the near term.

⁵ [BITO | Bitcoin Strategy ETF | ProShares](#)

⁶ <https://tether.to/en/tether-releases-breakdown-of-its-reserves/>

3. Credit risk

Credit risk in cryptoassets can come from defaults of intermediaries, or even stablecoins. This could have large impacts on markets, incurring losses for individual and institutional investors. As we have seen with the recent collapse of FTX, such defaults can have significant impact on market prices, spreading negative sentiment in the market. This risk is perceived by the ESMA as medium-high, with a negative risk outlook.

4. Internal contagion risk

As previously touched upon, there is a high degree of interconnectedness within cryptoasset markets. Stresses to individual platforms or major tokens have been seen to lower prices across the market. The ESMA therefore views internal contagion as high risk.

5. External contagion risk

External contagion has so far not been a real issue. While the risks discussed in more detail above are serious and should not be overlooked as immaterial, ESMA considers external contagion risk low. The outlook is labelled as uncertain as the transmission channels are real and are growing.

6. Operational risk

The operational risk in cryptoasset markets is marked as high due to the vulnerabilities that are inherent to the technology, both by nature and by its infancy. The technology continues to quickly evolve with fast innovation in areas such as DeFi, which without proper regulation exposes these operational risks. As such, the ESMA consider operational risk in cryptoasset markets as high, with a negative risk outlook.

What management should consider

Management should note that the ESMA report discusses several key risks seen in the cryptoasset market, as well as their exacerbation with the volatile nature of cryptoasset markets. Up to this point, risks have been fairly contained within the cryptoasset market. However, as the market grows and cryptoassets become more mainstream with institutional investors these spillover risks may be increasingly problematic. By understanding the risks, regulators can design a framework that addresses this issue without limiting innovation. Further, the ESMA is in the process of including cryptoassets in its risk monitoring framework to continue assessing risks as they emerge.

Contacts

Anindya Ghosh Chowdhury

Director, Financial Services Consulting

Anindya.ghosh.chowdhury@mazars.co.uk

Ollie Gassor

Senior Consultant, Financial Services Consulting

Ollie.gassor@mazars.co.uk