DIGITAL TOKENS AND THE BANKING SYSTEM: BASEL COMMITTEE PROPOSES RISK-WEIGHTED ASSETS FRAMEWORK FOR CRYPTOASSETS

Date: 12 July 2021

Financial Services Alert

By: Anthony R.G. Nolan

BACKGROUND

On 10 June 2021, the Basel Committee on Banking Supervision published a preliminary proposed framework for the prudential treatment of cryptoasset exposures based on classification cryptoassets (the Proposal).[1] Under the Proposal, banks would be subject to risk-weighted capital and liquidity and on-going monitoring requirements for cryptoassets held on their balance sheets. Specifically, the Proposal seeks to map the regulatory capital requirements for cryptoassets that are redeemable into physical assets to the treatment of those assets and to the exposure to any counterparties whose performance is required to effectuate such redemption. The Proposal would impose larger capital requirements on cryptoassets (such as Bitcoin) that neither represent nor are redeemable into underlying physical assets, as well as funds or other entities that derive their value from such other cryptoassets. Comments are due by 10 September 2021.

The Proposal marks an important milestone in central banks' efforts to recognize and account for the potential financial stability risks posed by cryptoassets. It is of importance not only to banks but also to managers of funds and other assets that may be marketed as investments to banks. This Article will describe the basic capital adequacy framework for cryptoassets and discuss the basis for calculating the risk-weighted asset value (RWA) of tokenized assets, stabilized coins and other cryptoassets. It also will cover some compliance issues for banks, their supervisors, and others who might be affected by prudential capital requirements of banks. It is part of a growing concern with the potential financial stability implications of cryptoassets.[2]

OVERVIEW OF THE PRUDENTIAL TREATMENT OF CRYPTOASSET EXPOSURES

The Proposal is agnostic as to the particular technical attributes of any cryptoasset, as the BCBS recognizes that it is not feasible to predict or prescribe how technology and any specific cryptoasset will evolve. Rather, it has proposed a principles-based approach under which the prudential treatment of cryptoassets would be guided by the following considerations:

1. *Same Risk, Same Activity, Same Treatment*: Regulatory capital requirements should be “technology neutral” so that equivalent economic functions and risks are the same, whether presented by a cryptoasset or a “traditional asset.” However, the prudential treatment should also account for any additional risks posed by cryptoassets.

©2005-2026 K&L Gates LLP. All Rights Reserved.

2. *Simplicity*: Since cryptoassets are currently a small asset class for banks, the prudential framework should focus on simplicity and should be revisited as the cryptoasset markets evolve.
3. *Minimum Standards*: While BCBS' guidelines are meant to be a minimum standard for internationally-active banks, jurisdictions may adopt more conservative measures, including prohibiting their banks from having any exposures to cryptoassets.

Under the Proposal, cryptoassets are divided into two broad groups. Group 1 cryptoassets consist of tokenized assets and stabilized tokens that are linked to particular underlying assets (such as US dollars or gold) and are therefore susceptible of risk-based capital treatment that is based on the risk weight of underlying assets and counterparties. All cryptoassets that do not fit within Group 1 (generally those that are not linked to any underlying assets) are classified into Group 2 and are subject to a more punitive risk weighted capital treatment. Group 2 cryptoassets would include, for example, Bitcoin, Ether, Litecoin, and Dogecoin.

Classification into Group 1 requires that four conditions are met on an ongoing basis:

Condition 1. The cryptoasset must either be a tokenized traditional asset (Group 1a), or must have an effective stabilization mechanism that references the cryptoasset's value to one or more underlying physical assets, such as dollars or an index of fiat currencies (Group 1b). Stabilization mechanisms that reference other cryptoassets as the underlying asset, or that rely on algorithms or other procedures to stabilize prices, such as by changing the cryptoasset's supply, do not satisfy this condition;

Condition 2. All rights, obligations, and interests resulting from the cryptoasset's arrangement must be “clearly defined and legally enforceable” in the jurisdiction where it is issued and redeemed. This arrangement must always be fully transferable and have settlement finality. The arrangements also must be properly documented, with varying requirements for Group 1(a) and (b). For cryptoassets with stabilization mechanisms, the underlying traditional asset must be redeemable at all times;

Condition 3. The cryptoasset, its network, or other technology upon which the cryptoasset is based must be sufficiently designed and operated to mitigate “material” risks to the cryptoasset's finality, redeemability, or transferability. Entities performing any mitigation functions will be subject to strong governance and risk control policies; and

Condition 4. Entities performing transfers, redemptions, or settlements for the cryptoasset, must be regulated and supervised. These entities include transfer and settlement system operators, stabilization mechanism administrators, and the underlying assets' custodians.

RISK-WEIGHTED ASSETS METHODOLOGY

Group 1a: Tokenized Traditional AssetsGroup 1a: Tokenized Traditional Assets

The Proposal would require banks to use the following criteria to assess the risk-weight of the tokenized traditional asset:

- *Bonds, loans, deposits, and equities*. The cryptoasset must confer the same type of legal rights as ownership of the traditional asset on which it is based. None of the cryptoasset's features may prevent obligations to the bank from being fully paid when due, as compared with the traditional version of the asset.

©2005-2026 K&L Gates LLP. All Rights Reserved.

- *Commodities*. The cryptoasset must confer the same level of legal rights as traditional account-based records of ownership of a physical commodity.
- *Cash held in custody*. The cryptoasset must confer the same type of legal rights as cash held in custody.[3]

Generally, if the underlying tokenized asset poses the same liquidity characteristics as the corresponding traditional asset, it will be considered equal to traditional assets when calculating minimum capital requirements and market risk. However, the tokenized traditional asset might not qualify for the treatment of the traditional asset in some circumstances, such as if the tokenized asset can be expected to have a different market value than the corresponding traditional asset, or if there is insufficient data to model the market value impact of different liquidity characteristics.

If the capital adequacy treatment of cryptoassets follows the same model as has been applied to derivatives used to obtain regulatory capital relief, banks seeking to establish the equivalency of legal rights will require appropriate opinions of counsel.[4]

Group 1b: Stabilization Cryptoassets

Group 1b cryptoassets must be redeemable for underlying traditional asset(s) such as cash, bonds, commodities, and equities. The Proposal offers the following two illustrative examples:

Example 1. An entity (the Redeemer) commits to exchange the cryptoasset for either the underlying traditional asset or its cash equivalent. The Redeemer uses a mechanism that maintains a sufficient pool of assets it can use to honor its commitment. All cryptoasset holders can directly transact with the Redeemer. In this scenario, there are two main risks to the holder: (i) the value of the underlying asset(s) changing or defaulting; and (ii) the Redeemer's potential default. To calculate the cryptoasset's risk-weighted asset value, the bank would evaluate both the asset value and the risk weight applied to an unsecured loan to the Redeemer.

Example 2. Only certain holders (Members) are permitted to interact directly with the Redeemer to exchange the cryptoassets for the underlying assets or cash. Those that cannot directly transact with the Redeemer (Non-Member Holders), can rely only on Members to maintain the value of the cryptoasset relative to the underlying asset. This type of relationship takes two forms:

(1) Members make legally-binding promises to Non-Member Holders to buy the cryptoassets at a price equal to the underlying asset. This creates the risk that, if the Redeemer defaults, the Member then must buy the cryptoassets back from the Non-Member Holders to satisfy their promise. To calculate the cryptoasset's risk-weighted asset value, the bank must evaluate the underlying asset's value, the risk weight applied to an unsecured loan to the Redeemer, *and* the risk associated with the “commitment to buy” for those Non-Member Holders relying on Members to buy back the cryptoassets on their behalf. This “commitment to buy” risk is represented by the credit risk-weighted assets, which must equal the total current value of all existing cryptoassets the bank may be required to buy from Non-Member Holders, multiplied by the risk weight applied to an unsecured loan to the Redeemer.

(2) Members do not make a promise, but instead are incentivized to buy the cryptoassets, which can in turn be exchanged with the Redeemer for the underlying assets or cash. Here, the risk to the Non-Member Holders is based on whether the Members have committed to buy cryptoassets in unlimited amounts from the Non-Member Holders.

©2005-2026 K&L Gates LLP. All Rights Reserved.

If no, the risks to the Non-Member Holder include: (i) the value of the underlying asset changing or defaulting; (ii) the Redeemer's potential default; and (iii) the potential default by all Members. In this case, the bank holder's risk-weighted assets must include the total risk-weighted assets for all three sources of risk.

If yes, the risks to the Non-Member Holder include: (i) the value of the underlying asset changing or defaulting; and (ii) the Member's credit risk. In this case, where the banks are Non-Member Holders, the risk-weighted assets for the two exposures should be added together. The first risk should be calculated as described in example 1; the second risk should be calculated based on the applicable risk weight for a loan to the sole Member or to the Member with the highest credit rating (if more than one Member).

Group 2

Group 2 cryptoassets are subject to deduction from Common Equity Tier 1 (CET1) capital in some cases.[5] These include funds of Group 2 cryptoassets (such as the ever-elusive Bitcoin exchange traded fund), other entities whose material value is primarily derived from Group 2 cryptoassets, equity investments, derivatives, or short positions in such funds or entities, and other assets representing Group 2 cryptoassets that are classified as intangibles under the applicable accounting framework.

The Proposal would require that risk-based capital be maintained for Group 2 cryptoassets that are not deducted from CET1 capital in the following manner:

- A 1,250 percent RWA -- as opposed to the normal range of 50%-100% -- is applied to a measure of the bank's exposure amount, determined by the greater of either the aggregate long positions' absolute value or the aggregate short positions' absolute value to which the bank is exposed. The RWA is calculated separately for each Group 2 cryptoasset to which the bank is exposed.
- For each cryptoasset derivative, the formulaic value is that of its underlying cryptoassets. If this value exceeds the cryptoasset derivative's maximum possible loss, the maximum loss can be used instead.

Applying the 1,250 percent risk weight ensures that banks hold risk-based capital at least equal in value to their Group 2 cryptoasset exposures. BCBS believes this capital requirement will be sufficient to absorb a full write-off of the cryptoasset exposures without exposing depositors and other senior creditors of the banks to a loss.

RESPONSIBILITY OF BANKS AND SUPERVISORS

The Proposal would impose responsibilities on both banks and their supervisors to assess on an on-going basis whether Group 1 cryptoassets are compliant with the requisite classifications described above, to assess risks and implement necessary risk management policies and procedures, and to disclose cryptoassets exposures in accordance with existing disclosure principles for capital adequacy based on RWAs, counterparty risk, and mitigants. To ensure consistency among supervisors and to account for jurisdictional discrepancies, the Proposal also recommends that there should be regular coordination among supervisors to compare and evaluate each other's approval criteria.

©2005-2026 K&L Gates LLP. All Rights Reserved.

CONCLUSION

Congress and the federal financial regulations have increased their focus on the current regulatory framework for cryptoassets recently and are thinking through potential revisions to that framework. In particular, the Federal Reserve, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency are coordinating on their approach to cryptoassets and could provide important updates as early as this summer. The BCBS' report is timely and could help shape potential approaches to regulatory capital, which will have direct effects on depository institutions, and important effects on cryptoasset funds, stablecoin issuers, and companies, foundations, and other entities whose business plan is focused on cryptoassets.

FOOTNOTES

[1] Basel Committee on Banking Supervision, Prudential Treatment of Cryptoasset Exposures, BANK FOR INTERNATIONAL SETTLEMENTS (June 2021), https://www.bis.org/bcbs/publ/d519.pdf.

[2] See, e.g. Eva Szalay, Central Banks Set Up Fight Against Cryptocurrencies, FINANCIAL TIMES (June 23, 2021), https://www.ft.com/content/b6a3bf06-ad6b-4ab4-9ae3-15aca453f50d.

[3] The recent decision of the Republic of El Salvador to make Bitcoin legal tender effective in September 2021 may create ambiguity as to the interpretation of this condition in some circumstances.

[4] See, e.g., [12 C.F.R. Part 3 App. A Table 3; 12 C.F.R. Part 225 App. A.III.B.3.c; 12 C.F.R. Part 325 App. A.II.B.5.c; 12 C.F.R. Part 567.6(a)(2)(v)(B).]

[5] CET1 is the highest quality of regulatory capital, as it absorbs losses immediately when they occur, and is typically required to be at least 6% of RWA. The effect of a deduction effectively would require a dollar-for-dollar increase of CET1 equity for holdings of cryptoassets.

KEY CONTACTS



ANTHONY R.G. NOLAN
PARTNER

NEW YORK
+1.212.536.4843
ANTHONY.NOLAN@KLGATES.COM

©2005-2026 K&L Gates LLP. All Rights Reserved.

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.

©2005-2026 K&L Gates LLP. All Rights Reserved.