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Consultation Paper (CP 24.01) on proposal to implement the Basel Committee on Banking Supervision's standards entitled '*Prudential treatment of cryptoasset exposures*'

1 Introduction

The Asia Securities Industry & Financial Markets Association ("**ASIFMA**") [1], on behalf of our members, welcomes this opportunity to comment on the Consultation Paper (CP 24.01) ("**Consultation Paper**") published by the Hong Kong Monetary Authority ("**HKMA**") in February 2024 to implement in Hong Kong[2] the standards issued by the Basel Committee on Banking Supervision ("**Basel Committee**") entitled '*Prudential treatment of cryptoasset exposures*' ("**Basel Cryptoasset Standards**").

We appreciate the work undertaken by the HKMA:

(a) in its capacity as a member of the Basel Committee, to develop and formulate the Basel Cryptoasset Standards at the global level; and

(b) in its capacity as Hong Kong's prudential regulator, to implement the Basel Cryptoasset Standards in Hong Kong and, together with other Hong Kong regulators and government departments, to promote innovation and establish a comprehensive legal and regulatory framework for cryptoassets in Hong Kong, consistent with the 'Fintech 2025 Strategy' and the 'All Banks Go Fintech' initiative.

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[1] ASIFMA is an independent, regional trade association comprising a diverse range of over 165 leading financial institutions from both the buy and sell side, including banks, asset managers, professional service firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, competitive and efficient Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

[2] Any reference in this consultation response to "Hong Kong" or "Hong Kong SAR" shall be construed as a reference to the "Hong Kong Special Administrative Region of the People's Republic of China".

We note at the outset that the Basel Cryptoasset Standards were finalised in December 2022, when cryptoassets were largely unregulated or under-regulated in many jurisdictions. However, during the one-and-a-half-year period since December 2022, the global legal and regulatory landscape for cryptoassets has evolved significantly, and many major jurisdictions have now proposed or enacted laws and regulations to comprehensively regulate cryptoassets as well as related activities and market participants, in line with the 'same activity, same risk, same regulation' principle as well as global standards published by the Financial Stability Board ("**FSB**"),[3] the International Organization of Securities Commissions ("**IOSCO**")[4] and the Financial Action Task Force ("**FATF**").[5]

In Hong Kong, in particular, the HKMA, the Securities and Futures Commission ("**SFC**") and other regulators have made significant progress within a short period of time to establish a comprehensive legal and regulatory framework for cryptoassets that covers, among other things, tokenised products,[6] stablecoins,[7] virtual asset trading platforms,[8] over-the-counter services in relation to virtual assets,[9] funds (including exchange-traded funds) that invest in spot virtual assets[10] as well as digital asset custody arrangements.[11] In addition, the HKMA itself has issued, on behalf of the Hong Kong government, Hong Kong's first digitally native tokenised bonds using distributed ledger technology ("**DLT**").[12]

Global reassessment, refinement and recalibration: One of the key themes in this consultation response is the need for the Basel Cryptoasset Standards to be continuously reassessed, refined and recalibrated, at the global level, to take into account fast-developing legal, regulatory and technological

[3] See e.g., FSB, *Global Regulatory Framework for Crypto-asset Activities* (17 July 2023), available here: https://www.fsb.org/2023/07/fsb-global-regulatory-framework-for-crypto-asset-activities.

[4] See e.g., IOSCO, *Policy Recommendations for Crypto and Digital Asset Markets – Final Report* (16 November 2023), available here: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD747.pdf.

[5] See e.g., FATF, *Updated Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers* (28 October 2021), available here: https://www.fatf-gafi.org/en/publications/Fatfrecommendations/Guidance-rba-virtual-assets-2021.html.

[6] *See e.g.*, HKMA, *Circular on Sale and distribution of tokenised products* (20 February 2024), available at: https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2024/20240220e2.pdf; SFC, *Circular on intermediaries engaging in tokenised securities-related activities* (2 November 2023), available at: https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=23EC52.

[7] *See* HKMA webpage on stablecoin issuers, available at: https://www.hkma.gov.hk/eng/key-functions/international-financial-centre/stablecoin-issuers.

[8] *See* SFC webpage on virtual asset trading platform operators, available at: https://www.sfc.hk/en/Welcome-to-the-Fintech-Contact-Point/Virtual-assets/Virtual-asset-trading-platforms-operators.

[9] *See* Hong Kong Government, *Government launches consultation on legislative proposals to regulate over-the-counter trading of virtual assets* (8 February 2024), available at: https://www.info.gov.hk/gia/general/202402/08/P2024020800238.htm.

[10] *See* SFC, *Circular on SFC-authorised funds with exposure to virtual assets* (22 December 2023), available at: https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=23EC65.

[11] *See* HKMA, *Circular on Provision of Custodial Services for Digital Assets* (20 February 2024), available at: https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2024/20240220e4.pdf.

[12] *See* HKMA, *HKSAR Government's Digital Green Bonds Offering* (7 February 2024), available at: https://www.hkma.gov.hk/eng/news-and-media/press-releases/2024/02/20240207-6.

advancements and enhancements to the cryptoassets ecosystem. As the Basel Committee itself has acknowledged, solutions to existing issues associated with certain aspects of cryptoasset-related activities may develop rapidly.[13] In this respect, we believe the HKMA is uniquely positioned to continue to play an important role in developing and calibrating the global Basel Cryptoasset Standards in an iterative manner. The HKMA's unique position owes to the fact that it:

(a) is directly involved in formulating the Basel Cryptoasset Standards at the Basel Committee level and co-chairs the FSB Regional Consultative Group for Asia;

(b) is a primary architect – and, in relation to authorized institutions ("**AIs**"), *the* primary architect – of the comprehensive legal and regulatory framework for cryptoassets in Hong Kong;

(c) has first-hand experience regulating and supervising cryptoasset-related activities and transactions;

(d) has direct experience with developing and applying tokenisation, digitalisation, DLT and other cryptoasset-related techniques and technologies in real-world transactions, such as working with the Hong Kong Government to issue the world's first tokenised government green bond in 2023[14] and the world's first multi-currency digitally native green bond in 2024;[15] and

(e) has formulated and is implementing the 'Fintech 2025 Strategy' and the 'All Banks Go Fintech' initiative, consistent with the Hong Kong Government's vision to turn Hong Kong into a global virtual assets hub.

Given the HKMA's unique position, we highly encourage the HKMA to continue to share its insights, expertise and first-hand experience with tokenisation, digitisation, DLT and other cryptoasset-related matters with the members of the Basel Committee, with the ultimate goal of, in the words of the HKMA, "*enabl[ing] the long-term, sustainable and responsible development of the virtual asset ecosystem*."[16] To this end, ASIFMA and our members would be pleased to continue to offer our support in whatever way the HKMA considers appropriate.

"Taking into account local circumstances": Another key theme in this consultation response is the need for Hong Kong's implementation and/or interpretation of the Basel Cryptoasset Standards to take into account local circumstances, while at the same time maintaining general consistency with the global

[13] *See* Basel Committee, *Consultative document on cryptoasset standard amendments* (December 2023) ("*The Committee acknowledges that technical solutions to many of these issues may develop rapidly in the future and would welcome ongoing feedback from industry participants on the risks of permissionless systems and the development of mitigants.*"), available at: https://www.bis.org/bcbs/publ/d567.pdf.

[14] *See* HKMA, *HKSAR Government's Inaugural Tokenised Green Bond Offering* (16 February 2023), available at: https://www.hkma.gov.hk/eng/news-and-media/press-releases/2023/02/20230216-3.

[15] *See* HKMA, *HKSAR Government's Digital Green Bonds Offering* (7 February 2024), available at: https://www.hkma.gov.hk/eng/news-and-media/press-releases/2024/02/20240207-6.

[16] *See* HKMA, *Press release regarding consultation on legislative proposal to implement regulatory regime for stablecoin issuers and announcement on introduction of sandbox arrangement* (27 December 2023) (quoting Mr. Eddie Yue, Chief Executive of the HKMA: "*We are supportive of financial innovation and believe that it is essential to put in place the necessary regulatory guardrails and standards to* ***enable the long-term, sustainable and responsible development of the virtual asset ecosystem****.*"), available at: https://www.hkma.gov.hk/eng/news-and-media/press-releases/2023/12/20231227-4/.

Basel framework. In this respect, we note that the Basel standards have always permitted (and in some cases encourage) certain implementation variations taking into account local circumstances. Indeed, the HKMA, in the context of cryptoasset regulation, has expressly stated that: "*In line with the international standards and practices, Hong Kong should put in place a regulatory regime,* ***taking into account local circumstances***" (emphasis added).[17]

We respectfully submit that the local implementation, interpretation and application of the Basel Cryptoasset Standards in Hong Kong should be "*taking into account local circumstances*." In particular, when implementing the Basel Committee's cryptoasset classification conditions and risk-weights in Hong Kong, the HKMA should take into account, and be cognisant of the following:

(a) cryptoasset-related activities take place within Hong Kong's fast-emerging comprehensive legal and regulatory framework, which is developed and directly overseen by the HKMA, SFC and other Hong Kong regulators;

(b) cryptoassets (especially tokenised traditional securities, digitally native securities and stablecoins) in Hong Kong are either issued by HKMA and/or SFC licensed/regulated entities or, in some cases, issued directly by the Hong Kong Government;

(c) the HKMA's own familiarity with cryptoassets, having itself issued digitally native green bonds using DLT;

(d) AIs have an important role to play in spearheading innovation in the digital asset ecosystem. In this respect, we note the HKMA's recent statement that: "*The HKMA is supportive of AIs' initiatives on tokenisation, and is encouraged by the progress the industry has made so far*";[18] and

(e) the Hong Kong Government's Web 3.0, 'Fintech 2025' and 'All banks go Fintech' strategies/initiatives.

We also encourage the HKMA to escalate key issues identified during the local consultation and implementation process to the Basel Committee, leveraging its unique position as described above. Consistent global calibration and implementation of the Basel Cryptoasset Standards not only promotes the Basel Committee's objective of full and consistent implementation of the Basel framework across major jurisdictions, it also fosters innovation in Hong Kong because many Hong Kong-incorporated AIs to which the *Banking (Capital) Rules* (Cap. 155 sub. leg. L) ("**BCR**") apply are also subsidiaries of global banking groups that are subject to Basel standards as implemented in their home country jurisdiction on a global consolidated level. Therefore, even if a particular issue were adequately addressed at the local implementation level in Hong Kong, if it is not addressed at the global and home country level, the banking group as a whole would still be subject to potentially punitive regulatory capital treatment in relation to the relevant cryptoasset exposure(s).

Besides the thematic comments and recommendations mentioned above, we also recommend some specific approaches to implementing, interpreting and applying the Basel Cryptoasset Standards in

[17] *See* HKMA inSight Article, *Eddie Yue on Stablecoins – Regulating issuers to accord protection to users* (24 December 2023), available at: https://www.hkma.gov.hk/eng/news-and-media/insight/2023/12/20231227/.

[18] *See e.g.*, HKMA, *Circular on Sale and distribution of tokenised products* (20 February 2024), available at: https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2024/20240220e2.pdf.

Hong Kong that facilitates responsible and sustainable innovation by AIs. These specific recommendations are set out further below in this consultation response. We are grateful to King & Wood Mallesons for their support in preparing this consultation response based on input from our members.

In addition, we would like to note that as discussions regarding the calibration and implementation of the Basel Cryptoasset Standards continue to evolve globally, the comments provided by ASIFMA in this response to the Consultation Paper should not be considered as final. ASIFMA and our members will continue to assess the Basel Cryptoasset Standards over the near term, and form our positions more fully.

Furthermore, we request that the HKMA provide the opportunity for further consultation and industry engagement, especially when implementing the conclusions of the Basel Committee's October 2023 consultation regarding Pillar 3 disclosures for banks' cryptoasset exposures[19] and December 2023 consultation on targeted adjustments to the Basel Cryptoasset Standards.[20] We understand that the substantive contents of these two consultations are not yet fully reflected in the Consultation Paper because the Basel Committee's consultation processes were still ongoing at the time the Consultation Paper was published.[21] In relation to the December 2023 consultation, we respectfully refer the HKMA to the joint submission to the Basel Committee from the Global Financial Markets Association, the Futures Industry Association, the Institute of International Finance, the International Swaps and Derivatives Association, and the Financial Services Forum ("**Joint Submission**"), which is set out in Annex A to this consultation response. We support the recommendations set out in the Joint Submission, and refer to aspects of the Joint Submission in this consultation response.

Finally, we welcome the opportunity to comment on the proposed textual amendments to the BCR to implement the Basel Cryptoasset Standards, which we understand are expected to be published in 2025.[22]

2 Executive summary

In this consultation response, we like to make the following specific recommendations in relation to the Consultation Paper and the implementation, interpretation and application of the Basel Cryptoasset Standards in Hong Kong:

(a) **Digitally native cryptoassets:** The HKMA should clarify that digitally native cryptoassets such as digital debt and equity securities should be eligible for treatment as Group 1a cryptoassets. We encourage the HKMA to share its first-hand experience with issuing digitally native bonds (such as the world's first multi-currency digitally native green bond) with other members of the Basel Committee so that the clarification we have requested in this consultation response can

[19] *See* Basel Committee, *Consultative document on disclosure of cryptoasset exposures* (17 October 2023), available at: https://www.bis.org/bcbs/publ/d556.pdf.

[20] *See* Basel Committee, *Consultative document on cryptoasset standard amendments* (December 2023), available at: https://www.bis.org/bcbs/publ/d567.pdf.

[21] *See* Consultation Paper at page 4 ("*The HKMA will further update the local implementation proposal after the conclusion of the BCBS' consultation process.*").

[22] *See* Consultation Paper at page 6.

be reflected both in the text of the global Basel standards as well as in Hong Kong's implementing rules.

(b) **The definition of "cryptoassets" should be clarified to exclude DLT or blockchain-based books and records systems:** The Basel Cryptoasset Standards and, consequently, the Consultation Paper, state that the term "cryptoasset" includes "dematerialised securities (securities that have been moved from physical certificates to electronic book-keeping) that are ***issued through DLT*** or similar technologies (emphasis added)" but excludes "dematerialised securities that use electronic versions of traditional registers and databases which are centrally administered". In many cases where DLT is used for settlement or recordkeeping, no asset is actually "*issued through DLT*". In fact, no distinct digital asset is created at all. Rather, the execution or recording of transfers of ownership occurs via DLT, which serves as an "electronic version" of traditional registers and databases. Reliance on DLT for recordkeeping or settlement purposes should not increase the risk or liquidity profile of the underlying assets themselves. Accordingly, we respectfully request clarification that the use of DLT as an "electronic version" of the traditional registers and databases would not lead to the underlying traditional assets being treated as "cryptoassets" under the Basel Cryptoasset Standards and the Consultation Paper.

(c) **Public permissionless blockchains:** In response to the call by the Basel Committee for "*feedback from industry participants on the risks of permissionless systems and the development of mitigants*"[23], we hereby express our support for the position regarding public permissionless blockchains set out in the Joint Submission. As stated in the Joint Submission, while there may be some risks associated with the use of public permissionless blockchains, we are of the firm view that the industry has all the necessary expertise and robust compliance frameworks to fully identify, manage and mitigate these risks. Therefore, we recommend permitting banks to conduct a Group 1 cryptoasset eligibility assessment in relation to public permissionless blockchains on a case-by-case basis. As long as banks can satisfy that relevant risks have been adequately addressed, the use of public permissionless blockchains by Group 1 cryptoassets should remain possible. We respectfully request the Basel Committee and the HKMA to continue engaging with the industry and share its assessment of public permissionless blockchains.

(d) **Infrastructure risk add-on:** We respectfully submit that, "taking into account local circumstances" in Hong Kong (including the HKMA's familiarity with DLT and the positive statements the HKMA has made regarding DLT), the HKMA should consider omitting the infrastructure risk add-on from the BCR. Having said this, should the HKMA believe it is appropriate to still include the concept of the infrastructure risk add-on in Hong Kong's implementing rules to maintain consistency with the global Basel standards, we would welcome a statement from the HKMA that it will seek meaningful public consultation in relation to any proposal to increase the infrastructure risk add-on (which will initially be set a zero).

(e) **Stablecoins issued by HKMA-licensed issuers:** Since the HKMA will be overseeing both Hong Kong's comprehensive licensing and regulatory regime for fiat-referenced stablecoins ("**FRS**") (including consenting to the issuance of FRS by licensees) and the bank capital regime (including the Basel Cryptoassets Standards as implemented in Hong Kong), we respectfully submit that an AI should be allowed to automatically classify any FRS issued by an HKMA-licensed FRS issuer as a Group 1b cryptoasset.

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[23] *See* Basel Committee, *Consultative document on cryptoasset standard amendments* (December 2023), available at: https://www.bis.org/bcbs/publ/d567.pdf.

(f) **Group 1b cryptoassets should be capable of being recognised as eligible collateral:** We support the recommendation in the Joint Submission that Group 1b cryptoassets should be capable of being recognised as eligible collateral under the Basel framework – provided that they satisfy the usual eligible collateral criteria that apply to traditional assets under the Basel framework – instead of being categorically excluded from collateral eligibility. Furthermore, "*taking into account local circumstances*" in Hong Kong, especially the comprehensive licensing and regulatory framework for FRS issuers to be introduced in Hong Kong, we respectfully request that Hong Kong's local implementing rules should provide, at a minimum, that any FRS issued by an HKMA-licensed FRS issuer (and therefore approved by the HKMA) should be capable of being recognised as eligible collateral under the BCR.

3 Clarifying that digitally native cryptoassets are eligible for treatment as Group 1a cryptoassets

Digitally native cryptoassets such as digital debt and equity securities should be eligible for treatment as Group 1a cryptoassets.

Under the Basel Cryptoasset Standards and, consequently, the Consultation Paper, Group 1a cryptoassets are currently limited to "tokenised traditional assets". The regulatory capital treatment of a Group 1a cryptoasset is generally based on the existing Basel capital rules, which means applying the applicable risk-weight for the non-tokenised version of the asset.

It is presently unclear whether digitally native securities qualify under Group 1a cryptoassets (a category that is limited to "tokenised traditional assets") because no traditional, off-chain version of the securities exists.[24] We respectfully request that when implementing, interpreting and applying the Basel Cryptoasset Standards in Hong Kong, the HKMA should clarify that digitally native securities are eligible for treatment as Group 1a cryptoassets. This clarification would foster the issuance of digitally native securities in Hong Kong and beyond, which is consistent with the HKMA's objective to "*promote the development of the digital securities market and encourage the wider adoption of digitalisation technology*."[25]

If digitally native securities are not capable of qualifying as Group 1a cryptoassets, most of them would be classified as Group 2b cryptoassets instead because they would likely not have the market capitalisation, daily trading volume and other attributes necessary to satisfy the hedging recognition criteria to be classified as Group 2a cryptoassets. For example, this means that a digitally native bond issued by a highly rated bank would likely receive a punitive 1,250% risk weight, whereas a traditional bond issued by the same bank would typically only receive a 20% risk weight under the BCR.[26] In other words, an AI would need to hold **62.5 times** more regulatory capital simply because the bond in question is digitally native. We respectfully submit that this may not be the outcome that the HKMA intended,

[24] As the HKMA explained: "*In a digital bond issuance, the bonds can be issued directly on the DLT platform (i.e. a "native" issuance), or first issued off-platform and then tokenised on the DLT platform (i.e. a "non-native" issuance).*" *See* HKMA, Bond Tokenisation in Hong Kong (August 2023) at paragraph 25, available at: https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2023/20230824e3a1.pdf.

[25] *See* HKMA, *HKSAR Government's Digital Green Bonds Offering* (7 February 2024), available at: https://www.hkma.gov.hk/eng/news-and-media/press-releases/2024/02/20240207-6.

[26] *See* BCR Table 4 (*Risk-weights for Bank Exposures with Short-term ECAI Issue Specific Ratings*).

especially considering the fact the HKMA has first-hand experience with issuing the world's first digitally native government green bond earlier this year. In fact, the HKMA has described the benefits of digitally native securities as follows:

> *"Native issuances enhance the degree of integration with the DLT platform, and may reduce the need for intermediaries, such as conventional CSDs, custodians and registrars, and thus lower the transaction costs and operational risks. Coupled with smart contract technology and automation features, it may also enable faster settlement and execution of the bond processes."* [27]

We encourage the HKMA to share its first-hand experience with issuing digitally native bonds (and the associated benefits) with other members of the Basel Committee so that the clarification we have requested in this consultation response can be reflected both in the text of the global Basel standards as well as in Hong Kong's implementing rules.

We also emphasise the importance for this recommendation regarding digitally native cryptoassets to be implemented together with our recommendation below regarding public permissionless blockchains. Even if the Basel Cryptoasset Standards were clarified to provide that digitally native securities are capable of qualifying as Group 1a cryptoassets, this clarification would not, in and of itself, foster responsible and sustainable innovation in the digital asset markets for so long as all cryptoassets (including digitally native securities) that use public permissionless blockchains are automatically excluded from Group 1 cryptoassets.

4 The definition of "cryptoassets" should be clarified to exclude DLT or blockchain-based books and records systems

The Basel Cryptoasset Standards and, consequently, the Consultation Paper, include the following statement on the scope of application of the term "cryptoasset":

> *"Dematerialised securities (securities that have been moved from physical certificates to electronic book-keeping) that are* ***issued through DLT*** *or similar technologies are considered to be within the scope of [the Basel Cryptoasset Standards] and are referred to as tokenised traditional assets, whereas those dematerialised securities that use electronic versions of traditional registers and databases which are centrally administered are not within scope" (emphasis added).*[28]

In relation to the abovementioned statement, we note that in many cases where DLT is used for settlement or recordkeeping, no asset is actually "issued through DLT". In fact, no distinct digital asset is created at all. Instead, the execution or recording of transfers of ownership occurs via DLT, which serves as an "electronic version" of traditional registers and databases. In this respect, we note that reliance on DLT for recordkeeping or settlement purposes should not increase the risk or liquidity profile of the underlying assets themselves. Where the underlying traditional assets can still be accessed

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[27] *See* HKMA, Bond Tokenisation in Hong Kong (August 2023) at paragraph 27, available at: https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2023/20230824e3a1.pdf.

[28] *See* SCO 60.2 of the Basel framework and paragraph 7 of the Consultation Paper.

through the traditional custodian network that is holding the assets, it may not be appropriate to apply conservative risk weightings or capital charges solely because of the use of DLT for evidencing transfers of ownership.

The financial markets would greatly benefit from clarification that the use of DLT as an electronic version of the traditional registers and databases would not lead to the underlying traditional assets being treated as "cryptoassets" under the Basel Cryptoasset Standards and the Consultation Paper. Otherwise, banks will be disincentivised from participating in innovative DLT-based solutions that are designed to improve market efficiencies. In this respect, we note that the HKMA has stated that it is "*supportive of AIs adopting DLT-based solutions so long as they can adequately manage the associated risks*."[29] Please also refer to section 6 of this consultation response where we set out the HKMA's positive descriptions of DLT in various regulatory contexts.

The clarification we have sought can be implemented by inserting clarificatory text (shown in bold, underlined and blue-coloured font) to the end of the abovementioned statement as follows:

> *"whereas those dematerialised securities that use electronic versions* ***<u>(including electronic versions based on DLT or similar technologies)</u>*** *of traditional registers and databases which are centrally administered are not within scope".*

5 Public permissionless blockchains and Group 1 cryptoasset eligibility

Under the Basel Cryptoasset Standards and, consequently, the Consultation Paper, cryptoassets such as tokenised traditional assets and stablecoins that use public permissionless blockchains are not eligible for inclusion in Group 1. Furthermore, since these cryptoassets typically would not have the market capitalisation, daily trading volume and other attributes necessary to satisfy the hedging recognition criteria to be classified as Group 2a cryptoassets, they would likely fall under Group 2b and receive a punitive 1,250% risk weight.

Although the Basel Committee reconfirmed its position on public permissionless blockchains in December 2023, it also "*acknowledge[d] that technical solutions to many of these issues [associated with permissionless blockchains] may develop rapidly in the future and would welcome ongoing feedback from industry participants on the risks of permissionless systems and the development of mitigants*."[30]

ASFIMA and our members would like to take this opportunity to provide the HKMA with feedback on public permissionless blockchains and risk mitigants.

We are supportive of the position regarding public permissionless blockchains set out in the Joint Submission. As stated in the Joint Submission, while there may be some risks associated with the use of public permissionless blockchains, we are of the firm view that the industry has all the necessary

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[29] *See* HKMA, *Circular on risk management considerations related to the use of distributed ledger technology* (16 April 2024), available at: https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2024/20240416e1.pdf.

[30] *See* Basel Committee, *Consultative document on cryptoasset standard amendments* (December 2023), available at: https://www.bis.org/bcbs/publ/d567.pdf.

expertise and robust compliance frameworks to fully identify, manage and mitigate these risks. Therefore, we recommend allowing banks to conduct a Group 1 cryptoasset eligibility assessment in relation to public permissionless blockchains on a case-by-case basis. As long as banks can satisfy that relevant risks have been adequately addressed, the use of public permissionless blockchains by Group 1 cryptoassets should remain possible. In this respect, we note that the HKMA has similarly stated that "*assuming an AI can find appropriate measures to manage the associated risks (e.g. cryptographic solutions like zero-knowledge proof or a mix of on and off-chain solutions), these [permissionless] networks* ***need not be ruled out by default****. . .*" (emphasis added).[31] Accordingly, we respectfully request the Basel Committee and the HKMA to continue engaging with the industry and share their assessment of public permissionless blockchains.

As the use cases for DLT are evolving, it is imperative not to disincentivise or prevent industry participants from investing in, exploring and innovating in all forms of technology, including public permissionless blockchains. If banks are effectively prevented from using public permissionless blockchains (by virtue of the highly conservative capital treatment imposed on Group 2b cryptoassets), this may encourage the market to focus on non-bank financial institutions and the shadow banking space, which may result in the build-up of systemic risks outside of the regulatory perimeter.

Among other things, we echo the point made in the Joint Submission that banks and indeed the entire global economy have been using permissionless networks for decades because the internet and email are both permissionless (i.e. open) networks. However, even though the internet and email are permissionless at the network layer, there are many forms of permissioning that have been implemented at the application layer, which are designed to enhance security and to ensure that products and services can be delivered via the internet in a safe, prudent and compliant manner that does not pose financial stability, compliance or investor protection risks. For example, a significant and growing portion of secure banking transactions and services are carried out via the internet and email. Yet, none of these transactions are automatically subject to a 1,250% risk weight under the Basel standards simply because they rely on permissionless networks.

Just as sophisticated security and regulatory compliance features can be introduced to permissionless networks such as the internet and email, the same also applies to permissionless DLT networks. To use Ethereum as a specific example, there are varying levels of token contracts that can be placed on the permissionless Ethereum blockchain that allow for graduating levels of controls, such as blacklists, whitelists and transfer restrictions. ERC-20, one of the most common token standards, allows for basic security functions encoded directly into the token contract (e.g., grants of permission to certain entities to move tokens at a pre-specified volume). ERC-1400, on the other hand, includes an encoded mechanism to restrict the usage of tokens based on identity and jurisdiction, stipulate the holding period of a token in a given wallet, approve only certain buyers and sellers, KYC certain wallets and require the approval to be updated at a specified frequency, as well as place limits on transactions sizes. ERC-3643 provides the foregoing functionality as well as a validation mechanism for on-chain transfers and a token recovery process, in addition to other enhanced features that mitigate some of the security concerns historically associated with permissionless blockchains.[32]

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[31] *See* HKMA, *Circular on risk management considerations related to the use of distributed ledger technology* (16 April 2024), available at: https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2024/20240416e1.pdf.

[32] The security and compliance features of ERC-3643 are explained in its whitepaper:

In sum, while the superficial features of permissionless blockchains (e.g., broad access, less centralised control, etc.) may give rise to some potential regulatory concerns, these can be effectively mitigated, and validated by banks through longstanding risk management practices, through token contracts themselves.

An example[33] of a permissioned bond on a permissionless network is the April 2021 digital bonds issuance by the European Investment Bank ("**EIB**"),[34] which runs on the public Ethereum DLT network. While the network itself is permissionless, the application for the issuance was tightly permissioned. This meant that all tokens had whitelisting in place to restrict holders to eligible counterparties and investors. Furthermore, smart contracts were put in place that conducted KYC/AML/CFT and sanctions checks to verify counterparty identities before the relevant transaction could take place. In addition, a monitoring system was put in place, outside of the distributed ledger, to track any potential operational risk issues.

In light of the foregoing, we respectfully submit that it may be appropriate for a cryptoasset that uses a public permissionless blockchain to be eligible as a Group 1 cryptoasset where the blockchain has inherent tools (such as permissioned tokens) to mitigate material risks in line with classification condition

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> *"[T]okenized securities, or security tokens cannot be permissionless tokens like utility tokens, which can be transferred to anyone. They must be permissioned tokens in order to track ownership and make sure that only eligible investors can hold tokens, in order to comply with securities laws. . . .*
>
> *The open-source ERC-3643 token standard and its T-REX implementation were designed to address this need to support compliant issuance and management of permissioned tokens, that are suitable for tokenized securities, either on a peer-to-peer basis or through regulated trading platforms. These tokens are issued in full compliance with the rules specified by the investors (via onchain identity) and the offerings based on issuers' guidelines. Furthermore, control mechanisms are baked into the tokens themselves.*
>
> *Adopting a "Compliance by Design" approach, T-REX ensures that an investor cannot become a holder of any digital securities without fulfilling all compliance requirements. Furthermore, regulators can affirm the issuer's compliance by auditing the smart contracts that underpin the entire life cycle of the security token. This innovation offers a secure, transparent, and efficient environment for managing security tokens while enforcing on-chain compliance, heralding a new era in the financial securities market."*

See ERC3643 Whitepaper: The T-REX protocol (Token for Regulated EXchanges), Version 4.0 (23 May 2023), available at: https://tokeny.com/wp-content/uploads/2023/05/ERC3643-Whitepaper-T-REX-v4.pdf.

We further note that ERC-3643 has recently received approval from the Ethereum community. *See Ethereum Community Approves ERC3643 as the First Tokenization Standard* (15 December 2023), available at: https://www.erc3643.org/news/ethereum-community-approves-erc3643-as-the-first-tokenization-standard.

[33] Another example is the cross-border transaction tested as part of Project Guardian, sponsored by the Monetary Authority of Singapore, where three participating banks (UBS, SBI and DBS) performed a repurchase agreement of debt instruments paid using a stablecoin. The whitelisting mechanism and asset-level governance input in the smart contract allowed full control of the participants in the transaction, while retaining the efficiency of a public network.

[34] *See EIB issues its first ever digital bond on a public blockchain* (28 April 2021), available at: https://www.eib.org/en/press/all/2021-141-european-investment-bank-eib-issues-its-first-ever-digital-bond-on-a-public-blockchain.

3 under the Basel Cryptoasset Standards, such as: the ability to whitelist and blacklist addresses; the ability to freeze transfers; the ability to grant permissions to an entity to transact; and mechanisms to restrict usage based on identity, jurisdiction and asset category. This recommendation can be implemented in Hong Kong by, among other means, including an interpretative provision in the BCR to the effect that a cryptoasset in the form of an eligible permissioned token on a permissionless network is deemed to exist on a permissioned blockchain or ledger.

6 Add-on for infrastructure risk for Group 1 cryptoassets

To account for the fact that DLT is a relatively new technology, the Basel Cryptoasset Standards and, consequently, the Consultation Paper permits an infrastructure risk add-on to apply to the capital requirement for exposures to Group 1 cryptoassets. We are very grateful for the HKMA's decision to initially set the infrastructure add-on at zero, which is consistent with the approach under the Basel Cryptoasset Standards.

In light of the HKMA's familiarity with, and first-hand experience in, using DLT, we expect (and hope) that, in Hong Kong, the infrastructure add-on will remain at zero for the foreseeable future. We also encourage the HKMA to share its experiences in using DLT with other members of the Basel Committee. In this respect, we note that the HKMA has provided the following positive descriptions of DLT:

- "*DLT offers attractive features such as being tamper-proof, immutable and transparent*."[35]

- "*[The Hong Kong Government's tokenised green bond issuance] showed the potential in DLT to enhance efficiency, liquidity and transparency in bond markets*."[36]

- "*A DLT-based design could be better for future interoperability compared to a non-DLT one, as transacting entities are likely to share a common architecture*."[37]

We support the recommendation in the Joint Submission that the infrastructure risk add-on should be removed in its entirety from the Basel Cryptoasset Standards. Alternatively, "taking into account local circumstances" in Hong Kong, we respectfully request that the HKMA consider omitting the infrastructure risk add-on from Hong Kong's implementing rules. Having said this, should the HKMA believe it is appropriate to still include the *concept* of the infrastructure risk add-on (albeit stating that the add-on is set at zero) in Hong Kong's implementing rules to maintain consistency with the global Basel standards, we would welcome a statement from the HKMA that it will seek meaningful public consultation in relation to any proposal to increase the infrastructure risk add-on.

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[35] *See* HKMA inSight Article, *Eddie Yue on Tokenised Bond: Huge Potential to be Unlocked* (16 February 2023), available at: https://www.hkma.gov.hk/eng/news-and-media/insight/2023/02/20230216/.

[36] *See* HKMA, Bond Tokenisation in Hong Kong (August 2023), Foreword by Mr. Eddie Yue, Chief Executive of the HKMA, available at: https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2023/20230824e3a1.pdf.

[37] *See* HKMA, *e-HKD Pilot Programme Phase 1 Report* (October 2023) at page 32, available at: https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2023/20231030e3a1.pdf.

7 Stablecoins issued by HKMA-licensed issuers should be deemed to qualify as Group 1b cryptoassets

The Hong Kong Government has proposed a comprehensive licensing and regulatory regime for issuers of FRS, which will be overseen by the HKMA.[38] Under the proposal, not only will FRS issuers in Hong Kong need to be licensed by the HKMA, the FRS they issue must meet a stringent set of requirements and must be approved by the HKMA. Significantly, the proposed requirements relating to an FRS' reserve assets, stabilisation mechanisms and redemptions are based on the Basel Cryptoasset Standards.

Since the HKMA will be overseeing both the FRS licensing and regulatory regime (including consenting to the issuance of FRS by licensees) and the bank capital regime (including the Basel Cryptoassets Standards as implemented in Hong Kong), we respectfully submit that an AI should be allowed to automatically classify any FRS issued by an HKMA-licensed FRS issuer as a Group 1b cryptoasset.

8 Group 1b cryptoassets should be capable of qualifying as eligible collateral

Under the Basel Cryptoasset Standards and, consequently, the Consultation Paper, Group 1b cryptoassets (qualifying stablecoins) are not eligible collateral under the Basel framework. We support the recommendation in the Joint Submission that Group 1b cryptoassets should be capable of being recognised as eligible collateral – provided that they satisfy the usual eligible collateral criteria that apply to traditional assets under the Basel framework[39] – instead of being categorically excluded from collateral eligibility.

Furthermore, "*taking into account local circumstances*" in Hong Kong, especially the comprehensive licensing and regulatory framework for FRS issuers to be introduced in Hong Kong, we respectfully request that Hong Kong's local implementing rules should provide, at a minimum, that any FRS issued by an HKMA-licensed FRS issuer (and therefore approved by the HKMA) should be eligible for collateral recognition under the BCR.

9 Other comments and recommendations

We support the recommendations in the Joint Submission regarding the other aspects of the Basel Cryptoasset Standards, including in relation to the Basel Committee's December 2023 consultation on targeted adjustments to the Basel Cryptoasset Standards.

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[38] *See* Financial Services and the Treasury Bureau and HKMA, *Consultation on legislative proposal to implement regulatory regime for stablecoin issuers and announcement on introduction of sandbox arrangement* (December 2023), available at: https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2023/20231227e4a1.pdf.

[39] *See e.g.*, the criteria for eligible collateral set out in CRE 22 *(Standardised approach: credit risk mitigation)* of the Basel framework.

In addition, we respectfully make the following comments regarding the Consultation Paper and the implementation, interpretation and application of the Basel Cryptoasset Standards in Hong Kong:

(a) **Meaning of "*private* digital assets":** The Basel Cryptoasset Standards and, consequently, the Consultation Paper, define "cryptoassets" as "***private*** *digital assets that depend on cryptography and distributed ledger technologies (DLT) or similar technologies* (emphasis added)". We would like to seek clarification and confirmation from the HKMA that the term "private" in this context means issued by an issuer in the private sector, such that government issued cryptoassets (including central bank digital currencies ("**CBDCs**") as well as tokenised or digitally native government bonds) would be out of scope. This interpretation of the term "private" is also consistent with, among other things: (i) the Financial Stability Institute's summary of the Basel Cryptoasset Standards, which describes cryptoassets as "*a type of* ***private sector*** *digital asset that depends primarily on cryptography and distributed ledger or similar technology* (emphasis added)"[40]; and (ii) the FSB's definition of "cryptoasset", which uses the term "*issued by the private sector*".[41]

(b) **Classification assessment of new types of cryptoassets:** The Consultation Paper requires that "*[i]n advance of any acquisition of a new type of cryptoassets, an AI must inform the HKMA of its classification assessment of the cryptoassets*." We seek clarification from the HKMA that after an AI has informed the HKMA of its classification assessment and is waiting for a response from the HKMA, the AI may enter into transactions relating to the new type of cryptoasset and apply the regulatory capital and prudential treatment prescribed in the Basel Cryptoasset Standards (as implemented in Hong Kong) based on the AI's own classification assessment.

(c) **CVA risk capital charge:** The Basel Cryptoasset Standards and, consequently, the Consultation Paper, describe how capital requirements for credit valuation adjustment ("**CVA**") risk are to be applied to cryptoasset derivatives exposures and SFTs referencing cryptoassets. We note that Section 322J(2) of the BCR (as amended) provides that: "*If the Monetary Authority determines an authorized institution's CVA risk arising from SFTs that are fair-valued for accounting purposes is material, the Monetary Authority may, by written notice given to the institution, require the institution to calculate the CVA risk capital charge for those SFTs".* We respectfully seek clarification from the HKMA that Section 322J(2) also applies to SFTs that are collateralised by cryptoassets belonging to any group (i.e., Group 1a, 1b, 2a or 2b), which means that an AI would not need to calculate the CVA risk capital charge for those SFTs unless required to do so by a written notice from the HKMA.

(d) **CVA risk for SFTs that reference Group 2b cryptoassets:** The Basel Cryptoasset Standards and, consequently, the Consultation Paper, provide that the treatment of CVA risk for Group 2b cryptoassets is covered by the 1,250% risk weight assigned to such assets, noting that the "*conservative treatment is intended to capture both credit and market risk,* ***including CVA risk*** (emphasis added)." We seek clarification from the HKMA that, in the case of SFTs that merely reference Group 2b cryptoassets, the conservative treatment for Group 2b cryptoassets set out in paragraphs 97 to 100 of the Consultation Paper (i.e., the 1,250% risk weight) would *not* apply and that these types of SFTs would instead be subject to the same rules for determining the CVA risk capital charge as SFTs referencing traditional assets.

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[40] *See* Financial Stability Institute, *Prudential treatment of cryptoasset exposures – Executive Summary* (31 May 2023), available at: https://www.bis.org/fsi/fsisummaries/crypto_exposures.htm

[41] See FSB, *High-level Recommendations for the Regulation, Supervision and Oversight of Crypto-asset Activities and Markets: Final report* (17 July 2023), available at: https://www.fsb.org/wp-content/uploads/P170723-2.pdf

(e) **Tokenised claims on a regulated and supervised bank:** The Basel Cryptoasset Standards and, consequently, paragraph 115 of the Consultation Paper, provide that, for the purposes of the liquidity coverage ratio ("**LCR**") and/or net stable funding ratio ("**NSFR**") requirements, "*if the issuing institution cannot identify, at all times, the holders of the cryptoassets, it must treat the cryptoliabilities as unsecured wholesale funding provided by **other legal entities*** (emphasis added)." We would be grateful if the HKMA can please clarify whether the term "other legal entities" is referring to Banking (Liquidity) Rule 41(1)(g) ("*unsecured wholesale funding other than funding mentioned in paragraphs (d), (e) and (f)*"), thus resulting in a 100% outflow rate. In this respect, we note that the corresponding paragraph in the Basel Cryptoasset Standards (SCO 60.107(2)(b)) refers to "*unsecured wholesale funding provided by other legal entity customers (**see [LCR40.42]**)* (emphasis added)" and LCR40.42 (entitled 'Unsecured wholesale funding provided by other legal entity customers: 100%') prescribes a run-off factor of 100%.

As noted above, we also welcome the opportunity to provide comments on the HKMA's further proposal(s) in the future to implement the conclusions of the Basel Committee's October 2023 and December 2023 consultations in Hong Kong.

* * *

10 Conclusion

As Mr. Eddie Yue, Chief Executive of the HKMA, recently stated: "*Hong Kong has always championed innovation and international collaboration*."[42] We are thankful of the HKMA and the Hong Kong Government's efforts to foster innovation and to create a coordinated regulatory framework for Hong Kong's growing cryptoassets ecosystem.

We are also supportive of the HKMA's efforts to "*put in place a regulatory regime that strikes a good balance between safeguarding financial stability and embracing innovation*".[43] We believe that this delicate balance can be struck if the Basel Cryptoasset Standards — both at the global level and as implemented in Hong Kong — can reflect the recommendations and clarifications described in this consultation response and in the Joint Submission.

ASIFMA takes this opportunity to convey our support and desire for continued constructive and on-going dialogue between the HKMA and market participants to assist the HKMA in implementing the Basel Cryptoasset Standards in Hong Kong, including working with the HKMA to explore the interaction between the Basel Cryptoasset Standards and other aspects of the cryptoassets ecosystem.

We look forward to continued engagement with the HKMA on the issues set out in this consultation response. If you have further questions or would otherwise like to follow up, please contact Diana Parusheva-Lowery, ASIFMA's Managing Director and Head of Public Policy and Sustainable Finance, at DParusheva@asifma.org or +852 9822 2340.

We would also be happy to meet with you to discuss this consultation response if you deem it appropriate.

Yours faithfully

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[42] *See* HKMA press release, *HKMA unveils Project Ensemble to support the development of the Hong Kong tokenisation market* (7 March 2024), available at: https://www.hkma.gov.hk/eng/news-and-media/press-releases/2024/03/20240307-5/.

[43] *See* HKMA inSight Article, *Eddie Yue on Stablecoins – Regulating issuers to accord protection to users* (24 December 2023), available at: https://www.hkma.gov.hk/eng/news-and-media/insight/2023/12/20231227/.

Annex A

Joint Submission to the Basel Committee on Banking Supervision regarding cryptoasset standard amendments from the Global Financial Markets Association, the Futures Industry Association, the Institute of International Finance, the International Swaps and Derivatives Association, and the Financial Services Forum

Link: https://www.gfma.org/correspondence/joint-response-to-bcbs-crypto-standard-amendments-consult/