

ISDA Crypto Forum 2022
October 26, 2022

Opening Remarks
Scott O'Malia, ISDA Chief Executive

Good morning, and welcome to the ISDA Crypto Forum. Thank you for joining us today, and a special thanks to all our sponsors for supporting this event.

Over the past year, the crypto-assets market has been an area of laser-like focus for ISDA as we've pushed forwards with two key issues – the development of legal standards and advocating for a risk-appropriate capital framework. We're grateful to have the support of our membership, which now includes a number of native crypto firms, and we've had great dialogue as we advance this work.

Since establishing the ISDA Digital Assets Legal Group last year, we've moved at pace to develop standard contractual terms for OTC crypto derivatives. We've also worked hard to assess the impact of the proposed capital framework for bank exposures to crypto assets, responding to two Basel Committee consultations to highlight our concerns over excess conservatism. I'll provide a brief update on both issues in my remarks this morning.

Of course, the crypto-assets market has been on a rollercoaster journey this year. After climbing to a peak market value of around \$3 trillion, a period of significant volatility sent asset values tumbling dramatically, with market capitalization now less than \$1 trillion.

Navigating this turbulence has certainly presented challenges for market participants, and we saw a number of failures earlier this year, including so-called algorithmic stablecoins Terra and Luna. But institutional interest in the asset class has remained robust. Asset managers, custodians and exchanges have deepened their commitment to the crypto market in recent months with new initiatives and acquisitions. The market value may be a fraction of what it was, but many participants remain committed to investing and innovating in crypto.

However, the recent volatility has led to questions over what would happen in a bankruptcy situation. How do crypto investors actually hold their assets and what rights do they have in the event of the bankruptcy of an exchange or wallet provider? At the moment, the answer is not always entirely clear, leaving investors with uncertainty over how they would recover their funds.

In the derivatives market, it has long been a key priority to create certainty over the treatment of transactions following a counterparty's bankruptcy. This is achieved through the ISDA Master Agreement, as well as ISDA's library of legal opinions. The Master Agreement provides a clear, consistent contractual framework that spells out the rights and obligations of both counterparties following a default. Developed 35 years ago, this document and the standard product definitions and confirmation templates that have developed alongside it have stood the test of time, providing certainty and confidence to market participants.

We're now adapting this contractual framework for the OTC crypto derivatives market. I'm pleased to report that our Digital Assets Legal Group is well advanced in producing standard terms for cash-settled forwards and options referencing Bitcoin and Ether, which we intend to publish before the end of the year.

This will avoid the need for institutions trading OTC crypto derivatives to do what they have been doing – either using amended versions of existing ISDA definitions and templates developed for other products like equity or FX derivatives, or using their own bespoke documentation. This not only results in a lack of standardization – it also means certain unique characteristics of crypto markets may not be covered by the documentation.

The ISDA Digital Assets Legal Group has been thinking hard about how to consider events like forks, which may result in two distinct versions of the blockchain code with different values. It has also considered the impact of other features of this market such as airdrops, as well as pricing disruptions that could impact the ability to value a transaction for settlement, close-out or margin calculations. Explicitly covering these unique features will help create greater certainty for market participants.

Once the first set of definitions is published, we'll look to promote their adoption by preparing standardized risk disclosures for firms trading these products, as well as guidance on the application of the new definitions to the various idiosyncratic events in the crypto market.

We also plan to carry out a global survey to determine the key issues related to netting, which will help us as we look to expand our netting opinions to crypto assets. As a further branch of work, we'll consider the development of collateral documentation so users of crypto derivatives have the same standard credit risk mitigation tools that have become indispensable for conventional derivatives. We'll also consider the addition of contractual standards for other product types, including swaps and physically settled transactions.

Just as the volatility in the crypto market has underscored the importance of robust contractual standards, it also highlights the need for a risk-appropriate capital framework. Earlier this year, the Basel Committee published its second consultation on the prudential treatment of bank exposures to crypto assets and wants to finalize the standards by year-end.

We welcome the development of these standards, but the conservatism of the proposed approach would make it uneconomic for banks to participate in this market in a meaningful way. In the second consultation, a very punitive risk weight for assets such as Bitcoin was modified so that banks could use standardized capital models – but additional measures were added that would constrain banks even more. These include an exposure limit that would cap a bank's exposure to certain crypto assets at 1% of tier-one capital, calculated on a gross basis. An infrastructure risk add-on of 2.5% has also been applied to account for the risk associated with the underlying technology.

ISDA worked with seven other trade associations to develop a joint response to the consultation. Our position is clear: without significant changes to the proposed framework, banks would be constrained or precluded from responding to customer demand for intermediation in crypto assets. We have set out the changes we believe should be made and will work with policymakers to make sure the impact of the proposed framework is properly understood.

Our work in this space extends to the accounting framework for digital assets. In May, we published a paper that explored the accounting treatment of digital assets under US GAAP and IFRS. Earlier this month, the Financial Accounting Standards Board announced it will require crypto assets to be measured at fair value – a decision we welcome as it would resolve some of the issues identified in our paper.

I've talked in these remarks about the importance of robust and appropriate legal, capital and accounting frameworks. Following recent turbulence in this market, it's more important than ever that we collaborate closely with market participants, policymakers and accounting standard setters to make sure those frameworks are watertight. Events like these provide a great platform for the networking and dialogue that is needed.

Thank you.