Bank of Israel
Banking Supervision Department
Office of the Supervisor

Jerusalem, February 26, 2023
22LM4623

Attn:
CEOs of banking corporations and credit-card companies

Re: Dealings in financial cryptographic assets

Dear Sirs:

1. Recent years have seen an increase in activity in the area of financial cryptographic assets (hereinafter: "crypto")[1] in Israel and abroad. Among other things, new and innovative assets and services are developing at an accelerated pace, are provided by a range of entities, and are geared to a wider community of customers. Events of the past year in the cryptoassets market, including failure events at several entities worldwide that deal in this area, which led *inter alia* to a considerable increase in volatility in this market and a sharp decline in the value of cryptographic assets, emphasized the range of risks in this activity.

2. The involvement of banking corporations and acquirers (hereinafter: "banking corporations") in activities associated with this field, directly or indirectly, may affect the ability to ensure a stable and reliable financial environment, prudential risks, and may raise concern about consumer– protection aspects. These risks and fears are growing because crypto-related activities are still not fully recognized and understood due to the short period of time involved and the relatively limited experience in this field due to its rapid development. Accordingly, all crypto-related activities must be undertaken cautiously and in a way that ensures the corporations' stability, protects customers, maintains fairness, and complies with existing statutes and regulations, particularly in reference to money-laundering and terror-financing risks.

3. Inconsistency in definitions of, and inadequate experience with, the various cryptoassets and their related activities make it difficult to identify these assets and activities categorically. Furthermore, the variety of asset types, the early stage of the market, and the changing structure of activity and its growing volume due to the dynamic nature of the field make it hard to perform proper risk assessment and examine the impact on financial stability and customer protection—even without discussing and relating to each activity separately and individually. Sometimes, too, these activities require cooperation between a banking corporation and third parties such as firms that specialize in the field, e.g., escrow services,

[1] The term "cryptoasset" usually pertains to any digital asset implemented by means of cryptographic technology. The expression "crypto-related activity" includes the issuance of crypto and other digital assets; custody services for cryptoassets; holding of stablecoin reserves; purchase and sale of cryptographic currencies; agent activity or settlement services; crypto-based credit activities; and future innovative related activities.

dedicated trading platforms, and fintech companies that provide ancillary services that may, *inter alia,* be considered the use of outsourcing, and so on.

4. Against this background, particularly in view of crypto failure events at various entities in the past year, and much like documents on this topic from regulatory authorities abroad, below we specify the main risks that crypto activity poses. We wish to emphasize, however, that this is not a complete list and that the exposure to risks on account of various activities and their effects is contingent upon the activity itself:

   a. **Prudential risks**

   Crypto-related activities present new, heightened, or special risks to the traditional world of risk as well. Several examples follow:

   1. There is a basic difficulty in authenticating and proving ownership of an asset and rights to it an authorized and validated way, especially in this rapidly developing environment.
   2. There is heightened concern about the involvement of cryptoassets in money-laundering and terror-financing activities, including reported cases of use of cryptoassets for illegal activities, due to difficulty in tracing the source of the money and determining the identity of the owner of the asset.
   3. The nature of the activity of companies that engage in the crypto field, including aspects of corporate governance, custodial procedures, property rights, and terms of redemption, is shrouded in legal uncertainty.
   4. There are implications for the management of information technology and security, including exposure to technological risks that challenge existing defense mechanisms, relating to the level of the risk, the maintenance of confidentiality, and the integrity and availability of the information systems.
   5. There is concern about exposure to credit risk due to a cryptoasset or the structure in which it is held, originating in difficulty in measuring asset quality and fair value, possibilities of liquidation, and exposure to counterparty credit risk. There is also a difficulty in determining whether the asset is bankable.
   6. A significant market risk exists due to doubt about the existence of appropriate methods of pricing and valuating cryptoassets. Furthermore, the standards for treatment of cryptoassets and crypto-related activities in books of account and financial statements are evolving and taking shape at the present time and may have a major impact on everyone dealing in this field, including an effect on capital allocation[2] for the activity, going so far as business non-viability.
   7. A liquidity risk is foreseen, especially in cases of cryptoassets of high price volatility.
   8. The unique characteristics of a cryptoasset, particularly when third parties are relied upon or used, may create fruitful opportunities for fraud, embezzlement, and trading manipulations, in addition to information-system, information-security, and cyber risks such as theft or loss of passwords and cyber attacks on cryptoasset exchanges.
   9. Operational risks exist when a banking corporation cooperates with third parties, such as institutions specializing in crypto, that are unsupervised and are thus typified by

[2] In June 2021, the BIS Committee on Banking Supervision issued a consultative document for the establishment of rules relating to capital allocation in cryptoasset services (Consultative Document—Prudential Treatment of Cryptoassets Exposures). The document is not final and corresponding guidelines in Israel have not yet been promulgated.

management and corporate-governance mechanisms that are in their developmental stages.

b. **Financial stability risk**

Certain cryptoassets, or activities related to them, may also pose a system risk. System risks may come about inadvertently, as the result of the structure of activity in the cryptoasset, or due to the effects of crypto activity on the traditional financial system and vice versa. Corruption or fraud in crypto-related activities may trigger a run on the financial assets that back the cryptoasset or the crypto-related activity. As in other manifestations of runs, this may set in motion a self-feeding cycle of redemption of financial assets and fire sales, possibly corrupting the financing markets and bringing on contagion risk. Furthermore, operational failures such as fraud, embezzlement, manipulation of trading, and cyber attacks in association with cryptoassets or related activities may destabilize corporations that engage in this activity.

c. **Conduct risk**

The Banking Supervision Department is aware of the consumer risks that stem from new activities associated with crypto, such as customers' lack of familiarity with the essence of crypto as offered by, or by means of, a banking corporation. For example, there are risks inherent to the speculative nature of certain cryptoassets in comparison with traditional banking products such as deposits. In addition, customers may not understand the role of the banking corporation in this activity and may attribute to the activity the trust that they attribute to the banking corporation.

Furthermore, a banking corporation faces compliance risks in the context of applying consumer requirements such as clear and broad due diligence expressed in clear and simple language that enables customers to understand the risks well, as well as directives pertaining to marketing methods and practices that are, or may be, misleading.

Moreover, the realization of some of the aforementioned risks may expose the banking corporation to reputation risk.

5. In view of the foregoing, I wish to make the Banking Supervision Department's stance clear: a banking corporation must act with abundant caution when it weighs the possibility of getting involved in crypto activity, including, *inter alia,* applying the new-product provisions of Section 16 of Proper Conduct of Banking Business Directive 310, "Risk Management," to crypto activity, and, among other things:

   a. A banking corporation that engages, or will engage, in any crypto-related activity, directly or indirectly, shall first make sure that the activity in question falls into its lawful purview of activities.

   b. A banking corporation that engages, or will engage, in any crypto-related activity, or one in which crypto is involved, directly or indirectly, shall, before it begins its activity in the field, carry out a risk-assessment process including reference to the requisite consumer protections in regard to said activity. The banking corporation must prove that it is able to manage these activities safely and soundly, in accordance with the various Proper Conduct of Banking Business Directives and in compliance with any other relevant law, ruling, or regulation.

   c. A banking corporation shall give the Supervisor of Banks written prior notice of its intention to engage in the crypto field, describing the activity in detail, including the process mentioned in Section a above, and noting the timeframe of said activity.

d. The Supervisor of Banks may ask the banking corporation to provide additional information as is needed to assess the effect of the activity on the banking corporation's resilience and stability prudential implications, and the consumer protections that shall be applied. Said information shall vary in accordance with the circumstances of the case at hand and the type of activity or asset in question.

e. To the extent necessary, the Supervisor of Banks will give relevant feedback after receiving all the requisite information.

6. The Banking Supervision Department intends to review applications for activities by banking corporations in the crypto field, as stated, with due caution and with attention paid to the recent failures that have occurred in this area of activity.

Respectfully,

Yair Avidan
Supervisor of Banks