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National Banks Untethered in Race to Upgrade Money

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The OCC indicated to banks on Friday (Interpretive Letter 1183) that crypto-asset custody, distributed ledger, and stablecoin activities discussed in interpretive letters from 2021 are permissible. **We believe this action creates advantages for banks because it levels the playing field for banks and non-bank stablecoin issuers.** We believe this dynamic is especially important as the market for stablecoins evolves beyond crypto pair trading to applications in commerce, institutional securities trading, and P2P payments. As a reminder, the entire market value of stablecoins (mostly crypto pairs) is $218 Billion; the entire value of retail deposits in the US is $18 Trillion.

We have long predicted the first, and necessary, action from the OCC would be a recall of Biden era guidance (IL 1179), requiring banks to get written approval before engaging in activities involving crypto among other ambiguities. We believe additional letters will follow in the months to come on tokenization, cyber security, and other key topics relevant to these activities.

This action begins the widely expected shift of bank supervision away from subjective political control that aims to prevent all failure (and to exert political pressure) to a regime where banks determine the levels and types of risks that are acceptable.

Key takeaways from the new letter and the 2021 letters:

- Banks still need to notify/consult with their supervisors before taking action.
- While these actions ease the environment for non-bank stablecoins, the primary beneficiary of these actions are banks – now these regulated entities can issue stablecoins or tokenize deposits
- Compliance programs will need to adapt and expand to keep pace with reporting and recordkeeping requirements depending on the risks of a cryptocurrency transaction

- Risk management should equal the level of risk
- Not all banks will dive into these markets – most are extremely risk adverse by design
- Banks that do jump in will need to build internal controls and do significant due diligence to structure compliance programs
- Enabling insurance on the reserves at the individual account level will likely prove too complex for most issuer/banker relationships
- Banks will likely be more accepting of US minted and burned stablecoin (USDC) reserves compared to offshore issuers (USDT)
- While it will be on the bank to determine the risk level, we believe the application of AML, CID, and BSA rules is not straightforward for stablecoins running on permissionless blockchains – innovative solutions will arise

We believe this action opens the door to bank issued stablecoins, new payment systems, deposit tokens, and experimentation with DLT. PolicyPartner's conversations with banks indicate most management teams have been on the sidelines having assumed an extremely cautious approach. **We believe a handful of banks with higher risk appetites will begin offering these services as soon as they speak with their supervisors, others will hesitate until these early movers show profit.**

Revisiting Trump era interpretive letters

Custody Services

OCC Interpretive Letter 1170: Can a national bank provide cryptocurrency custody services to customers? Yes, so long as banks "effectively manage the risks and comply with the applicable law."

Considerations for banks:

- "…national banks may escrow encryption keys used in connection with digital certificates because a key escrow service is a functional equivalent to physical safekeeping."
- "….The OCC's regulations in Subpart E of Part 7 explicitly authorize national banks to perform, provide or deliver through electronic means and facilities any activities that they are otherwise authorized to perform."
- "…A national bank holding cryptocurrencies in a fiduciary capacity—such as a trustee, an executor of a will, an administrator of an estate, a receiver,

or as an investment advisor—would have the authority to manage them in the same way banks can manage other assets they hold as fiduciaries."
- "…including having adequate systems in place to identify, measure, monitor, and control the risks of its custody services. Such systems should include policies, procedures, internal controls, and management information systems governing custody services."

Other requirements and plans that may be necessary for banks to engage in cryptocurrency custody services:

- Banks should consult with OCC supervisors as appropriate prior to engaging in cryptocurrency custody
- Effective information security infrastructure and controls should be in place to mitigate hacking, theft, and fraud.
- Banks should reviewed for compliance with anti-money laundering rules
- Procedures set to safeguarding assets under custody
- Banks should be able to produce reliable financial reports
- Compliance with laws and regulations is a requirement

Other suggestions / examples of requirements:

- A bank made need to implement dual controls
- Segregation of duties and accounting controls
- Segregation of asset
- Maintenance under joint control
- Physical access controls and security servicing
- Controls may need to be tailored depending on the services
- A banks access controls may need to be verified for a cryptographic key
- Banks should conduct legal analysis
- Banks should assess and address risks associated with an individual account prior to acceptance
- Acceptance process should provide an adequate review of the customer's needs and wants

Holding dollar deposits as reserves backing stablecoins

OCC Interpretive Letter 1172: national banks can provide deposit services to stablecoin issuers. As with all 2021 guidance, banks are required to comply with all applicable laws and regulations – appropriate controls and sufficient due diligence that equal the risk presented by a business relationship.

National banks will likely struggle to get comfortable with KYC/CID/AML requirements when placing reserves for offshore permissionless tokens as they are currently structured.

Deposit insurance could be placed with stablecoin reserve accounts at the issuer or individual stablecoin holder if the requirements for passthrough insurance are met. **Enabling insurance on the reserves at the individual account level will likely prove too complex for most issuer/banker relationships.**

Due diligence process:

- Understand the risks of crypto
- Review for compliance with applicable laws and regulations including BSA and AML
- CDD requirements under BSA and CID under the USA PATRIOT Act
- Identify the beneficial owner of a legal entity
- Ensure compliance with securities laws

Other requirements:

- Detailed agreement between the issuer and the bank
- "…appropriate agreements in place with an issuer to verify and ensure that the deposit balances held by the bank for the issuer are always equal to or greater than the number of outstanding stablecoins issued by the issuer."
- Such agreements should include mechanisms to allow the bank to verify the number of outstanding stablecoins on a regular basis
- interagency guidance specifically contemplates that banks would enter into contracts with third-party program managers permitting banks to audit the third-party program managers

Using the technology for permissible payment activities

OCC interpretive letter 1174: A bank can use DLT, with the appropriate controls, and use it for payment related activities. In the OCC's view, digitized representations of currency, like stablecoins, can serve just as debit cards, checks, and ESV systems. **We interpret this as banks can tokenize deposits.**

- "…a bank may **validate, store, and record payments transactions** by serving as a node on an INVN."

- "…a bank may **use INVNs and related stablecoins** to carry out other permissible payment activities."

The OCC stated that the bank must conduct these activities consistent with "applicable law and safe and sound banking practices." Banks should have the capability to obtain and verify the identity of all transacting parties, including those using Unhosted wallets.

In this new regime, where regulators defer to the bank to determine and manage risk, we believe banks will be expected to have appropriate systems, controls, and practices in place to manage these risks, including to safeguard reserve assets.

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Read Our Research

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