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IN FOCUS

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Crypto and Banking: Policy Issues

Some banks have expressed interest in offering services related to cryptocurrencies and other digital assets. Yet extreme and persistent price volatility—along with several high-profile scandals, scams, thefts, and failures—have generated debate on the risks crypto could pose for banks and their customers if not properly managed.

Banks could gain exposure to crypto by providing some types of cryptocurrency services. Alternatively, cryptocurrency firms may seek bank charters, forming banking organizations with crypto operations. While regulators at the state and federal levels have already begun to allow certain crypto firms to obtain limited purpose banking charters (see CRS In Focus IF11997, *Bank Custody, Trust Banks, and Cryptocurrency*), this In Focus analyzes the extent to which banking regulators—the Federal Reserve (Fed), Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC)—are considering the role traditional banks should have in crypto markets. To date, Congress has deferred to regulators to set crypto policy for banks but may consider future legislation due to policy differences or because regulators have not created an overarching framework, instead employing an ad hoc approach generally outside the administrative rulemaking process.

Bank Regulation and Crypto

Crypto poses many of the risks for which banks are closely regulated, including safety and soundness, consumer protection, and anti-money laundering. Because banks are protected by a federal safety net, safety and soundness risks to banks are ultimately borne by taxpayers. Regulators or Congress can choose whether to manage these risks by prohibiting activities that are not consistent with these requirements or by imposing regulatory requirements to mitigate them.

Regulators or Congress could set regulatory requirements around crypto that make it attractive or unattractive for bank participation. When an activity is highly risky, regulators can allow it but set the regulatory cost unattractively high. Alternatively, sometimes regulators or Congress decide that the risk-benefit trade-off of an activity is not favorable and impose blanket bans on bank participation in certain activities or asset classes—an option for addressing crypto. A downside to a blanket ban is that different types of crypto-related activities pose different levels of risk. Instead of regulating crypto uniformly, Fed Vice Chair Barr has called for ensuring that "crypto activity inside banks is well regulated, based on the principle of same risk, same activity, same regulation, regardless of the technology used for the activity."

Risk is not the only reason a bank might not be allowed to engage in an activity under current law. A central tenet of bank regulation is that banks should engage only in activities that are part of or incidental to the business of banking. Some such activities are explicitly laid out in statute, while others have been interpreted to be related by the bank regulators. Bank regulators or Congress could choose to allow (or prohibit) some or all activities related to cryptocurrency on the basis that they are (or are not) closely related to the business of banking.

Although bank regulators can manage the risks a bank takes, they cannot directly address risks in underlying crypto markets. Fed Vice Chair Brainard argued, "It is important for banks to engage with beneficial innovation and upgrade capabilities in digital finance, but until there is a strong regulatory framework for crypto finance, bank involvement might further entrench a riskier and less compliant ecosystem." Further bank entry into crypto might increase risk. For example, banks can be a source of systemic risk to financial stability. High-risk crypto activities might pose minimal systemic risk outside the banking system (even if they pose other risks) but could pose systemic risk if bank involvement threatened the stability of the banking system.

Until now, this In Focus has considered options to *limit* bank involvement in crypto in order to reduce risk to banks (and by extension the financial system). Another strategy is to bring aspects of crypto *into* the banking regulatory umbrella to reduce the risk of crypto and provide legitimacy to the industry. Some policymakers have proposed limiting certain crypto activities *only* to banks. For example, a 2021 report issued by the Treasury and regulators called for prudential regulation of payment stablecoins to address systemic risk (on the grounds that stablecoins are prone to destabilizing run risk). Specifically, the report called for legislation allowing only insured depositories to issue payment stablecoins. Today, stablecoins available to consumers are generally issued by nonbanks. Other proposals call for banks to issue payment stablecoins in competition with nonbank issuers. Under existing authority, bank regulators may be able to allow banks to issue payment stablecoins but could not prevent nonbanks from issuing them. (See CRS Legal Sidebar LSB10754, *Stablecoins: Legal Issues and Regulatory Options (Part 2)*.)

One strategy would be for regulators to take no significant action in the short run. This could discourage banks from taking risks that might result in disciplinary action while regulators evaluate and formalize potential rules. It is also possible that regulators could slow-walk regulation and guidance in an attempt to avoid clashes with industry while at the same time allowing banks to develop their own

blockchain-based technologies (like those underlying crypto) to compete with the crypto sector. Regulators used a wait-and-see approach during the advent of mobile payments, which ultimately became largely a bank product, limiting the need for new regulation.

Bank Holding Companies (BHCs)

Instead of engaging in crypto activities through a bank subsidiary, a parent BHC might choose to place crypto-related activities in a nonbank subsidiary legally separate from any bank subsidiaries. BHCs are subject to a different set of rules than banks are. Generally, BHCs may own nonbank subsidiaries so long as the business of those subsidiaries is "financial in nature." As the regulator of BHCs, the Fed has limited authority over nonbank subsidiaries, which is even more limited if the subsidiary had another primary regulator, such as the Securities and Exchange Commission. Under "source of strength" requirements, the Fed would have authority to require that the subsidiary not place the safety and soundness of the bank subsidiaries or holding company at risk. Thus, for a BHC to operate a crypto subsidiary, it would need to meet the "financial in nature" and "source of strength" tests.

Current Bank Involvement in Crypto

There are multiple types of activities a bank could potentially undertake involving crypto. In 2021, the Fed, OCC, and FDIC identified areas where banks might engage in crypto-related activities, such as issuing payment stablecoins (discussed below), providing custody services, facilitating crypto transactions for customers, making loans using crypto as collateral, and holding crypto on their own balance sheets. This section highlights examples of crypto services offered by traditional banks, but it is not exhaustive.

Custody services is generally defined as settlement, safekeeping, and reporting of customers' marketable securities. Commercial banks offer these types of services in addition to their core banking activities, while trust or custodian banks focus primarily on custody and fiduciary activities. Bank of New York Mellon (BNYM), for example, one of the largest custodian banks, provides primary custodial services of reserves for the USD Coin (USDC), a stablecoin issued by Circle. In addition, BNYM permits certain clients to hold and transfer Bitcoin and Ether, and State Street Bank announced it may do so soon.

Silvergate, a state-chartered bank regulated by the Fed, specializes in crypto-related services. Silvergate offers the Silvergate Exchange Network (SEN), which allows its various crypto clients to send dollars and euros among members "enabling near real-time transfers and immediate availability of funds." The fiat reserves of crypto platforms—presumably clients of SEN—made up 90% of the bank's liabilities as of the end of the third quarter 2022. The bank also advertises loans collateralized by Bitcoin. Silvergate, whose SEN network was used by entities owned by FTX, the failed crypto exchange that lost more than $8 billion, demonstrates how cryptocurrency could pose risks to a bank's safety and soundness. In the wake of numerous crypto platform collapses and concerns of contagion in the industry, Silvergate's business model was challenged, and it experienced a sharp decline in deposits and share price. Signature Bank also experienced a sharp decline in deposits and share price after concerns about its crypto exposure.

Banks may also use the technology that facilitates crypto to carry out functions currently performed by traditional technologies. For example, JPMorgan Chase (JPM) has begun experimenting with various blockchain applications. Unlike the blockchains employed by cryptocurrencies such as Bitcoin, those used by JPM are accessible only to approved users, usually JPM employees. This controlled use of the technology that supports cryptocurrencies may introduce operational risks, but it is fundamentally different from industry exposure to crypto markets.

Bank Regulatory Policy Initiatives

Regulation of bank involvement in crypto is still evolving. Currently, regulators have not created a transparent and overarching framework for bank participation in crypto. Instead, regulators are making decisions on a case-by-case basis through the supervisory process. In the past decade or so, federal bank regulators have developed guidance and policy to provide clarity to the banking system on permissible crypto activities. However, as leadership has changed and crypto markets have risen and fallen, some agencies have changed their positions on the risk-benefit trade-off of crypto, such that it may not be entirely clear what banks might expect from regulators long term. For example, in 2020 and 2021, then-acting OCC head Brian Brooks issued a series of interpretive letters to provide guidance and clarify that national banks and federal savings associations were authorized to provide custody services for cryptocurrency assets, hold certain stablecoin reserves, and use stablecoins to engage in and facilitate payment activities. But then, current OCC acting head Michael Hsu issued an interpretive letter to clarify that banks must notify and obtain permission from their supervisory offices before they engage in these activities. Similarly, in 2022, the Fed and FDIC separately released supervisory letters informing banks under their jurisdictions that they must notify their regulators before engaging in crypto-related activities.

Most recently, the federal banking regulators issued a joint statement clarifying that banks are "neither prohibited nor discouraged from providing banking services" to legal crypto firms. However, the statement also emphasized the multiple risks posed by crypto and noted that banks "issuing or holding as principal crypto-assets that are issued, stored, or transferred on an open, public, and/or decentralized network, or similar system is highly likely to be inconsistent with safe and sound banking practices."

One way that banks are regulated for safety and soundness is through capital requirements. Although U.S. regulators have not yet determined under what circumstances banks could hold crypto assets on their balance sheets, the Basel Committee on Bank Supervision (an international forum to devise regulatory standards) is in the process of formulating international capital standards for bank exposures to crypto. Typically, U.S. bank regulators have implemented Basel standards through the domestic rulemaking process.

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