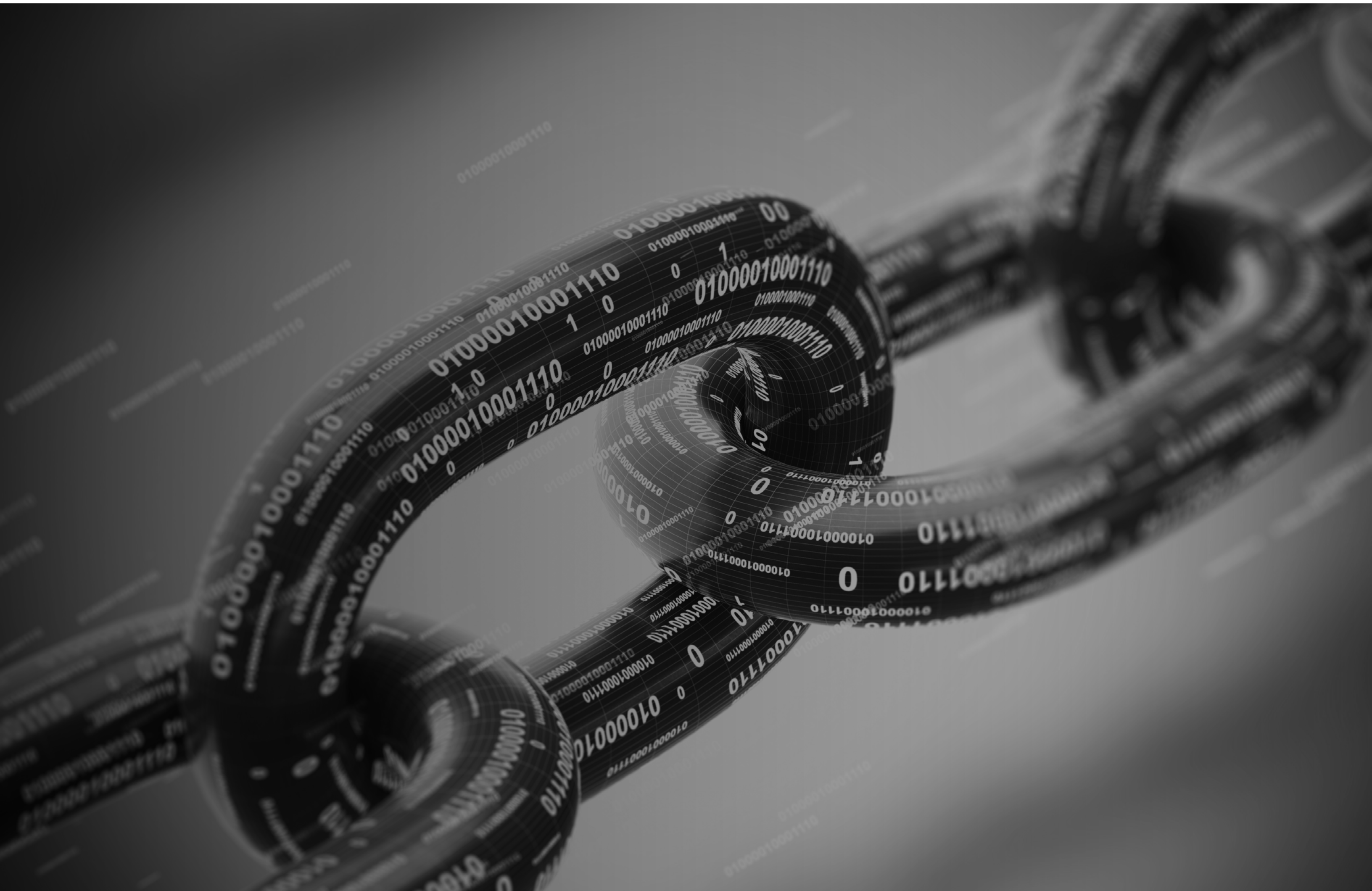
CRYPTOCURRENCIES RECEIVE ANOTHER SIGNIFICANT ENDORSEMENT FROM U.S. REGULATORS



OCC GUIDANCE PUSHES BANKS TO EXAMINE STABLE COINS

The Office of the Comptroller of the Currency (OCC) supports the burgeoning world of cryptocurrencies and digital assets with a recent letter outlining how federally chartered banks can incorporate stable coins into their business. The most recent letter, dated January 4, 2021, clarifies that U.S. banks can use stable coins for payments (both internal to the bank and external to other parties). Additionally, they can use them to participate as nodes on "independent node verification networks" (INVNs), also known as blockchain networks. This letter is the latest in a line of favorable rulings from the U.S. bank regulator, an agenda that has been pushed by Brian Brooks, the former Acting Comptroller of the Currency. Brooks, who also lists former general counsel of the cryptocurrency exchange Coinbase on his resume, stepped down on January 14, 2021, likely to make way for President-elect Joe Biden's head of the agency. While it remains to be seen whether OCC and other federal regulators will continue to support the crypto-favorable agenda championed by Brooks, this latest regulation does open the door immediately for banks and savings associations to take advantage of stable coins as an alternative payment rail. However, the question remains, are stable coins the way of the future or a fad? In this blog, we examine the potential benefits and risks of the nascent technology and posit how organizations can leverage stable coins to improve their businesses.

WHAT IS A STABLE COIN?

A stable coin is a cryptocurrency backed by a reserve asset and whose value is pegged to a specific reference, commonly to the U.S. dollar. These assets attempt to control the volatility common with cryptocurrencies such as Bitcoin and Ethereum while still retaining the paperless efficiency and secure settlement of blockchain technology. While there are lots of stable coins already on the market, the largest market capitalization are Tether and USD Coin, both of which are pegged to the U.S. dollar and have some form of reserve asset in USD to collateralize the issuance of the stable coin. JP Morgan has also dipped their toes into the stable coin world by issuing its own JPM Coin, which is also pegged to the U.S. dollar and backed by assets held in accounts by JP Morgan. Contrary to Tether and USD Coin, JPM Coin is issued on a private blockchain and is not available for purchase on digital asset exchanges such as Coinbase or Gemini.

STABLE COIN BENEFITS – OPERATIONAL IMPROVEMENTS AND PATHWAYS TO DIGITAL DOLLAR

Stable coins can potentially help improve financial institutions' efficiency and cost reduction efforts across a host of areas. The movement of funds both externally and internally is one of the most applicable use cases. The use of stable coins largely removes the need for a central intermediary (i.e., SWIFT, ACH, FedWire). This makes it cheaper and faster for banks to transfer funds, as these flows are not subject to third-party transaction fees and or slowed by holidays, weekends, or 24-hour payments systems. Moreover, stable coins can offer stronger security controls given the decentralized nature of the verification process necessary to move funds. Instead of relying on a single or small group of entities, INVNs allows for a larger pool of actors to validate transactions, limiting potential errors and unwanted tampering. The increased use of stable coins will also help banks lay the groundwork to better interface with the Federal Reserve if it develops its Central Bank Digital Currencies (CBDC). An established stable coin network will be necessary for the Federal Reserve to properly transfer its CBDC directly to banks and other members of the financial ecosystem. As such, we expect the recent OCC guidance to further fuel banks' development of stable coin frameworks, which would support a digital dollar's efficacy.

NAVIGATING THE SIGNIFICANT OPERATIONAL AND COMPLIANCE RISKS

However, the large benefits that can be realized do not come without a large amount of operational and compliance risk. Banks using stable coins must ensure they have procedures reasonably designed to assure and monitor compliance with the BSA/AML and their implementing regulations, including but not limited to: (i) customer due diligence requirements under the BSA; (ii) the customer identification requirements under section 326 of the USA PATRIOT Act; and (iii) identification/verification of the beneficial owners of legal entity customers opening accounts. Extending BSA/AML processes and procedures for existing processes may not be enough and may require more bespoke processes and technologies to ensure compliance – e.g., transaction monitoring, KYC, and sanctions.

Banks offering INVN and stable coin must also evaluate and manage the risks presented by offering cryptocurrency services. For example, because banks may receive cash reserves backing an issuer's stable coin via deposits, they must be aware (among other things) of deposit insurance coverage requirements and related customer disclosure needs. The OCC will expect banks offering these deposit services to manage the related liquidity risk with "sophistication equal to the risks…and complexity of exposures." This effectively means a sufficient availability of a cushion of unencumbered highly liquid assets without legal, regulatory, or operational impediments that can be sold or pledged to obtain funds in a range of stress scenarios. With various types of stable coin, financial institutions should be mindful of the collateral requirements that come with each option (e.g., decentralized stable coins backed by cryptocurrencies rather than fiat will require more collateral to mint) and assess alignment with their overall plan/strategy.

MOMENTUM IS BUILDING – PATHS FORWARD FOR BANKS AND FINTECHS

In conclusion, as with any new development, banks will have to weigh the benefits versus the risks in their decision to integrate stable coins into their payment infrastructure. Those best poised to take advantage of these developments are fintechs with low technical debt and a high ability to adapt to changing regulatory environments. Legacy organizations may best be served by partnering with a fintech to implement a service like this through an API, allowing the fintech to take on some risks and provide the processing power. In other positive news for the crypto-world, the OCC also recently granted a national trust charter to Anchorage, the first US-based digital asset bank. Anchorage will be providing custody of digital assets, including stable coins, and financing products based on digital assets. Serious integration possibilities arise in this new landscape where established players can integrate with a firm such as Anchorage to offer a new service to customers while retaining their core business and account infrastructure. What's most important for organizations to take advantage of this changing landscape is to have flexibility in operating models, technology landscape, and risk evaluation models.

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