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Prudential Regulators Issue Joint Statement on Crypto-Asset Risks

Federal Reserve, FDIC, and OCC statement highlights crypto-asset risks to banking organizations

SUMMARY

On January 3, 2023, the prudential bank regulators released a joint statement regarding banking organizations and the crypto-asset sector. The statement highlights "crypto-asset risks" of which the regulators believe banking organizations should be aware. While acknowledging that banking organizations are, subject to applicable law, neither prohibited nor discouraged from providing services to any particular class of customers, the regulators state that: (1) 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" and (2) the agencies have "significant safety and soundness concerns" associated with business models that are concentrated in crypto-asset-related activities or have concentrated exposures to the crypto-asset sector.

THE JOINT STATEMENT

The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (the "Prudential Regulators") released a Joint Statement on Crypto-Asset Risks to Banking Organizations (the "Joint Statement") on January 3, 2023.[1] Noting that events of the past year have been characterized by "significant volatility and the exposure of vulnerabilities in the crypto-asset sector,"[2] and following other recent actions taken by the Prudential Regulators and others,[3] the Joint Statement (1) highlights key risks relevant to banking organizations and (2) discusses the Prudential Regulators' views regarding whether crypto-asset activities are consistent with safe and sound banking practices.

A. CRYPTO-ASSET RISKS

The Joint Statement lists the following "key risks" relating to crypto-assets and crypto-asset sector participants:

- Risk of fraud and scams among crypto-asset sector participants.
- Legal uncertainties related to custody practices, redemptions, and ownership rights, some of which are currently the subject of legal processes and proceedings.
- Inaccurate or misleading representations and disclosures by crypto-asset companies, including misrepresentations regarding federal deposit insurance, and other practices that may be unfair, deceptive, or abusive, contributing to significant harm to retail and institutional investors, customers, and counterparties.
- Significant volatility in crypto-asset markets, the effects of which include potential impacts on deposit flows associated with crypto-asset companies.
- Susceptibility of stablecoins to run risk, creating potential deposit outflows for banking organizations that hold stablecoin reserves.
- Contagion and concentration risk within the crypto-asset sector resulting from interconnections among certain crypto-asset participants, including through opaque lending, investing, funding, service, and operational arrangements.[4]
- Risk management and governance practices in the crypto-asset sector exhibiting a lack of maturity and robustness.
- Heightened risks associated with open, public, and/or decentralized networks, or similar systems, including, but not limited to, the lack of governance mechanisms establishing oversight of the system; the absence of contracts or standards to clearly establish roles, responsibilities, and liabilities; and vulnerabilities related to cyber-attacks, outages, lost or trapped assets, and illicit finance.[5]

B. IMPLICATIONS

Given these risks, the Joint Statement provides that the Prudential Regulators will "continue to take a careful and cautious approach" in supervising current or future crypto-asset-related activities and exposures of banking organizations, including entities seeking to become chartered.[6] In this regard, the Prudential Regulators will continue to assess "whether or how current and proposed crypto-asset-related activities by banking organizations can be conducted in a manner that adequately addresses safety and soundness, consumer protection, legal permissibility, and compliance with applicable laws and regulations, including anti-money laundering and illicit finance statutes and rules."[7]

Notably, the Joint Statement outlines the Prudential Regulators' views that: (1) "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"; and (2) "business models that are concentrated in crypto-asset-related activities or have concentrated exposures to the crypto-asset sector" raise "significant" safety and soundness concerns.[8]

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ENDNOTES

1 Joint Statement on Crypto-Asset Risks to Banking Organizations, Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (January 3, 2023), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf.

2 The Joint Statement uses "crypto-asset" to "refer generally to any digital asset implemented using cryptographic techniques." *Id.* at 1.

3 *See*, *e.g.*, (1) the Federal Reserve's supervisory letter regarding crypto-asset-related activities (*see* Sullivan & Cromwell LLP, "Federal Reserve Requires Notification of Crypto-Asset-Related Activities" (August 22, 2022), *available at* https://www.sullcrom.com/sc-publication-federal-reserve-requires-notification-of-crypto-asset-related-activities); (2) the FDIC's Financial Institution Letter regarding crypto-related activities (*see* Sullivan & Cromwell LLP, "FDIC Requires Notification of Crypto-Related Activities" (April 8, 2022), *available at* https://www.sullcrom.com/sc-publication-fdic-requires-notification-crypto-related-activities); (3) President Biden's Executive Order on Digital Assets (*see* Sullivan & Cromwell LLP, "Executive Order on Digital Assets" (March 9, 2022), *available at* https://www.sullcrom.com/files/upload/sc-publication-executive-order-on-digital-assets.pdf); (4) the OCC's interpretive letter regarding the authority of banks to engage in cryptocurrency activities (*see* Sullivan & Cromwell LLP, "OCC Issues Interpretive Letter Regarding the Authority of Banks to Engage in Cryptocurrency Activities" (December 21, 2021), *available at* https://www.sullcrom.com/sc-publication-occ-issues-interpretive-letter-regarding-authority-of-banks-to-engage-in-cryptocurrency); (5) the federal banking regulators' joint statement on their crypto-asset "policy sprint" (*see* Sullivan & Cromwell LLP "Federal Banking Agencies Release Joint Statement on Crypto-Asset 'Policy Sprint' Initiative" (November 24, 2021), *available at* https://www.sullcrom.com/sc-publication-federal-banking-agencies-release-joint-statement-crypto-asset-policy-sprint-initiative); and (6) the President's Working Group on Financial Markets' Report on Stablecoins (*see* Sullivan & Cromwell LLP, "President's Working Group on Financial Markets Issues Report on Stablecoins" (November 5, 2021), *available at* https://www.sullcrom.com/sc-publication-presidents-working-group-on-financial-markets-issues-report-on-stablecoins).

4 In this regard, the Joint Statement notes that "[i]t is important that risks related to the crypto-asset sector that cannot be mitigated or controlled do not migrate to the banking system." Joint Statement at 1.

5 *Id.*

6 *Id.* at 2; n. 3.

7 *Id.* at 2. In this regard, the Joint Statement also highlights that each of the Prudential Regulators has developed processes to enable banking organizations to engage with the relevant regulator to discuss proposed and existing crypto-asset-related activities. *Id.* at 2, n.2. Please see the memoranda cited in endnote 3 above discussing these processes.

8 *Id.*

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