Statement for the Record

On Behalf of the

American Bankers Association

Before the

Committee on Financial Services

U.S. House of Representatives

December 8, 2021

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Chairwoman Waters, Ranking Member McHenry, and distinguished Members of the Committee, the American Bankers Association (**ABA**)[1] appreciates the opportunity to submit a statement for the record for the hearing titled "Digital Assets and the Future of Finance: Understanding the Challenges and Benefits of Financial Innovation in the United States." The topic of today's hearing is an important one.

We appreciate the Committee's attention to these important issues. The digital asset marketplace is growing rapidly. The total market capitalization of all cryptocurrencies (including stablecoins), by some estimates, reached over $3 trillion in November of 2021. Digital assets have the potential to be a catalyst for change in traditional financial markets, with significant implications for our financial system, economy, markets, and most importantly for the American consumer.

The origins of cryptocurrency were driven by the desire to build a "trustless" financial system, where parties can transact directly with each other without the need for a trusted third party. It is ironic, therefore, that as interest in cryptocurrencies and other digital assets continue to grow, consumers engaging with digital assets most often seek out trusted financial institutions to act as financial intermediaries. ABA believes that customers who choose to access digital asset markets will be best served when they can do so through fully regulated banks where they are afforded robust consumer protection. To accommodate this customer demand, banks are actively evaluating ways to safely and responsibly allow their customers to buy, hold, and sell digital assets through their existing banking relationships.

Today, the digital asset marketplace can feel like the Wild West—where there is seemingly limitless opportunity for growth, but the risks are not always adequately addressed. For example, hundreds of millions of dollars in cryptocurrencies can go missing on a lost USB drive, the world's largest coin exchange can go bust after the theft of 850,000 bitcoin, stablecoin issuers misrepresent the reserves backing their coins, and crypto is the currency of choice in ransomware attacks.

[1] *The ABA is the voice of the nation's $23.3 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $19.2 trillion in deposits and extend $11 trillion in loans.*

By comparison, banks, which have been around for hundreds of years and understand the risks inherent to their businesses, have in place comprehensive risk management procedures. Moreover, banks are subject to a robust set of safety and soundness regulations, adhere to stringent consumer protection laws, and maintain robust anti-money laundering practices. In addition, banks are subject to rigorous oversight and supervision to ensure compliance with these and other requirements. These factors, in combination with deposit insurance from the Federal Deposit Insurance Corporation (**FDIC**), make banks a safe place for consumers to store their funds.

This level of oversight and supervision should be applied to banks and non-banks alike to ensure all customers are protected equally, regardless of where they engage with the financial marketplace. As non-bank technology firms begin offering banking products and services through digital channels, Congress should ensure that these activities are appropriately monitored, emerging risks adequately captured, and all applicable legal requirements met.

Ultimately, a level regulatory playing field in digital assets means a simple proposition: offer bank-like services, receive bank-like oversight. In other words, as Acting Comptroller Michael Hsu has emphasized, "Because you do, you are; and because you are, you do."[2] Securities and Exchange Commission Chairman Gary Gensler is right to observe that the crypto sector is "at the level and the nature that if it's going to have any relevance five and 10 years from now, it's going to be within a public policy framework. History just tells you it doesn't last long outside."[3] Permitting digital asset activity to occur outside the regulatory perimeter poses risks to consumers and the financial system.[4]

To aid the Committee in its consideration of the complex issues surrounding the three main types of digital assets—cryptocurrencies, stablecoins, and central bank digital currencies—we have appended to this statement the following four documents:

(1) The comment letter the ABA submitted in response to a recent request for information by the FDIC on banks' use of digital assets.[5] In this letter, we offer recommendations for regulators on how banks can responsibly facilitate customer access to these markets, arguing that customers who choose to

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[2] Acting Comptroller Michael J. Hsu, "Modernizing the Financial Regulatory Perimeter," Remarks before the Federal Reserve Bank of Philadelphia Fifth Annual Fintech Conference (Nov. 16, 2021), https://www.occ.gov/news-issuances/speeches/2021/pub-speech-2021-117.pdf.

[3] Financial Times, "Crypto Platforms Need Regulation to Survive, Says SEC Boss" (Aug. 31, 2021), https://www.ft.com/content/fb126d79-2e60-4002-8aba-b08887fca609.

[4] *See, e.g.*, Acting Comptroller Michael J. Hsu, "Modernizing the Financial Regulatory Perimeter," *supra* note 2.

[5] ABA Comment Letter on FDIC RFI on Digital Assets (July 15, 2021), https://www.aba.com/advocacy/policy-analysis/aba-comment-letter-on-fdic-rfi-on-digital-assets.

access these markets are best served when they can do so through banks that are subject to rigorous oversight and supervision to ensure compliance with appropriate safety and soundness and consumer protection requirements.

(2) The ABA's response to the recent Basel Committee's consultation on the prudential treatment of cryptoasset exposures.[6] In this letter, we address the prudential treatment of banks' cryptoasset exposures and note that the overall stability of the global financial system will benefit from the transparency that will result by conducting a significant share of the cryptoasset market through supervised financial institutions, as opposed to being driven outside the banking system.

(3) An assessment of the report on stablecoins by the President's Working Group on Financial Markets, together with the FDIC and the Office of the Comptroller of the Currency. In this document, we support the recommendations made by the PWG to require stablecoin issuers to be insured depository institutions subject to appropriate supervision and regulation at the depository institution and the holding company level and require custodial wallet providers to be subject to appropriate federal oversight, as well as require stablecoin issuers to comply with activities restrictions that limit affiliation with commercial entities.

(4) The statement for the record that the ABA submitted on CBDC to the Subcommittee on National Security, International Development, and Monetary Policy of the House Financial Services Committee.[7] In this statement, we argue that the retail use case(s) for CBDC introduce risks far in excess of possible benefits because (1) a high proportion of American consumers have retail bank accounts, and (2) electronic payments in U.S. are pervasive, highly efficient and competitive. Moreover, a retail CBDC that competes for commercial bank deposits would adversely affect bank cost of funding, and ultimately, the cost of credit to the real economy by reducing commercial banks' ability to make loans. We further note that a wholesale CBDC model also raises a number of difficult policy issues, but is beyond the scope of this statement. Depending on its structure, including whether such a payments system would be interoperable with existing systems, this could adversely affect U.S. payments systems.

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[6] ABA Letter to BCBS re: Crypto Consultation (Sep. 10, 2021), https://www.aba.com/advocacy/policy-analysis/aba-letter-to-bcbs-re-crypto-consultation; *see also* Basel Committee on Banking Supervision, *Consultative Document: Prudential Treatment of Cryptoasset Exposures* (June 2021), https://www.bis.org/bcbs/publ/d519.pdf.

[7] Statement for the Record Before the Subcommittee on National Security, International Development, and Monetary Policy Of the Financial Services Committee (July 27, 2021), https://www.aba.com/-/media/documents/testimonies-and-speeches/cbdc-testimony-hfsc-nsidmp-subcommittee-hearing-07272021.pdf?rev=86c7a8b8fa6c4cfabe906db9c972e9f8.

Appendices

(1) ABA Assessment of President's Working Group on Financial Markets' Report on Stablecoins

(2) ABA Comment Letter on FDIC RFI on Digital Assets (submitted July 15, 2021)

(3) ABA Letter to BCBS re: Crypto Consultation (submitted Sep. 10, 2021)

(4) ABA Statement for the Record on Central Bank Digital Currency (submitted July 27, 2021)

APPENDIX 1

Filling Gaps in Stablecoin Regulation

The President's Working Group on Financial Markets, together with the FDIC and OCC, recently released a report on crypto tokens pegged or linked to the value of fiat currencies, so-called stablecoins (Report).[1] Given the risks these products pose to consumers, the payments system, and the broader financial system, the Report recommends that Congress act promptly to enact legislation to ensure that stablecoin arrangements are subject to a consistent and comprehensive federal prudential regulatory framework. The Report also identifies certain interim measures detailing how financial and banking regulators can address stablecoin risks falling within their respective jurisdiction. In addition, in the absence of Congressional action, the Report recommends that the Financial Stability Oversite Council (FSOC) consider steps to address the risks outlined in the Report. **ABA agrees that action is urgently needed to address the gaps in the federal regulation of the stablecoin market and supports many of the Report's recommendations.**

Stablecoins, unlike other financial instruments, are currently not subject to a consistent, comprehensive set of regulatory standards that mitigate the risks they pose to consumers and the financial system. The lack of regulation is particularly concerning as the rapidly evolving uses of stablecoins is fueling significant market growth. To date, stablecoins have primarily been used to facilitate digital asset trading and lending activities, but increasingly they are being used as a means of payment for real-world goods and services (*e.g.*, Facebook/Meta's new digital wallet using stablecoins, called "Novi Wallet").

While enthusiasts claim that stablecoins have the potential to support faster and more efficient payments options, stablecoins pose a number of unmitigated risks. These risks include harm to consumers as well as a range of prudential concerns, including the potential for stablecoin runs and payment system risks, both of which could spill over into the broader financial system. The possibility that some stablecoins may rapidly scale also raises additional issues related to the concentration of economic power.

Accordingly, ABA supports appropriate regulatory and legislative actions to provide a comprehensive regulatory framework for stablecoins. While Congressional action is pending, we encourage regulatory agencies to use their existing authorities to identify and address the risks of stablecoin arrangements, as well as FSOC to engage in a determination of whether certain activities conducted within a stablecoin arrangement are, or are likely to become, systemically important payment, clearing, and/or settlement activities.

In connection with this, ABA wishes to emphasize that any regulatory or Congressional action should:

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[1] President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, *Report on Stablecoins* (Nov. 2021), https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf.

- Provide a clear and comprehensive definition of "stablecoin" that avoids creating loopholes or permitting regulatory arbitrage and that clearly differentiates stablecoins from other types of digital assets. This would also ensure the regulatory treatment of stablecoins is appropriately calibrated to their risks;
- Recognize that stablecoin arrangements pose *both* financial risks *and* consumer and investor protection concerns, making it critical to regulate not just the issuers of stablecoins, but also other participants in the stablecoin ecosystem, including custodial wallet providers and parties engaged in the business of stablecoin trading and/or brokerage;
- Encourage banking and financial regulators to collaborate on and coordinate a comprehensive approach to prevent the rise of unregulated (or under-regulated) stablecoin issuers and platforms that could pose risks to consumers, investors, the financial system, and the general economy; and
- Provide consistent treatment of banks and non-banks that engage in similar stablecoin activity to prevent regulatory arbitrage and ensure all customers are protected equally.

* * *

ABA Assessment of Legislative Recommendations in the PWG Report	
Legislative Recommendations	**ABA Assessment**
Stablecoin Runs: Require stablecoin issuers to be insured depository institutions, subject to appropriate supervision and regulation at the depository institution and the holding company level, and require them to be subject to standards and regulations aimed at managing liquidity risk.	ABA supports this recommendation. Requiring stablecoin issuers to be insured depository institutions, subject along with their key affiliates to consolidated supervision and prudential regulation, is the most effective way to address risks to stablecoin users and guard against stablecoin runs.
Payment System Risk: Require custodial wallet providers to be subject to appropriate federal oversight. Provide the federal supervisor of a stablecoin issuer with the authority to require any entity that performs activities that are critical to the functioning of the stablecoin arrangement to meet appropriate risk-management standards.	ABA supports these recommendations. Custodial wallet providers play a key role in the stablecoin ecosystem, and it is critical that they be subject to appropriate federal oversight to address payment system risk. This should include, among other things, requirements for clear and complete disclosures and protections against fraud, manipulation, and related risks, as well as appropriate risk management standards.
Systemic Risk and Concentration: Require stablecoin issuers to comply with activities	ABA supports imposing activities restrictions that limit the affiliation of stablecoin issuers

restrictions that limit affiliation with commercial entities. Supervisors should have authority to implement standards to promote interoperability among stablecoins. In addition, Congress may wish to consider other standards for custodial wallet providers, such as limits on affiliation with commercial entities or on use of users' transaction data.	with commercial entities to prevent the concentration of economic power and address additional concerns about systemic risk. Interoperability among stablecoins and between stablecoins and other payment instruments is critical in order not to disrupt existing payments systems. Appropriate restrictions that limit affiliation of custodial wallet providers with commercial entities and the use of users' transaction data will help to prevent concentration of economic power.

APPENDIX 2

American Bankers Association
Building Success. Together.

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July 15, 2021

FEDERAL DEPOSIT INSURANCE CORPORATION
James P. Sheesley
Assistant Executive Secretary
Attention: Comments-RIN 3064-ZA5
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Re: Request for Information and Comment on Digital Assets (RIN 3064–ZA25)

Ladies and Gentlemen:

The American Bankers Association ("**ABA**")[1] welcomes the opportunity to comment on the request by the Federal Deposit Insurance Corporation ("**FDIC**") for information and comment concerning insured depository institutions' current and potential activities related to digital assets ("**RFI**").[2] This RFI is a timely look at an important issue. Digital asset markets are relatively new and have the potential to be a catalyst for change in financial markets.

Banks are actively evaluating ways to safely and responsibly allow their customers to buy, hold, and sell digital assets through their existing banking relationships. ABA believes that customers who choose to access these markets are best served when they can do so through banks that are subject to rigorous oversight and supervision to ensure compliance with appropriate safety and soundness and consumer protection requirements. However, significant questions remain regarding the regulation of these markets. In this letter, we highlight the need for (1) a consistent taxonomy for digital assets, (2) regulatory clarity regarding what digital asset activity is permissible for a bank, and (3) consistent regulation of banks and non-banks engaged in digital asset activity.

Accordingly, we support the FDIC's efforts to seek more information regarding the use of digital assets in financial markets and intermediation, as well as in connection with settlement and payment systems. ABA encourages the FDIC to promote responsible innovation so that banks can meet their customers' needs by offering products and services in the digital asset space.

[1] The American Bankers Association is the voice of the nation's $21.5 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard $18 trillion in deposits and extend nearly $11 trillion in loans.

[2] FDIC, Request for Information and Comment on Digital Assets, 86 Fed. Reg. 27602 (May 21, 2021), https://www.govinfo.gov/content/pkg/FR-2021-05-21/pdf/2021-10772.pdf.

I. Background

The FDIC requests comment generally on the broad categories of digital assets and related activities described in the RFI. However, the RFI does not define the term "digital asset." While there is no generally agreed upon definition, for the purposes of this letter, we will broadly construe the term "digital asset" to mean private digital assets that depend primarily on cryptography and distributed ledger or similar technology.[3] This includes privately-issued cryptocurrencies (such as Bitcoin and Ethereum), stablecoins, and non-fungible tokens. In this letter, we will not address the treatment of tokenized commercial bank money,[4] tokenized securities, or central bank digital currencies ("**CBDCs**").[5]

Digital assets, in the form of cryptocurrencies, were initially intended to be used to facilitate payments transactions. In some cases, their protocols claim to make participants' transactions anonymous. As the market has developed, new use cases have emerged. In fact, there is a diverse, complex, and rapidly evolving ecosystem of digital asset products today. The digital and programmable nature of these products means that they can be used to facilitate many kinds of financial activities that increasingly mirror the products and services offered by traditional financial institutions—to cite two examples: decentralized finance ("**DeFi**") lending and stablecoin yield farming.[6]

Although this market continues to develop at a rapid pace, there remains significant uncertainty related to the regulation of digital assets. Among other things, this uncertainty makes it difficult to identify the legal status of a cryptocurrency. Given the regulatory uncertainty surrounding the framework applicable to digital assets, banks have moved more carefully to market than many of the less regulated providers of these services. Such non-bank market entrants are typically not subject to prudential regulation and examination, are not subject to robust capital and liquidity requirement, and could expose consumers and counterparties to harm.[7]

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[3] *See, e.g.*, Financial Stability Board, Regulation, *Supervision and Oversight of "Global Stablecoin" Arrangements* (Oct. 13, 2020), https://www.fsb.org/wp-content/uploads/P131020-3.pdf.

[4] Tokens and/or digital coins issued by commercial banks that represent U.S. dollars held in specified accounts are fundamentally different from stablecoins issued by non-bank entities, as they present a mere alternative means for accessing and using funds placed with depository institutions, similar to checks and prepaid debit cards. As direct bank liabilities that meet the statutory definition of "deposits," such tokens do not raise the same risks and issues posed by stablecoins and are already subject to a robust and extensive regulatory framework.

[5] CBDC raise important and complex policy issues that are beyond the scope of this letter.

[6] For a discussion of products and services in the digital asset marketplace, please see ABA, *Understanding Cryptocurrency: What Banks Need to Know* (July 2021), **https://www.aba.com/news-research/research-analysis/understanding-cryptocurrency**.

[7] Given customer demand, not having a clear regulatory framework for financial institutions may push this activity to a less regulated sector with potential implications for financial stability and consumer protection.

II. General Considerations

ABA recognizes that regulators are increasingly interested in the digital asset ecosystem, and we support their continued work to ensure that banks can provide their customers products and services related to digital assets. We encourage regulators to continue to engage in a coordinated fashion to help develop a framework for banks to engage in such activities in a safe and responsible manner. To that end, we wish to raise the following general considerations in connection with the RFI.

A. Characterization of Digital Assets

The ability to understand these markets and how existing regulation applies requires a clear and consistent taxonomy between the FDIC and other regulators. A common taxonomy and understanding of crypto assets' risks and features, broadly consistent and coordinated across all the relevant regulators, is essential to fostering prudent innovation within a sound risk management framework.

To the extent that the FDIC or other U.S. regulator provides regulatory guidance or policy regarding digital assets, it is critical that it work with other regulators and stakeholders to define the term "digital asset," and any related terms, clearly for purposes of the guidance or policy. Lack of clarity regarding what products and services are being addressed or covered by agency action can inadvertently sweep in more products than intended. This can discourage banks from engaging in digital asset activity by imposing unnecessary regulatory costs. For example, the risk profiles of cryptocurrencies like Bitcoin are different from the risk profiles of stablecoins, and therefore their regulatory treatment should be tailored to correspond to their respective riskiness.

Furthermore, to avoid confusion and simplify regulatory compliance, it is critical that the FDIC and other regulators use digital asset terms consistently. Different categorization of the same instrument by different regulators will increase legal uncertainty and lead to unnecessary complexity and inefficiency. In addition, we encourage the FDIC and other banking regulators to work with non-banking regulators to reach consensus and clarity regarding the status of digital assets as cash equivalents, intangibles, securities, or commodities that are not securities, as the legal characterization of digital assets affects their bank regulatory treatment. Regulatory coordination will inevitably take time, so regulators should be transparent in their process and be ready to quickly respond to requests.

B. Regulatory Clarity

Well managed banks have robust risk management and compliance systems that can account for the risks of digital assets, particularly where the core products and services offered (*e.g.*, secured lending) are largely consistent with those offered by banks today. Consistent with prior agency actions, we think it would be appropriate for the FDIC and other banking regulators to clarify that such activities are generally permissible when conducted in a safe and sound manner, notwithstanding the novel technology involved.

Furthermore, since banks often have multiple regulators, it is important for regulators to take a coordinated approach that fosters innovation and gives banks clarity regarding their expectations for safe and responsible digital asset activities. The FDIC can play an important role in collaborating with other banking agencies to promote a common understanding and consistent

application of laws, regulations, and guidance that will support responsible innovation. The FDIC could work more closely not only with the other banking agencies, but also with non-bank agencies whose actions can affect innovation by banks (*e.g.*, the Commodity Futures Trading Commission, Securities and Exchange Commission, Consumer Financial Protection Bureau, and Federal Trade Commission).

C. Consumers and other Market Participants Should Receive Consistent Protections

Banks are already subject to a comprehensive regulatory framework and supervision that help ensure that digital asset activities are implemented carefully and do not lead to unintended consequences. This activity is backed by a culture of compliance and supervision and examination that ensures that any risks are identified and remediated before there is harm to consumers or other market participants.

This level of oversight and supervision should be applied to banks and non-banks alike to ensure all customers are protected equally, regardless of where they engage with the financial marketplace. To this end, the FDIC and other regulators should coordinate their approaches to digital assets to create consistent expectations regarding digital assets, to the extent possible and appropriate. As non-bank technology firms begin offering banking products and services through digital channels, the FDIC and other regulators should coordinate their efforts, to the extent the activity falls within their jurisdiction, to ensure that these activities are appropriately monitored, emerging risks adequately captured, and all applicable legal requirements met.

Certain novel charters raise concerns regarding an uneven application of supervision and regulation. The state of Wyoming created a Special Purpose Depository Charter ("**SPDI**") for cryptocurrency-focused firms that accept uninsured deposits. This exempts these state-chartered banks from being subject to the prudential standards required of federally-insured or supervised financial institutions. The OCC has granted three trust charters to firms operating business models facilitating cryptocurrency payments and digital asset custody instead of traditional trust fiduciary services.[8] Bank policy makers should recognize that although these entities are chartered, they are not subject to all of the same laws and regulations as insured banks.[9]

[8] *See* OCC Interpretive Letter No. 1176, OCC Chief Counsel's Interpretation on National Trust Banks (Jan. 11, 2021), https://occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1176.pdf.

[9] See ABA's previous advocacy in this area: ABA Statement for the Record Before the Subcommittee on Consumer Protection and Financial Institutions re: Banking Innovation and Financial Charters (Apr. 15, 2021), https://www.aba.com/advocacy/policy-analysis/aba-statement-consumer-protection-financial-institutions-banking-innovation; Joint Trades Letter on Interpretive Letter 1176 (May 27, 2021), https://www.aba.com/advocacy/policy-analysis/joint-trades-il-1176; Joint Trades Letter to OCC re: Trust Charter Application (Jan. 8, 2021), https://www.aba.com/advocacy/policy-analysis/joint-trades-letter-to-occ-re-trust-charter-application; Joint Trades Letter to OCC re: Figure Bank (Dec. 7, 2020), https://www.aba.com/advocacy/policy-analysis/joint-trades-letter-to-occ-re-figure-bank; and Joint Trades Letter to OCC re: Novel National Bank Chart Applications (Nov. 20, 2020), https://www.aba.com/advocacy/policy-analysis/joint-trades-letter-to-occ-re-novel-national-bank-chart-applications.

III. Specific Issues

A. Custody Services

ABA believes an appropriately chartered and regulated state or national bank may provide cryptocurrency custody services on behalf of customers, including by holding the unique cryptographic keys associated with cryptocurrency, as part of its existing custody business. Providing cryptocurrency custody services, including holding the unique cryptographic keys associated with cryptocurrency, is a modern form of traditional bankinmg activities.[10] As financial markets develop and become increasingly technological, there will be increasing need for banks to leverage new technology and innovative ways to provide traditional services on behalf of their customers. By providing such services, banks can continue to fulfill the financial intermediation function they have historically played in providing payment, loan, and deposit services.[11] Banks are ideally suited to perform custody services in connection with digital assets because they have the legal and compliance systems in place to address applicable anti-money laundering ("**AML**") requirements, as well as address cybersecurity and risk management issues.

We encourage the FDIC to recognize that providing custodial services for digital assets is a modern form of traditional banking activities.

B. Partnerships with Technology Firms

Developing and bringing to market new or improved financial products, services, and processes is an integral part of a typical bank's business model. Technology firms partner with banks to access the payments system to onboard and offload deposits. Such partnerships are becoming increasingly common and already subject to existing regulatory requirements applicable to banks entering into partnerships with third parties.

We encourage the FDIC to support bank partnerships with non-bank technology firms, where appropriate.

C. Capital Treatment

ABA is working to provide a response to the recent Basel Committee's consultation on the prudential treatment of cryptoasset exposures.[12] We would be happy to share our response to the Basel Committee with the FDIC after it is submitted. We encourage the FDIC to consider the information that is being gathered by the Basel Committee in connection with this consultation, as it is directly relevant to the use of digital assets by banks, as well as their characterization and treatment under various aspects of bank regulatory regimes, including capital and liquidity treatment.

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[10] *See, e.g.,* OCC Interpretive Letter No. 1170, Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers (July 22, 2020), https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1170.pdf.

[11] *See id*.

[12] *See* Basel Committee on Banking Supervision, *Consultative Document: Prudential Treatment of Cryptoasset Exposures* (June 2021), https://www.bis.org/bcbs/publ/d519.pdf.

D. Stablecoins

ABA believes a state or national bank should be able to issue or hold stablecoin "reserves" as a service to bank customers that are issuers of stablecoin. For example, stablecoin issuers may desire to place assets in an account with a state or national bank to provide assurance that the issuer has sufficient assets backing the stablecoin in situations where there is a hosted wallet.[13] State or national banks should also be able to issue stablecoins as direct liabilities of the bank to ensure that utilization of the banking system is not lost over time due to the failure to provide products in demand by customers.[14]

ABA further believes a state or national bank should be able to serve as a node on an independent node verification network ("**INVN**") and use INVNs and related stablecoins to conduct permissible banking activities, including authorized payment activities.[15]

We encourage the FDIC to recognize that engaging in such activities with respect to stablecoins is permissible banking activity.

IV. Conclusion

ABA appreciates the opportunity to provide comments on the FDIC's RFI on digital assets. Digital assets represent a rapidly developing marketplace, and banks are actively evaluating ways to safely and responsibly allow their customers to buy, hold, and sell digital assets through their existing banking relationships. For the reasons set forth above, we believe that customers who choose to access these markets are best served when they can do so through banks that are subject to rigorous oversight and supervision to ensure compliance with appropriate consumer protections and other regulatory requirements.

Sincerely,

Matthew A. Daigler

Vice President & Senior Counsel
Innovation Policy and Regulation

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[13] *See, e.g., OCC* Interpretive Letter No. 1172, OCC Chief Counsel's Interpretation on National Bank and Federal Savings Association Authority to Hold Stablecoin Reserves (Sep. 21, 2020), https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1172.pdf.

[14] In addition, state and national banks should be able to record bank deposits using cryptography or other technology as a separate and distinct product from stablecoins. *See supra* note 4.

[15] *See* OCC Interpretive Letter No. 1174, OCC Chief Counsel's Interpretation on National Bank and Federal Savings Association Authority to Use Independent Node Verification Networks and Stablecoins for Payment Activities (Jan. 4, 2021), https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-2a.pdf.

APPENDIX 3

American Bankers Association
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Via Electronic Submission

September 10, 2021

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 – Basel, Switzerland

RE: Consultative Document - Prudential Treatment of Cryptoasset Exposures (June 2021)

Ladies and Gentlemen:

The American Bankers Association (ABA)[1] is pleased to respond to the consultative document (Consultation) dated June 2021, issued by the Basel Committee on Banking Supervision (BCBS) concerning prudential treatment of banks' cryptoasset exposures. The Consultation provides a useful starting point for analysis of the regulatory issues relevant to bank cryptoasset activities. ABA believes, however, that considerable further work is required to inform this policy debate, which should be framed by three key principles:

- Market participants and supervisors should acknowledge the need for and work to develop a broad, common understanding of key features of the many existing cryptoassets, as well as the principal risks they present, as the basis for prudential treatment of these assets.[2]

- As banks seek to serve customers who want exposure to cryptoassets, national regulatory and supervisory authorities must permit prudent innovation to accommodate those customer desires. Authorities should be careful to avoid preempting technological innovation by being overly prescriptive - technological evolution is rapid, and highly prescriptive regulation cannot be adjusted quickly enough to remain current. Inflexibility would constrict financial inclusion and other benefits of emerging technology.

- The overall stability of the global financial system will benefit from the transparency that will result by conducting a significant share of the cryptoasset market through supervised financial institutions, as opposed to being driven outside the banking system. Rational supervision and regulation that avoids overly prescriptive approaches will promote key

[1] The American Bankers Association is the voice of the nation's $22.8 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard nearly $19 trillion in deposits and extend $11 trillion in loans.

[2] This document, unless otherwise specified, uses the definition of "cryptoasset" set out in the Consultation, drawing on earlier consultative documents: private digital assets that depend primarily on cryptography and distributed ledger or similar technology. *See* Consultation at 1, https://www.bis.org/bcbs/publ/d519.pdf.

public objectives of law enforcement, and suppression of terrorism finance and other security threats.

Numerous aspects of the Consultation bear directly on these principles. The balance of this discussion explores these aspects in more detail.

Summary of Recommendations

- The proposed definition of Group 1 cryptoassets creates operational problems and a potential "cliff effect" that could undermine financial stability. Below are several suggestions for mitigating or eliminating these risks.

- The proposed risk weight for Group 2 cryptoassets is unnecessarily high.

- Credit risk and market risk for Group 2 cryptoassets should be assessed separately as is currently done for other assets.

- Hedging and netting should be recognized and encouraged as risk mitigants.

The general principles that guided the Consultation fail to highlight adequately several key factors that could produce adverse results.

The Consultation's three guiding principles (summarized) are:

- Same risk, same activity, same treatment;
- Simplicity; and
- Minimum standards (*i.e.,* national regulatory and supervisory authorities would be free to add additional and/or more conservative requirements).[3]

Though appealing at first impression, application of these principles in a regulatory and supervisory scheme requires careful judgment.

First, equivalent treatment that is "technology neutral" is a sensible approach only if it is based on a thorough understanding of the relevant technology and the related operational risks. Lack of a thorough understanding on the part of regulatory and supervisory agencies would mean difficulties in understanding whether the "same risk" is present, likely leading to overregulation. The recent intense focus on operational risks generally (*e.g.,* cybersecurity) makes concern about potential overregulation even greater.

Second, the principle of simplicity as discussed in the Consultation appears to conflict in important respects with the principle of "same treatment." As discussed in detail below, the

[3] *See* Consultation at 2.

Consultation's proposed capital treatment for cryptoassets conflates capital protections against credit risk with those that protect against market risk. Though such an approach would arguably be simpler in many ways (and, indeed, regulatory capital regimes from decades past could be described as doing the same), the approach was discarded in favor of more granular measures of risk, with which internationally active banks are now familiar and which they have operationalized. Particularly with respect to cryptoassets that exhibit significant market volatility, national regulatory and supervisory authorities should seek consistent treatment for cryptoassets and traditional assets presenting similar risks, bearing in mind the relevance of differing technological characteristics discussed above.

Third, though the principle of minimum standards properly acknowledges the legal and practical aspects of the relationship of BCBS to national regulatory and supervisory authorities, divergence in national standards applied to internationally active banks creates a significant risk of regulatory fragmentation. Not only could this approach result in unfair terms of competition among those banks, but it also risks skewing markets because of regulatory arbitrage. An original objective of BCBS's work was to place regulation of international banking activity on a reasonably consistent basis across jurisdictions,[4] and that objective certainly is important to this rapidly evolving financial sector.

The proposed definition and treatment of Group 1 assets would raise practical and operational problems and create a potential cliff effect that could undermine financial stability.

For tokenised traditional assets (Group 1a) and cryptoassets with effective stabilization mechanisms (Group 1b), the Consultation proposes application of the same risk-based capital treatments that apply to the underlying traditional assets, as long as the cryptoassets meet specified structural conditions.[5] The conditions generally require either (in the case of Group 1a assets) that cryptoassets be digital representations of traditional assets using cryptography, Distributed Ledger Technology (DLT) or similar technology, or (in the case of Group 1b assets) that the asset have a stabilization mechanism that is effective at all times in linking their value to underlying traditional assets or a pool of traditional assets. The arrangements establishing these structures must be legally enforceable, have robust operational risk management, and be transparent such that all transactions and participants are traceable. In addition, only regulated and supervised entities could execute redemptions, transfers, and transaction settlements.[6] For Group 1b cryptoassets, the Consultation proposes that the daily difference between the value of the cryptoasset and the underlying traditional asset(s) must not exceed 10bp of the value of the underlying traditional asset more than three times over a one-year period.[7]

[4] *See* History of the Basel Committee, *available at* https://www.bis.org/bcbs/history.htm.
[5] Consultation at 3. Stabilization mechanisms that: (i) reference other cryptoassets as underlying assets, or (ii) use protocols to increase or decrease the supply of the cryptoasset are not considered to meet this condition. *See* Consultation at 4.
[6] Consultation at 4-5.
[7] Consultation at 4.

Thus, the risk-based capital treatment of Group 1 cryptoassets would depend entirely on compliance with all of these tests, and, because of the highly punitive proposed risk weight proposed for other cryptoassets, discussed below, the consequences of failing any part of the tests could be catastrophic from a compliance and economic standpoint. If legal aspects of a cryptoasset's stabilization mechanism were called into question, *e.g.,* by an adverse court ruling in litigation to which a given institution was not a party, the bank could be required to reclassify its investment upon very short notice and with no opportunity to contest the result. The undesirable choice between dealing with a suddenly recognized capital deficiency and liquidating a position in what is likely a highly uncertain environment (at least as concerns that specific asset) is unlikely to further either institutional safety and soundness or financial stability generally.

Another potentially harmful (and avoidable) "cliff effect" would occur when values diverge beyond the 10bp collar more than three times in a year. Though it may be easier to foresee the potential test failure in advance, a third breach of the collar means a potentially drastic change in capital structure, with the poor choices of solution noted above.

Both of these scenarios can be avoided if national regulatory and supervisory authorities adhere to the principles noted at the beginning of this letter. A thorough common understanding among regulators, supervisors, and regulated institutions of key cryptoasset features should help significantly to avoid unexpected reclassification of assets (*e.g.,* from Group 1 to Group 2) due to misunderstandings or disputes about legal structure and enforceability.[8] In addition, if market volatility (including divergence between a stabilized cryptoasset and the underlying traditional asset) is addressed by more precisely targeted measures, with incrementally higher volatility requiring only incrementally higher capital commensurate with the risk that volatility presents, part of the cliff effect noted above could be avoided. The ability to address market volatility in a more targeted way depends on a more thorough common understanding of cryptoassets by regulators and regulated institutions.[9]

In addition, the proposed requirement that, for Group 1 cryptoassets, entities that execute redemptions, transfers, or settlements of the cryptoasset be regulated and supervised is likely to inhibit banks' dealings with some existing major cryptoasset market participants.[10] Some degree

[8] The Consultation does not reach the question of who decides whether a particular cryptoasset meets the conditions for Group 1 treatment. Though national regulatory and supervisory authorities would certainly have significant voices in such decisions, it is unlikely that regulatory processes alone would be sufficiently flexible and nimble to accommodate rapid market innovation. On the other hand, supervised banks might be discouraged from market participation if there lingering uncertainty about classification, particularly if the "cliff effects" discussed in the text are not addressed. Both of these considerations have the potential to inhibit banks' service to customers and to create a bias in favor of unregulated, unsupervised market participants in cryptoasset transactions. The entire cryptoasset classification logic must be judged against these considerations.

[9] Moreover, as discussed more generally below, a comprehensive capital treatment of cryptoasset market risk should follow existing, well-understood models, and the classification problems described above could more easily be appropriately addressed.

[10] For example, a recent €100MM bond offering by the European Investment Bank was delivered to investors via the Ethereum blockchain. *See* https://www.eib.org/en/press/all/2021-141-european-investment-bank-eib-issues-its-

of diligence to verify other structural and legal aspects of stabilization mechanisms, as well as monitoring of market data, are logically necessary, but these prudent requirements do not necessarily depend upon, or even benefit from, the regulated and supervised status of service providers involved in the transaction. As long as banks can satisfy supervisors that these other conditions are met, supervisors should be flexible regarding the status of other parties.

The proposed risk weight of 1,250% for Group 2 cryptoassets is punitively high, particularly in light of the "cliff effect" of a classification failure.

The Consultation proposes that any cryptoasset that fails any aspect of the Group 1 tests be treated as a Group 2 cryptoasset, which would carry a 1,250% risk weight.[11] This proposed risk weight amounts to a mandate to fund long positions in Group 2 cryptoassets 100% with capital, not permitting any leverage,[12] and to hold similar capital against the notional amount of short positions. The rationale for this punitive risk weight is that it is intended to address both credit risk and market risk,[13] and it may be an attempted analogy to the capital treatment of intangible assets.[14]

This aspect of the proposal raises several concerns. First, as noted above, a change in classification from Group 1 to Group 2 would have drastic results if the proposed risk weight is used. Regardless of the cause of the classification shift, the dramatic increase in risk weight, especially if unanticipated, may force liquidation of the position. Moreover, as noted above, such liquidations would be likely to occur under adverse market conditions for that asset, when either the legal status of a stabilization arrangement is suddenly thrown into doubt, or market conditions have resulted in (or market participants anticipate) an increase in volatility. In the latter case, liquidation of positions ahead of an expectation that a cryptoasset is likely to breach the Group 1 volatility collar could create a self-fulfilling prophecy.

These risks of sudden, adverse regulatory consequences, in addition to the punitively high risk weight *per se,* would likely amount to an effective prohibition of Group 2 cryptoasset activity by many banks. The unfavorable economics of positions in acknowledged Group 2 cryptoassets, combined with the potential uncertainty inherent in the proposed classification of Group 1 cryptoassets, would seriously inhibit banks from accommodating their customers' desire for cryptoasset exposure, even if managed conservatively and prudently.

The 1,250% risk weight also assumes that all Group 2 cryptoassets present equivalent combined credit and market risks. Both regulated banks and national regulatory and supervisory authorities are unlikely to accept this implicit conclusion. At a minimum, assets that do not present a risk of

first-ever-digital-bond-on-a-public-blockchain. The financial and legal terms of this security would clearly meet the requirements of Group 1a, but [certain steps in] its transfer and settlement were not through a regulated entity.

[11] Consultation at 13. This treatment would not, however, apply to any assets that have already been deducted from Common Equity Tier 1 (CET1) under applicable risk-based capital regimes.

[12] This calculation assumes a basic risk-based capital requirement of 8% of risk-weighted assets.

[13] *See* Consultation at 14.

[14] Note that intangible assets usually lack available market quotations. Even many highly volatile cryptoassets have readily available market quotations.

a particular party failing to perform an obligation (because the structure of the cryptoasset includes no such obligation) present essentially no credit risks compared to those that do, and this difference should be reflected in an appropriate difference in risk weight.[15]

Finally, banks involved in or contemplating cryptoasset market-making have noted that some assets, such as tokenized bonds, involve payment of fees and similar charges in Group 2 cryptoassets.[16] For example, to send bonds that have been issued via the Ethereum blockchain network to investors, firms must pay transaction fees in Ether. Ether and other Group 2 assets held for such purposes should be subject to a significantly lower risk weight.

Given all of these concerns, BCBS should propose a risk weight for Group 2 cryptoassets no higher than 400%. This risk weight is currently applied to "speculative unlisted equity," including private equity securities and similar assets that typically offer very limited liquidity or price transparency. Many Group 2 cryptoassets offer a significantly higher degree of liquidity and price transparency. The development of a cryptoasset capital regime would ideally be based on a range of risk weights subject to this 400% maximum. To account appropriately for credit exposure will require further empirical research, but a range of risk weights should be an integral part of setting capital requirements for cryptoasset exposure.

Credit risk and market risk for Group 2 cryptoassets should be assessed separately as is currently done for other assets, and hedging and netting should be recognized and encouraged as risk mitigants.

Over several decades, BCBS and national regulatory and supervisory authorities have developed highly detailed, carefully calibrated risk-based capital regimes for addressing both credit and market risk. These capital regimes are now applied across the universe of asset types and activities that involve bank balance sheet exposure. As noted above, the Consultation proposes to depart from this framework with respect to Group 2 cryptoassets, substituting a 1,250% risk weight for more carefully calibrated approaches. Both because it would apply concepts already familiar to bank risk managers, supervisors, and public markets, and also because it should more precisely capture risks, BCBS and national regulatory and supervisory authorities should maintain separate but integrated approaches to credit and market risk of cryptoassets.

In this regard, the Consultation proposes restrictions on netting Group 2 cryptoasset positions, including requiring capital against the greater of the gross long and short positions in a given cryptoasset, without netting.[17] This treatment is particularly problematic in light of the further proposal that, since (unhedged) short positions can theoretically lead to infinite losses, national regulatory and supervisory authorities are encouraged to consider incremental capital under Pillar 1 to address this risk.[18] To the extent a long position is partially offset by a short position,

[15] Assessing market risk separately, as discussed below, would facilitate clearer recognition of such structural distinctions.
[16] *See, e.g.,* https://support.blockchain.com/hc/en-us/articles/360000939903-Transaction-fees.
[17] Consultation at 13.
[18] Consultation at 13-14.

holding capital, particularly at such a high risk weight, against the gross long position is unwarranted. Assuming an appropriate range of risk weights below 1,250% can be established, calculating capital based on net long positions (after deduction of short positions in the same cryptoasset) should be adequate. Net short positions, which could still theoretically pose infinite risk, require further analysis, but, again, the existing framework for holding capital against credit and market risk should be the guide.[19]

Beyond netting long and short positions, similar logic supports the recognition and encouragement of hedging to address cryptoasset risks. Practical hedging products exist for numerous Group 2 cryptoassets,[20] and these generally present negligible basis risk. Given the extensive history and effort that has gone into hedge recognition for trading book assets generally, it is both unnecessary and potentially dangerous to ignore this aspect of risk management in cryptoasset activities. Participating banks are likely to implement them as part of their own risk management strategies, and regulatory and supervisory regimes should acknowledge their benefits.

Concerning the related issue of recognition of collateral, existing capital frameworks again point to an appropriate approach. Qualification as collateral necessarily entails having adequate liquidity, and that requirement (and other criteria, *e.g.,* requiring a perfected security interest) currently in place for acceptable financial collateral should apply to cryptoassets also. In addition, current rules already address assessment of value and volatility (providing for haircuts). Like other aspects of the existing framework, these features should be incorporated into the capital treatment of cryptoassets.

Moreover, the market risk considerations applicable to Group 2 assets are also inconsistent with the proposed risk weight. For example, as noted above, speculative unlisted equity investments carry a 400% risk weight, and there is normally no market quotation available for such assets. In contrast, many of the best-known Group 2 cryptoassets are regularly quoted, and volatility can be measured and tracked. Graduated capital requirements reflecting documented volatility and the availability of quotations would be preferable to a single, excessively conservative risk weight.

In a final analysis, for all the reasons outlined, BCBS and national regulatory and supervisory authorities should build on and follow existing accounting, hedging, netting, and legal documentation concepts in existing risk-based capital requirements. The propriety of this approach for exchange traded or centrally cleared assets is especially clear, but the same logic applies to other assets as well.

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[19] In fact, the Consultation notes that, in addressing capital requirements for short positions, "…the capital add-on would be calibrated…to calculate aggregate capital requirements under the [BCBS's] revised market risk framework…and to use this amount if the result is higher than the requirement based on a 1250% risk weight." Consultation at 15. This aspect of the proposed framework demonstrates the logic of using existing credit and market risk capital frameworks to address cryptoasset risks.

[20] Examples include: CME bitcoin futures and options and various ETPs/ETFs, such as ABTC, QBTC11, and BTCC.

The Consultation leaves other risks for future evaluation, but appropriate capital treatment cannot be developed, and definitely cannot be finalized, in isolation from regulatory and supervisory approaches to those risks.

The Consultation correctly notes that national regulatory and supervisory authorities (and presumably BCBS) will have to address other risks related to cryptoasset holdings, including leverage capital and liquidity ratios and supplemental capital requirements to address large exposures. Moreover, it notes that cybersecurity/resiliency and other operational risks will be left to Pillar 1 supervision.[21] Though the Consultation provides a very useful opening discussion of risk-based capital requirements for cryptoasset activity, a fully developed risk-based capital regime is impossible to achieve in a context isolated from these other requirements. As the policy discussions of which the Consultation is an important part progress, these topics require concurrent thoughtful examination.

Throughout the policy development process, BCBS and national regulatory and supervisory authorities should operate under the key principles noted at the beginning of this letter: working toward a broad market consensus concerning the key features and risks of cryptoassets; permitting prudent innovation so banks can accommodate customer needs; and avoiding overly prescriptive approaches that shift cryptoasset transactions into less transparent parts of the financial market, with negative consequences for law enforcement and security. Doing so will promote the public interest in competitive, convenient, and secure financial services.

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Thank you for your consideration of the matters discussed. Should you have any questions, please do not hesitate to contact the undersigned at hbenton@aba.com.

Very truly yours,

/s/

Hu A. Benton

Vice President, Banking Policy

[21] Consultation at 15-17.

APPENDIX 4

Statement for the Record

On Behalf of the

American Bankers Association

Before the

Subcommittee on National Security, International Development, and Monetary Policy

Of the

Financial Services Committee

July 27, 2021

American Bankers Association®

Statement for the Record

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Of the

Financial Services Committee

July 27, 2021

Chairman Himes, Ranking Member Barr, and members of the Subcommittee on National Security, International Development, and Monetary Policy, the American Bankers Association (ABA) appreciates the opportunity to submit a statement for the record for the hearing titled "The Promises and Perils of Central Bank Digital Currencies." The topic of today's hearing is an important one, with significant implications for our financial system, economy, markets, and most importantly for the American consumer.

Policymakers around the world, including at the U.S. Federal Reserve, are examining the potential opportunities and risks associated with issuing Central Bank Digital Currencies (CBDCs).[1] A number of central banks are moving from conceptual research to developing pilot programs to explore the uses and efficiency of CBDCs.[2] As this work progresses, there is a growing recognition that central bank digital currencies may be weighed down by very significant real-world trade-offs. The reality is that the dollar is largely digital today. The proposed benefits of CBDCs to international competitiveness and financial inclusion are theoretical, difficult to measure, and may be elusive, while the negative consequences for monetary policy, financial stability, financial intermediation, the payments system, and the customers and communities that banks serve could be severe.

The primary reason for this disconnect between the commonly-touted benefits of CBDCs and the more privately-assessed risks of re-engineering our financial system is that we tend to treat CBDCs superficially, as though a digital currency is a single concept, and one that could be implemented beside, rather than on top of, our existing system. Neither is true. A CBDC is not a single proposal; rather, it refers to a wide range of different proposals with varied potential

[1] In its simplest terms, a CBDC is a digital representation of a country's government-issued, central-bank-controlled money (a "digital dollar"). A CBDC would be a liability of the central bank, just as the dollar is today.

[2] *See* BIS Papers No. 114, *Ready, Steady, Go? – Results of the Third BIS Survey on Central Bank Digital Currency* (Jan. 2021), https://www.bis.org/publ/bppdf/bispap114.pdf.

designs, each with specific costs and benefits. Nor does CBDC fill a fundamental gap in our financial architecture that it could slide neatly into to perform a discrete role. Some designs are more disruptive than others, but all have the potential to transform the way money flows through our economy in ways both intended and unintended.

The Highlight Reel Effect

Current policy discussions often fail to acknowledge that many of the purported benefits of CBDC are mutually exclusive and driven by how the CBDC is designed. Choosing between the various designs requires serious and complex policy tradeoffs. Too often CBDC proponents take a "highlight reel" approach to describing CBDC, cherry picking all the perceived benefits, while downplaying the serious risks to consumers and our financial system. In particular, all CBDC designs would take the money currently held on bank balance sheets and place it directly on that of the Federal Reserve.[3] In today's economy, most money takes the form of bank deposits. Money—and therefore deposits—is created through the private credit allocation process, which is a critical driver of economic growth and prosperity. Taking deposits out of the banking system would disrupt this key economic function by bifurcating deposit taking and lending, making lending more expensive, among other things.[4]

Federal Reserve Chairman Jerome Powell highlighted the importance of this in a recent video where he noted that any potential CBDC "serve as a complement to and not a replacement of cash and current private-sector digital forms of the dollar such as deposits at commercial banks."[5]

The U.S Already Has the Most Robust Financial System in the World

As Governor Brainard has recently noted, "In any assessment of a CBDC, it is important to be clear about what benefits a CBDC would offer over and above current and emerging payments options, what costs and risks a CBDC might entail, and how it might affect broader policy objectives."[6]

For example, it is unclear what policy goals a CBDC would achieve in the United States. For some countries, a CBDC could enhance weak or nonexistent financial systems. Unlike many other countries, the United States has a well-developed and robust financial system that is the

[3] In a May 24, 2021 speech Federal Reserve Governor Lael Brainard highlighted these concerns noting, "Banks play a critical role in credit intermediation and monetary policy transmission, as well as in payments. Thus, the design of any CBDC would need to include safeguards to protect against disintermediation of banks and to preserve monetary policy transmission more broadly." https://www.federalreserve.gov/newsevents/speech/brainard20210524a.htm.

[4] Even a CBDC with account limits would likely have a significant impact on the deposit base. The ECB estimates that a CBDC with account limits of €3,000 would lead to deposit outflows of € 1trillion.

[5] Chair Powell's Message on Developments in the U.S. Payments System, May 20, 2021 https://www.federalreserve.gov/videos.htm.

[6] Lael Brainard, Member Board of Governors of the Federal Reserve System, "Private Money and Central Bank Money as Payments Go Digital: An Update on CBDCs," Remarks at the Consensus by CoinDesk 2021 Conference Washington, D.C. (May 24, 2021), https://www.federalreserve.gov/newsevents/speech/brainard20210524a.htm.

backbone of our economy and markets. As they have done for hundreds of years, American banks today provide a broad array of essential financial and economic functions that benefit their communities, most notably, safekeeping deposits and making loans. For other countries, a CBDC could enhance their payment systems. The United States, however, has one of the most efficient, safe, and modern payments systems in the world. Banks have invested significant resources in expanding faster, safer, more inclusive options, including P2P, real-time payments systems (*e.g.*, The Clearing House Real Time Payment Network (RTP) and the Federal Reserve's FedNow), and upgraded Automated Clearing House (ACH) products. Solutions to pay gig workers instantly and put funded bank accounts into the hands of disaster victims have recently come online, addressing key use cases proffered for CBDC.

The United States should not implement a CBDC simply because we can or because others are doing so. Policy changes of this magnitude should be driven by a careful analysis of the benefits and risks. A CBDC may be beneficial in an economy that does not have an advanced payment system or a robust banking system, or in jurisdictions where the central government is already a major provider or facilitator of financial services and expectations of individual privacy are not strong. **However, after a careful review of the benefits and risks of various proposals to implement a CBDC, it does not appear that a CBDC is well-positioned to enhance underlying financial capabilities or extend the reach of financial services in well-developed markets, at least not in the U.S. context, despite the overly optimistic promises from proponents.**

Policymakers Should Proceed with Extreme Caution

Given the important policy implications of CBDC and the potential to disrupt the U.S. financial system, we support the Federal Reserve's thoughtful and considered approach. The forthcoming Federal Reserve Bank of Boston findings will be an important next step for understanding the feasibility of this novel technology in our unique economy.[7] We further support the Federal Reserve's recognition that the development of a CBDC would require input, engagement, and support from a range of stakeholders in both the public and private sectors. To this end, we look forward to responding to the discussion paper the Federal Reserve intends to issue this summer, which, according to Chairman Powell, will outline the Federal Reserve's current thinking on digital payments, with a particular focus on the benefits and risks associated with CBDC in the U.S. context.[8] Before the introduction of a CBDC, we believe the Federal Reserve Board, with input from the Treasury and the other banking regulators, should publish a rigorous analysis that assesses the benefits and risks of a CBDC and that convincingly

[7] *See* "The Federal Reserve Bank of Boston Announces Collaboration with MIT to Research Digital Currency" (Aug. 13, 2021), https://www.bostonfed.org/news-and-events/press-releases/2020/the-federal-reserve-bank-of-boston-announces-collaboration-with-mit-to-research-digital-currency.aspx.

[8] The authority of the Federal Reserve to issue CBDC remains an open—and fundamental—question in this policy debate, which must be resolved before Federal Reserve action on this issue. Chairman Powell has expressed reluctance to proceed with a CBDC without Congressional approval. *See* American Banker, "'We don't need to rush' on Fed digital dollar, Powell says" (Mar. 22, 2021), https://www.americanbanker.com/news/we-dont-need-to-rush-on-fed-digital-dollar-powell-says (quoting Powell as saying, "I think that would ideally come in the form of an authorizing law, rather than us trying to interpret our law, to enable this").

establishes (if findings warrant) that a CBDC would not create adverse impacts on consumers, markets, or the economy.

In the remainder of this testimony we will:

- Outline the risks and benefits of CBDC designs being considered today, and
- Highlight the challenging tradeoffs policymakers face in achieving their intended goals.

CBDC Design Choices Matter

The potential benefits and risks of a CBDC depend heavily on the way it is structured, making it impossible to evaluate the merits of CBDC in the abstract. Design choices involve tradeoffs, and so we must avoid a rush to action driven by cherry-picked benefits. By contrast, some of the disadvantages and risks of CBDC carry across all designs.

While a number of factors affect the theorized operation of a CBDC (*e.g.*, whether to use distributed ledger technology or a centralized database), the most important factors are *architecture,* or the role of the central bank in the distribution of CBDC, and *access*, or consumer's utilization of CBDC.[9] The following identifies some of the most significant potential benefits and risks of each architecture and access design choice that policymakers should consider as they determine whether to implement a CBDC in the United States.

Architecture Choices

Architecture goes to the operational role of the central bank in the CBDC. There are a number of different CBDC architectures, but the two principal models are (1) a "direct" CBDC that provides retail consumers with central bank accounts and (2) an "intermediated or hybrid" CBDC (or "two-tiered" model) where the distribution of CBDC would be through a commercial bank or other financial intermediary, such as a nonbank digital wallet provider.[10]

The following sets forth some of the purported benefits and potential risks of these models.

Direct CBDC	
Potential Benefits	***Potential Risks***
➢ Provides additional monetary policy tools (*e.g.*, increases	➢ Takes money out of the real economy, diverts deposits and

[9] We assume that, in whatever form it takes, CBDC will be compatible with other forms of money (cash, bank notes) and interoperable with pre-existing payment systems that choose to interface with it. Financial institutions, consumers, and end users also should remain free to use CBDC or continue to use conventional digital or physical currency.

[10] A wholesale CBDC model, which focuses on cross-border payments, also raises a number of difficult policy issues, but is beyond the scope of this testimony. Depending on its structure, including whether such a payments system would be interoperable with existing systems, this could adversely affect U.S. payments systems.

influence on deposit rates and reduces the risk of alternative units of account—such as privately-issued cryptocurrencies—dominating) ➢ May improve access to financial services and enhance financial inclusion ➢ May facilitate direct government disbursements to citizens ➢ May improve efficiency of payment system by some measures	stymies money creation, thereby undermining commercial lending and the deposit insurance system ➢ Makes the Federal Reserve a massive retail bank, introducing significant costs and operational burdens (*e.g.*, interfacing with customers, building front-end wallets, fraud resolution/mitigation), as well as fundamentally changing the mission of the central bank ➢ Likely would lead to less privacy than for those using cash or other forms of digital payments

Intermediated or Hybrid CBDC	
Potential Benefits	***Potential Risks***
➢ Decentralized relative to other models (*e.g.*, central bank will not have customer relationship) ➢ Facilitates compliance with anti-money laundering (AML)/combating the financing of terrorism (CFT) and know your customer (KYC) frameworks ➢ Provides a more convenient and modern alternative to paper cash ➢ Means of countering new private digital currency	➢ Potential for CBDC to move out of banks into non-bank financial institutions ➢ If counted as cash, likely would not be available to support lending in the real economy ➢ Raises information security risks and the potential for fundamental design mistakes ➢ Changes the economics of the payments system, potentially reducing incentives for product innovation

Takeaways:

Policymakers throughout the world have generally concluded that the direct model is not feasible because of the increased costs and operational burdens placed on central banks.[11] A direct CBDC model would effectively set the Federal Reserve up as a retail bank to every household in the nation. This would present an immense operational burden on the central bank, which would be responsible for onboarding customers and servicing those accounts. Today U.S. banks employ over 2 million employees to accomplish the same goal. Among the most critical technical and operational challenges that would need to be dealt with is the risk of creating a global target for cyberattacks or a new avenue for money laundering. A CBDC could be a very attractive target for cyberattacks.[12]

If policymakers determine that a CBDC is warranted to address payments system gaps, a "two-tier" CBDC architecture should form the basis of further work. Under this approach, the Federal Reserve would continue to focus on monetary policy and the underlying design of CBDC, and only commercial banks and appropriately regulated and supervised financial institutions should be permitted to distribute CBDC.[13]

Access Choices

Access addresses how consumers can utilize CBDC. Generally speaking, CBDCs may be account-based or token-based.[14] A key difference between the two types of access is the mode of verification when a transaction takes place. Account-based CBDCs are tied to an identity scheme, similar to existing bank accounts. In an account-based system, the accountholders on either end of the transaction are authenticated. Token-based CBDC is more similar to cryptocurrencies and would be freely transferrable tokens, which may be held in an "unhosted"

[11] This appears to be the approach the ECB is taking. *See, e.g.*, Fabio Panetta, Member of the Executive Board of the ECB, "Evolution or Revolution? The Impact of the Digital Euro on the Financial System," Bruegel Online Seminar (Feb. 10, 2021), https://www.ecb.europa.eu/press/key/date/2021/html/ecb.sp210210~a1665d3188.en.html ("[t]he ECB does not plan to interact directly with potentially hundreds of millions of users of a digital euro. We simply would not have the capacity or the resources to do so. Financial intermediaries—in particular banks—would provide the front-end services, as they do today for cash-related operations. We would provide safe money, while financial intermediaries would continue to offer additional services to users.").

[12] *See, e.g.,* Lael Brainard, Member Board of Governors of the Federal Reserve System Cryptocurrencies, "Digital Currencies, and Distributed Ledger Technologies: What Are We Learning?" Remarks at the Decoding Digital Currency Conference Sponsored by the Federal Reserve Bank of San Francisco, San Francisco, California (May 15, 2018), https://www.federalreserve.gov/newsevents/speech/files/brainard20180515a.pdf.

[13] The Federal Reserve is keenly aware of the longstanding legal and policy framework maintaining the separation of banking and nonbank commercial activities. If it decides that private-sector financial intermediaries should play a role in CBDC distribution and transactions as intermediaries, it should assure that this separation is maintained, taking into consideration whatever aspects of banking functions such intermediaries ultimately play.

[14] *See* Alexander Lee, Brendan Malone, and Paul Wong, FEDS Now, "Tokens and Accounts in the Context of Digital Currencies" (Dec. 23, 2020), https://www.federalreserve.gov/econres/notes/feds-notes/tokens-and-accounts-in-the-context-of-digital-currencies-122320.htm (highlighting some issues with the "tokens vs. accounts" dichotomy).

digital wallet on the holder's smartphone.[15] In a token-based system, the token itself is authenticated. This makes the token a bearer instrument, much like cash today.

The following sets forth some of the purported benefits and potential risks of these models.

Token-Based CBDC	
Potential Benefits	***Potential Risks***
➢ More consumer privacy in comparison to account-based models ➢ Promotes ease of transfer ➢ More resilient to infrastructure outages and cyberattacks ➢ Most like digital cash ➢ Frees the central banks from the duties of large-scale account keeping and reconciliation	➢ Complicates compliance with AML/CFT and KYC frameworks ➢ May drain deposits from banks and the real economy, reducing the amount available for banks to lend. ➢ May lead to destabilizing runs on bank deposits into central bank money ➢ Introduces risk of loss or theft of the private key for the token

Account-Based CBDC	
Potential Benefits	***Potential Risks***
➢ Most akin to traditional bank accounts ➢ Facilitates compliance with AML/CFT and KYC frameworks ➢ Helps to preserve banks' deposit base, and money creation function that is essential to lending and economic growth	➢ May not achieve the potential benefits of introducing CBDC ➢ May pose threat to financial anonymity and privacy for citizens ➢ May not be available to support lending in the real economy

[15] An "unhosted" wallet describes situations where transactions from the wallet do not require the use or involvement of a financial institution.

Takeaways:

In considering the trade-offs between account-based and token-based CBDC, including the ability to use unhosted wallets and engage in offline transactions, policymakers should ensure they are not facilitating money laundering or more generally impeding the ability of financial institutions to comply with AML/CFT and KYC frameworks, or to respond to lawful government orders. They should also be mindful of privacy concerns related to direct government oversight of consumer accounts. These two objectives are difficult to reconcile and may be mutually exclusive.

Policymakers Face Challenging Tradeoffs to Achieve Desired Outcomes

As discussed above, the various designs of CBDC being considered today all come with significant tradeoffs. As policymakers consider how to achieve their desired outcomes, they must seriously consider these tradeoffs. The intended benefits of implementing a CBDC are often less than expected, given these tradeoffs. In some cases, these benefits may be effectively non-existent because they come at such a high cost. Below, we briefly describe some key considerations for policymakers as they look to achieve their desired outcome.

Risks

Financial Intermediation:

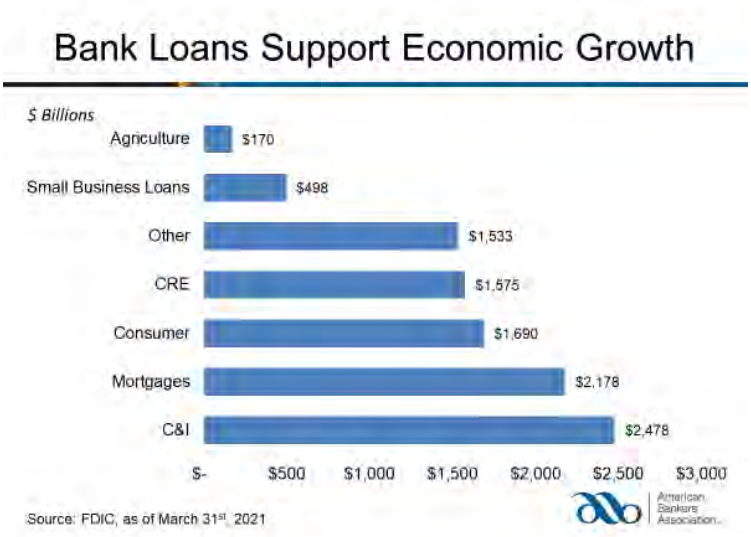
As noted above, every construction of CBDC requires moving funds from banks' balance sheets to the Federal Reserve. Regardless of the model chosen, a CBDC is a direct liability of the central bank. This contrasts to bank deposits, which are a liability on an individual bank insured by the Federal Deposit Insurance Corporation (FDIC).

In effect, these accounts will serve as an advantaged competitor to retail bank deposits that will move money off bank balance sheets where it can be lent back into the economy and into accounts at the Federal Reserve. Philadelphia Fed Research referenced above found that these proposals would create a "deposit monopoly" that would "attract deposits away from the commercial banking sector."[16]

While depositors at FDIC insured banks have never lost a penny of an insured deposit, it is hard to compete with a government agency that prints that money. Philadelphia Federal Reserve research found that depositors value this and will, in equilibrium, choose to hold their funds at the Federal Reserve instead of at retail banks, establishing the Federal Reserve as a "deposit monopolist."

[16] https://www.philadelphiafed.org/-/media/frbp/assets/working-papers/2020/wp20-19.pdf.

These bank deposits are the primary funding source of bank loans. These loans are critical drivers of economic growth and prosperity. In the United States today, banks fund more than $10 trillion in loans. This includes $2.1 trillion in consumer mortgages, $1.6 trillion in consumer loans, and $498 billion in small business loans.[17] Any reduction in this deposit base would quickly impact consumers and small businesses in the form of reduced credit availability and increased cost, undermining the goal of financial inclusion and undercutting economic growth.



Some models seek to minimize this effect by capping the amount of funds that can be held in CBDC. However, this limits the potential benefits of a CBDC account. These limits would reduce the business use cases often cited as in arguments for CBDC's ability to promote international competitiveness. It also does little to offset the problem. For example, the ECB estimates that a CBDC with account limits of €3,000 would lead to deposit outflows of €1 trillion.

Unlike retail banks, the Federal Reserve is not prepared to make loans to consumers and businesses. As deposits migrate from bank balance sheets to the Federal Reserve, capital that fuels economic growth will be severely restricted.

In times of economic hardship, the bank balance-sheet driven model is even more important. Banks' balance sheets and strong capital position allow them to make long-term investments and continue lending throughout a downturn, just when it is needed most.

A digital currency also creates a risk to financial stability. In times of economic stress, depositors are likely to prefer holding their money at the Federal Reserve. This creates a risk of bank runs that would undermine financial stability.

Anti-Money Laundering, Sanctions Enforcement, and Countering the Financing of Terrorism:

One significant challenge associated with many CBDC models is whether the central bank has the ability to identify users and track funds held in CBDC. Today, it is difficult to track the movement of physical cash throughout the economy. There is significant investment in programs to address this; however, any of those rely on the fact that is logistically challenging

[17] Federal Deposit Insurance Corporation Quarterly Banking Profile (May 26, 2021).

to move large amounts of physical cash. Simply put, it is difficult to move large volumes of physical cash. Digitizing that cash as a CBDC allows users to more easily move larger sums, making a CBDC more attractive to those looking to circumvent these important measures.

In the case of a direct CBDC, the Federal Reserve would be able to control for account onboarding and implement these checks itself. However, the operational burdens of doing so are significant. Today U.S. banks employ an estimated 20,000 employees to accomplish this.

Moving to an indirect model does not solve this challenge either. A token-based CBDC presents even more challenges to implementing these controls. Token-based CBDCs are authenticated by the token (not the user) similar to many cryptocurrencies in the market today. These tokens are held in software-based programs like "unhosted" digital wallets. Regulators could police the access points to these assets but will have little control once they leave that controlled environment.

Minimizing this risk would point to an indirect, account-based CBDC. These would function similarly to bank accounts today; however, as discussed below this also minimizes many of the purported benefits associated with CBDC.

Privacy

Another challenging question around the implementation of a CBDC is the level of insight that governments have into the use of CBDC. Unlike physical cash, many constructions of CBDC allow the government to directly track and monitor the use of these assets. This raises important public policy questions around the appropriate role of government.

Pervasive government surveillance of consumer and commercial payments may be considered a benefit to some governments issuing CBDC, but this feature should not be taken lightly in a democracy where the government is not meant to have access to the details of financial transaction without proper legal cause.

There are models that minimize this risk, like an indirect token-based CBDC, but this involves a tradeoff in the ability to monitor for illicit uses of CBDC as discussed above. In many cases privacy is mutually exclusive with the objectives of AML/KYC programs.

Role of Government

By making a governmental body into the nation's near-monopoly provider of currency, bank accounts, and payment services, the Federal Reserve would quickly become politicized as the central control point for monitoring and potentially denying transactions. For controversial but locally-regulated purchases such as cannabis and firearms, a CBDC would entangle the Federal Reserve as a national arbiter of social issues.

Desired Outcomes

Financial Inclusion

A foundational goal of direct CBDC proposals (and similar proposals like postal banking) is to promote financial inclusion. Access to banking services provides people with a means to save for their future and economic opportunity that is critical to promoting social equity. This is an important and urgent goal.

The pandemic has laid bare the consequences of being unbanked, from delays in receiving stimulus payments to navigating additional barriers in the Paycheck Protection Program. Sustainable economic opportunity requires a long-term banking relationship, but according to the FDIC's 2019 "How America Banks" survey, despite some encouraging trends, over 7.1 million US households – 5.4% – remain unbanked, and another 24 million households are underbanked.[18] While the FDIC observed "particularly sharp" declines between 2017 and 2019 for Black and Hispanic households, 13.8% of Black households and 12.2% of Hispanic households remained entirely unbanked in 2019, "substantially above the unbanked rated for White households (2.5 percent). Our nation and industry can do better.

America's banks are committed to promoting financial inclusion and are working to address this challenge. Today, unbanked customers have numerous options to open bank accounts that are designed to address the reasons most unbanked individuals cite as barriers to becoming banked. Through the Bank On program, run by the Cities for Financial Empowerment Fund and other efforts, free and low-cost bank accounts are widely available at banks of all sizes, with new accounts being certified every day. Bank On sets account standards that provide a benchmark for safe, affordable accounts at mainstream financial institutions, setting consumers on a path toward financial inclusion. Today, these accounts are available at over 32,500 branches across the United States. And importantly, they represent the beginning of a banking relationship, which can grow to include lending, saving, investing and other opportunities.

As the government rushed to distribute millions of Economic Impact Payments during the COVID-19 pandemic, the FDIC, the IRS, Bank On and the ABA worked to promote awareness of such accounts so American taxpayers could receive their payments quickly and securely. We have another critical opportunity to promote Bank On-certified accounts ahead of the expanded and newly-advanceable Child Tax Credit payments, which will be available to 36 million taxpayers starting in July.

Unlike programs like Bank On, it is unclear whether access to a direct account at the Federal Reserve would address the reasons families report not having a banking relationship.

[18] Underbanked means that a household has an account at an insured institution but also obtained financial products or services outside of the banking system.

Moreover, by taking too narrow a view of the problem, these proposals risk undermining the real progress underway with Bank On and similar efforts.

In addition, direct CBDC proposals focus solely on the question of access to a deposit account. While it is true that deposit accounts are often the first step towards inclusion, the benefits of a long-term banking relationship go well beyond a deposit account. The same is not true of a CBDC account with the Federal Reserve, which would not grow into a lending or investing relationship.

Not only do direct CBDC proposals not address this serious issue, they will likely exacerbate it. Philadelphia Fed Research referenced above found that these proposals would create a "deposit monopoly" that would "attract deposits away from the commercial banking sector." This has the effect of reducing the funds on banks balance sheets that is available to lend which would reduce access to credit to the communities that need it the most.

Payments system efficiency

Many CBDC proponents cite the need to speed up payments by digitizing them; the reality is that the majority of payments in the U.S. are already digital. Today, consumers and businesses have the option to pay with credit or debit cards, payments applications like Zelle or Venmo, and via ACH.

Efforts to modernize and speed up our payments system have been underway for some time and are already being implemented. The Federal Reserve's 2017 Faster Payments Task Force examined the entirety of the payment system and its experts, including consumer groups, recommended faster networks – not a new currency. As a result of these efforts, the Federal Reserve is building out an instant payments solution called FedNow.

Industry has been driving these improvements as well. The RTP Network is a brand-new instant payment system that represents an advancement equivalent to moving from dial-up to broadband in terms of speed and features. ABA was a strong advocate for using this capability as part of the EIP program to speed electronic payments to those with bank accounts or even prepaid cards.

Together, RTP, FedNow, and faster ACH systems are forming a web of super-fast, low-cost or free digital payment options that will make waiting for days to receive a payment a thing of the past.

Conclusion

A U.S. CBDC could fundamentally change the role of the central bank in the United States and reshape the banking system. Given the additional complexity, delay, and transition costs involved in creating a new form of money, there are strong efficiency interests that suggest

CBDC should only be pursued as a final option to meet clearly-defined public policy goals that cannot be achieved through payments innovations that leverage existing digital dollars. As of today, those use cases have not emerged.

If a viable use case for CBDC in the United States does emerge in the future, design choices must be carefully considered to ensure that the benefits as well as the risks of introducing a CBDC are fully appreciated.