CRYPTO EXCHANGE S01EP05, BANKING IN A CRYPTO WORLD

Ethan Ostroff:

Welcome to another episode of the Crypto Exchange, a Troutman Pepper podcast focusing on the world of digital assets and payments. As longtime leaders in the intersecting worlds of law, business, and government regulations, our lawyers can go beyond the buzzwords and headlines to make sense of the emerging legal and regulatory frameworks for operating in the digital asset and payments industries. I'm Ethan Ostroff, one of the hosts of the podcasts and a partner at Troutman Pepper.

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Today I'm thrilled to be joined by our colleague, James Stevens, to discuss recent crypto-related activities and the federal banking regulators. James, I'm looking forward to talking with you today. Just to kick it off, I guess, high level, what have the federal banking regulators been saying recently about banks engaged in crypto-related activities?

James Stevens:

Thanks for having me, Ethan. Pleasure being with you.

The bank regulators started to get into the regulation of crypto activities of banks in the summer of 2020. The comptroller of the currency under the Trump administration, Brian Brooks, came out with a sweeping statement saying that national banks could engage in all manner of crypto-related activities. That led to a couple of fast moving banks to rapidly get into the space and start serving that market.

However, ever since then, the federal banking regulators have been trying to walk back what Brooke said in 2020. Specifically, in the fall of 2021, the OCC came back and said that while they are not rescinding the statements that Brooks made in 2020 that national banks should not engage in those activities without first talking to the OCC, which is tantamount to having to get regulatory approval. The FDIC had a similar statement in April of 2022, and more recently, the Fed has also jumped on that bandwagon.

At this point, the position of the federal banking regulators is that banks cannot engage in crypto activities without consulting with and giving notice to their federal banking regulators.

Ethan Ostroff:

James, I understand there's been some political pushback on the FDIC's review of banks' proposed crypto activities. Could you talk a little bit about what's going on and whether you think it will have an impact?

James Stevens:

Very recently, there's been, in light of the FDIC coming out in April of 2022 and saying that banks need to run crypto activities by the FDIC before they engage in them, of course, the FDIC is then reacting to them. And some of the people in Washington have said that they don't believe that the FDIC is acting quickly, that they're giving a rational basis for denying the ability of banks to do certain things and things like that. That kind of political pushback on the federal banking regulator has a very limited chance of success. The courts and the regulators, basically everyone, thinks that the regulators are better suited than certainly politicians and others in trying to determine what it is appropriate for banks to do. And so they have essentially a very long leash in order to regulate those activities.

So I'll call it interesting political pushback, but chances of impacting the way the FDIC is going to behave are very low.

Ethan Ostroff:

So just taking a step back. High level, could you talk a little bit about how there's the Federal Reserve, there's the FDIC, there's the OCC, how do those three regulators interact with banks or different types of financial institutions? And how do they overlap or not overlap in how they regulate banks?

James Stevens:

We have a federal banking system, and there's a dual banking system that every bank that is in America that's operating is either a national bank, or it's a creature of state law, it's a state bank. National banks are regulated by the OCC. State banks that have a state banking regulator that they're chartered under, that have deposit insurance, and all banks operating in the US have deposit insurance, are regulated by the FDIC, unless those banks have chosen to become members of the Federal Reserve. If they're a Federal Reserve member, they're regulated by the Federal Reserve Board.

Ethan Ostroff:

From a bank's involved in crypto perspective then there's a need for consistency and uniformity. I take it amongst these three federal regulators as to how they're approaching crypto-related activities. Would you agree with that?

James Stevens:

I agree and disagree a little bit. I think what I agree about is there is always a sense in the banking world that you don't want to make it advantageous to sort of regulator shop. You shouldn't have a dramatically different approach to solving from one regulator to the other, because it gives the banks different advantages and disadvantages, depending on where they're chartered. So that's a general concept that I think that we want to see is we want to see basically all the regulators behaving within a certain level of similarity in how they regulate these activities.

On the flip side, I do think that having three regulators in a sense creates a little bit of a competitive environment. Usually that results in trying to figure out who's going to be meaner and faster at being mean and things like that, and so the competitive environment doesn't work. But I think that it can work when you're talking about novel banking activities if the federal banking regulators, if, for example, the OCC became much more open to these kinds of activities by national banks.

Now, I think it would encourage the Fed and the FDIC to look at what they're doing and say, "Hey, should we get in line with what the OCC is doing? Are we putting our banks at a competitive disadvantage? Are we not thinking about something the right way?"

So there's pluses and minuses, but I think you're right, as a general matter, we want parody.

Ethan Ostroff:

And right now, from that perspective with banks involved in crypto-related activities, do you see a consistency amongst the three regulators, or do you see a break amongst them or material differences amongst them about how they're approaching bank-related crypto activities?

James Stevens:

I don't think that there is. And frankly, to be honest with you, the sample set is incredibly small. There was a moment between the summer of 2020 and when the administration rolled over in 2021, where it was sort of a free-for-all and banks could get into crypto activities. But ever since the new administration came into power, people have been very slow and hesitant to get into it because, of course, these statements have now come out at this point. But even before these formal statements came out, the regulators were sort of hinting at the exam staff level that, hey, really shouldn't go get in these activities without talking to us. And then what's happened this year in the crypto industry where there's been this dramatic decrease in valuations, I think that it's frankly put the brakes on a lot of activities going on at the banks.

So my point is ever since the regulators have said that you got to go and get approval, there's been not a huge amount of banks that have actually gone down that road. But my observation notwithstanding that limited sample set is that it's not that they necessarily are treating banks any differently or necessarily think about it differently, but I do think that, and if you see this in all areas in the regulatory environment, is that some of the agencies have more expertise than others. For example, the OCC, I think, may have more expertise than the other banking regulators, because there have been more natural banks involved in these activities for a longer period of time. The OCC has also really tried to push itself to be kind of a regulator in the FinTech world generally. And so I think that they've made some investments.

I'm not saying that the Fed and the FDIC is not really smart about it. I think they are. And I think that they have a lot of experienced people there that have a lot of expertise. But if you had to say, is there somebody that's a little bit ahead, maybe that's the OCC. That could change tomorrow with somebody bringing in a new staff member or another bank that's being regulated, getting into those activities at one of those regulators and that regulators getting a rapid need to get up to speed.

Ethan Ostroff:

It seems there's also been some recent activity on the Hill with political forces pushing back on allowing banks to engage in crypto activities at all. What are you seeing in that regard? And what's driving that perspective by some people in Congress?

James Stevens:

I think this is a great example. You asked me earlier about the political pressure on the FDIC of not green-lighting crypto activities. The reason that the political realm has so little impact on the federal banking regulators when it comes to policy type decisions is because you usually have two and maybe more different views and different political persuasions that it's hard to jump on one side or the other.

But yeah, I think what we're seeing now that's kind of interesting is because of the rapid decline in the value of cryptocurrencies, we're seeing a lot of consumers that are getting hurt out there, consumers that borrowed against cryptocurrency that's now lost its value. They're having huge margin calls. For example, people that had basically put all their eggs in one basket and had their entire net worth wrapped up into cryptocurrency, only to see it being cut in more than half. And so there is a political push to try to limit the activities of banks in engaging in those activities before there's some rules of the road with respect to consumer protection.

You also have the environmental lobbyist and the politicians that are working on those issues. Mining of cryptocurrency is a very, very energy demanding activity. And there's a real concern that mining this crypto asset is going to have a very bad effect on our climate. And so you have another faction of our politicians working on that angle.

Ethan Ostroff:

Yeah, my recollection is I think Senator Elizabeth Warren has been involved in a number of those letters that have been sent by groups of senators to various federal agencies, including the Department of Energy and the EPA, about the potential impacts of crypto mining. Most recently there was the letter earlier in August, I think it was Senator Warren and that group of other senators, requesting that the OCC rescind the previous guidance in an issue about cryptocurrency and replace it, and I think suggesting that it should be replaced in coordination with the other federal banking regulators.

From a practical perspective, do you have any thoughts about what happens when the OCC gets a letter like this from a group of senators, and how it may impact banks that are subject to the supervision of the OCC?

James Stevens:

I truly believe it has very little impact. I think that certainly the people that had these agencies or political appointees, they care about what the politicians are saying to them, but these are huge agencies with career regulators that fill all the key positions. They are so far ahead of what Elizabeth Warren knows about cryptocurrency mining, that it just is not really meaningful. It'd be like if I sell a letter to a professional golfer and told them about their swing; it just doesn't have a lot of impact because it's not backed by the expertise that these regulators have.

Ethan Ostroff:

Most recently, we've seen a lot of activity by the FDIC with respect to deposit insurance and deposit insurance disclosures. Could you talk a little bit about that and what you see as coming down the pipeline because of that activity?

James Stevens:

That has actually been really interesting. I think this is a place where cryptocurrency companies that are having control over customer deposits or directing traffic on customer deposits, and more specifically banks that are partnering with these cryptocurrencies, really need to look at the guidance that's coming out. And frankly, this is not new guidance. I mean, one of the big, hot buttons for the FDIC, because that FDIC insurance is so valuable and so meaningful to customers is they do not like it when anyone misleads someone about being a bank or stating that whatever assets that they are holding are insured by the FDIC, unless they are. The FDIC only ensures bank deposits. It doesn't ensure securities. And it certainly doesn't secure a digital wallet that has crypto assets in it.

What has happened over the past couple of months is that the FDIC has issued cease and desist letters to a handful of cryptocurrency operators telling them that they have statements on their websites and in their marketing materials, which either imply that the wallets that hold those assets are ensured by the FDIC, or they're holding themselves out as banks, or that the money that they're holding is in an insured deposit account.

We have actually done that on behalf of a bunch of our clients. It's not just cryptocurrency. That's where the focus is right now. But it's really any FinTech company that's engaged in holding money or transfer money. If you're one of those companies, you need to go look at your website, make sure that you're not holding yourself out as having insured deposits unless you do. And then if you're a bank that's providing access to deposit accounts to those companies, you really got to take a look at that and make sure that it's very clear what's an insured deposit and what is not. I think a lot of those operators were just not as crisp as they needed to be on their website.

I think FDIC will continue to crack down on this as these partnerships between banks and FinTech companies grow, which I think they will exponentially. As they continue to grow, and anybody that's on the deposit side of that or money transmission side of those partnerships really needs to study this guidance. And study the historic guidance that FDCI has put out on implying that you're an insured institution or that you have insured deposits and make sure that you're in compliance with that guidance.

Ethan Ostroff:

Well, that's great, James. I really appreciate it. And thank you for joining us today.

James Stevens:

Glad to be with you.

Ethan Ostroff:

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