Cravath Financial Institutions Insights

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Mid-Year 2022 Review of Bank Regulation Developments

A few months ago, we noted that "it would be a significant (and achievable) accomplishment if we go into the late summer and fall with a clear path to comprehensive stablecoin regulation and some indication of how cryptoassets more broadly will be treated in the banking sector". Although a clear path has yet to emerge, many policymakers certainly are trying.

For example, members of Congress have proposed or are considering bipartisan legislation. The Bank for International Settlements ("BIS") has stated in no uncertain terms that "[r]egulatory action is needed to address the immediate risks in the crypto monetary system and to support public policy goals". Moreover, Michael Barr's likely confirmation as the next Vice Chair for Supervision at the Federal Reserve Board ("FRB") should ensure that the leadership positions necessary for the federal banking agencies to make progress are filled.

To that end, below we review some of the more recent cryptoasset-related developments in the banking sector over the mid-year period and offer thoughts on what they mean for the remainder of the summer and fall.

- The BIS has declared that "[t]he crypto universe is in turmoil" and that stablecoins "lack the qualities necessary to underpin the future monetary system". That latter statement underscores the views of both proponents and skeptics of putting in place a regulatory framework for stablecoins. That is, proponents tend to view a new framework as necessary to allow innovation to flourish and to protect consumers and financial stability, whereas skeptics see stablecoins as a less safe way to provide the same products and services that traditional banks can provide through an enhanced payment system.

- At the same time, the Office of the Comptroller of the Currency, in its recently published semiannual risk perspective, said that cryptoasset "products and services can create opportunities for banks and their customers" and "also amplify existing risks and introduce new risks". The agency noted that "additional regulatory guidance is anticipated", but did not provide further details.

- In addition, FRB Vice Chair Lael Brainard recently said, "This is the right time to establish which crypto activities are permissible for regulated entities and under what constraints so that spillovers to the core financial system remain well contained".

- Meanwhile, the *American Banker* has reported that an "accounting bulletin from the Securities and Exchange Commission has complicated bank regulators' plans to clarify how institutions should treat digital assets they hold in custody". Nevertheless, some policy making work continues.

- For example, Senators Gillibrand (D-NY) and Lummis (R-WY) introduced the Responsible Financial Innovation Act, which would: provide for a new regulatory framework for cryptoassets and stablecoins (see here for our summary of this and various other stablecoin legislative proposals); change the law with respect to access to the Federal Reserve's payment system; and make changes to neutralize the effect of the accounting bulletin noted above.

- Representative Jim Himes (D-CT) released a thought piece entitled "Winning the Future of Money: A Proposal for a U.S. Central Bank Digital Currency".

    - This paper is intended to "begin the dialogue, education and debate that will lead to draft legislation to authorize further studies, pilot projects, and the possible creation of a U.S.-issued CBDC".

    - Interestingly, the paper discussed the concept of a wholesale CBDC, noting that the Federal Reserve "should allow financial institutions the option to tokenize assets" and use them as part of the Federal Reserve's payment system "to provide an option to make settlement, clearing, interbank transfers, and other wholesale banking activities faster, cheaper, and more efficient" and to "eliminate credit risk between intermediaries". This articulation is one of the clearer ones from the government about what a wholesale CBDC could be and, notably, does not appear to limit access to a wholesale CBDC to banks (the paper refers to "qualified financial institutions", which is not defined).

- Rep. Himes is not the only official to make this point. FRB Vice Chair Brainard raised similar issues in a speech, stating that a "digital native form of safe central bank money could enhance stability by providing the neutral trusted settlement layer in the future crypto financial system" and could be a "natural evolution" in payments.

- As we anticipated, the Basel Committee on Banking Supervision ("BCBS") issued its "Second consultation on the prudential treatment of cryptoasset exposures". See our summary here. The BCBS asked for comments by September 30, 2022 and said it aims to finalize the standards by year-end. The finalization of the BCBS standards will be an important step toward clarifying the economics of cryptoasset activities for banking organizations, as regulators across the globe will seek to implement its standards for the capital charges and other requirements applicable to such activities.

- In an apparent attempt to keep up the momentum for stablecoin legislation, at the end of June, Treasury Secretary Janet Yellen called a meeting of the President's Working Group on Financial Markets ("PWG") to discuss stablecoin risks. The readout from the meeting noted Secretary Yellen's view that there needs to be "serious legislative efforts" and highlights the need for a "federal framework on a consistent and comprehensive basis".
    - This latter statement seems to suggest that the administration's view is that any legislation should not retain an option for state regulation, such as the approach proposed by Senator Pat Toomey (R-PA) (see here for our summary of his proposal).
    - Thus, this issue appears to be a fundamental one that will need to be resolved, and we are skeptical that the administration would be willing to cede ground on this point.

- U.S. Treasury Under Secretary for Domestic Finance Nellie Liang, who oversaw the PWG Report on Stablecoins (see here for our summary) recently signaled as part of a wide-ranging speech that the administration is considering both bank and nonbank models for the issuance of stablecoins. This approach is consistent with recent news reports that the PWG, in contrast to its stablecoin report, is now open to permitting nonbanks (as well as banks) to issue stablecoins. Under Secretary Liang added, referring to President Biden's executive order on digital assets (see here for our summary and timeline of reports required under the order), that stablecoins raise a broader range of policy issues than those that have been the primary focus of the financial regulators and that the regulators would benefit from collaborating with other agencies to address national security and other non-prudential risks.[1]

- At the 2022 Consensus Conference in Austin, Texas, Senators Gillibrand and Toomey, and Representative Patrick McHenry (R-NC), the ranking member of the House Financial Services Committee ("HFSC"), agreed that stablecoin legislation could happen this year. This exchange was interesting, insofar as conventional wisdom might suggest that Rep. McHenry would be inclined to wait until after the mid-term elections to pursue legislation, when he could be the Chairman of the HFSC.

- As the debate about stablecoins and the role of the states continues, some state regulators are not waiting to act. For example, the New York Department of Financial Services issued guidance for its regulated institutions that issue or seek to issue U.S. dollar-back stablecoins (see here for our summary of the guidance).

- Although the banking agencies have not formally weighed in, principals have commented. These comments often center around the institutional interests of each agency. For instance, FRB Chair Jerome Powell noted during testimony before the HFSC that the FRB is "very important in payments" and so if stablecoins "have anything to do with . . . payments that the public is involved in", then the FRB should be involved.[2]
    - That comment conceptually relates to the point raised in Rep. Himes' CBDC paper about wholesale CBDCs.

[1] Under Secretary Liang also noted that Treasury is leading a number of reports required under the executive order. For example, the Treasury, in consultation with a number of other agencies, recently delivered to President Biden a framework for interagency engagement with foreign counterparts and in international fora as directed by the executive order.

[2] House Financial Services Committee, Hearing on Monetary Policy and the State of the Economy (June 23, 2022) (exchange with Rep. Gottheimer).

- For example, if a nonbank stablecoin issuer were to have access to the Federal Reserve's payment system (Senator Toomey's proposal would provide such access), questions about how that firm is regulated and the terms of such access would come to the fore.

- Further, if that payment system access at some point evolved to incorporate tokenized assets, then a logical consequence could be the introduction of the type of wholesale CBDC that Rep. Himes envisions (and that FRB Vice Chair Brainard appears to discuss in her speech noted above) and that would allow settlement of transactions between the "on-chain" world (on which stablecoins exist) and the traditional financial system.

Other issues continue to percolate as well. For example, the BCBS finalized principles for effective management and supervision of climate-related financial risks (see here for our overview of climate-related issues). In addition, the federal banking agencies have not yet finalized the Basel III end-game standards and also are undertaking a debate about how to approach bank mergers (see here for a comment letter we submitted on the topic). We will be watching over the next several months to see which of these issues gain traction once Michael Barr is in place as Vice Chair for Supervision. We suspect Mr. Barr has been considering thoroughly those issues he would prioritize as Vice Chair and we anticipate he will communicate his agenda. Based on the points noted above, it seems like the administration and certain members of Congress would like cryptoassets and, in particular, stablecoins to be at the top of the agenda. We also look forward to seeing if the prediction made by Senators Gillibrand and Toomey and Rep. McHenry that legislation can happen this year becomes reality.