

The OCC's recent interpretive letter clarifying stablecoin-related activities for national banks and federal savings associations may further encourage these activities amidst growing public interest.

On September 21, 2020, the Office of the Comptroller of the Currency (OCC) issued an interpretive letter and provided clarifying guidance to national banks and federal savings associations on their authority to hold stablecoin reserves and manage stablecoin-related activities.¹

Simultaneously, officials with the Securities and Exchange Commission's Strategic Hub for Innovation and Financial Technology (FinHub) published a statement on the OCC's interpretive letter, noting that "[w]hether a particular digital asset, including one labeled a stablecoin, is a security under the federal securities laws is inherently a facts and circumstances determination."² The SEC statement encourages issuers of stablecoins to contact the regulator to ensure activities are structured, marketed, and operated in compliance with the federal securities law. This is the first major collaboration between the SEC and OCC on digital assets as both agencies

deem that regulatory clarity is an important next step in the maturation of stablecoins in the US.

As a type of digital asset, stablecoins have several distinct features: they aim to maintain stable value by tying the digital currency to an asset or basket of assets, such as fiat currency, commercial bank deposits, or government-issued bonds. It is common for stablecoins to be issued by a central entity and rely on third-party institutions for certain aspects (e.g. financial data protection).³

Companies that issue stablecoins have sought to place the funds backing the stablecoin, so-called "reserve funds," with a US bank. The OCC notes that several stablecoin issuers have promoted these reserve funds to support the trustworthiness of their stablecoin.⁴ The interpretative letter clarifies that US banks have the legal authority to receive deposits from issuers of stablecoins, including deposits that establish reserves for fiat-pegged

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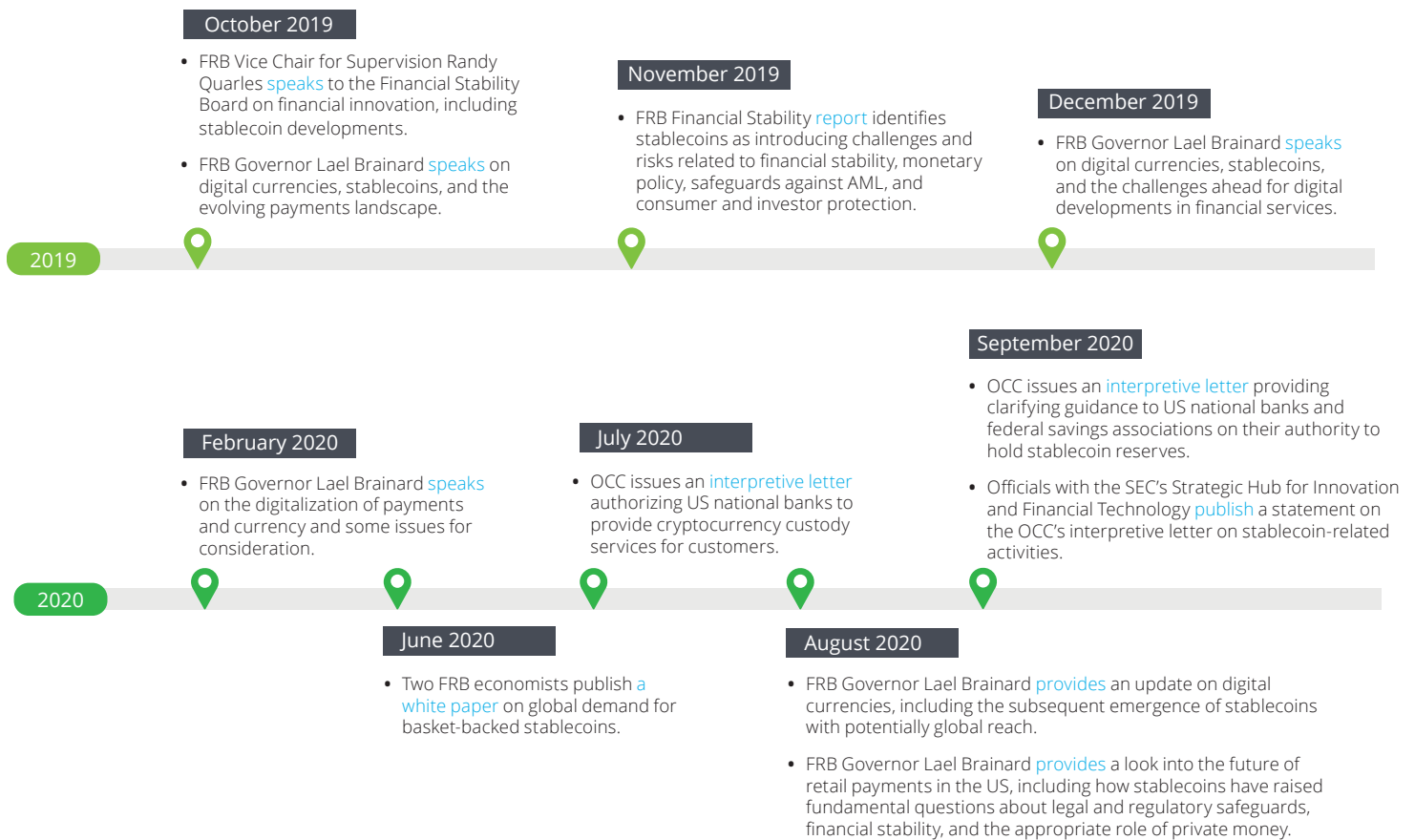
stablecoins associated with hosted wallets,⁵ and to engage in activities related to receiving deposits from issuers.

Public interest in stablecoin activities prompted the OCC to issue the interpretive letter, which comes on the heels of recent initiatives by the agency to encourage innovation in financial services, including its Advance Notice of Proposed Rulemaking on digital banking activities⁶ and its interpretative letter authorizing national banks to provide cryptocurrency custody services.⁷

As such, stablecoins and other innovative payment systems may appear on the regulator's roadmap for years to come, as highlighted in the *OCC's Fiscal Year 2021 Bank Supervision Operating Plan*.⁸ Additionally, the Board of Governors of the Federal Reserve System (FRB) has also expressed significant interest in monitoring stablecoin activity globally, particularly among central banks and the legal and regulatory considerations for the financial industry (see chart below).⁹

Evolution of US Financial Regulators on Stablecoin-related Activities¹⁰

Recent announcements (October 2019 – September 2020)



What does the interpretive letter mean for US banks?

The OCC considers stablecoin-powered payments systems to be responsible and permissible if they are based in the US, have full Anti-Money Laundering (AML) protection, and are collateralized on a fiat system. As with any financial innovation, new banking activities like stablecoins should be developed and implemented consistently with sound risk management principles and should align with banks' overall business plans and strategies.¹¹

The interpretive letter focuses on several risk areas that this new area of banking activity may impact in the short-term. With the regulatory clarity now in place, there may be considerable uptake in stablecoin-related activities by banks, and this may entail some longer-term implications for the US financial industry to consider.

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Nearer-term considerations for US banks holding stablecoin reserves:

- **Identify and control risks with stablecoin-related activities:** "A bank providing services in support of a stablecoin project must comply with all applicable laws and regulations and ensure that it has instituted appropriate controls and conducted sufficient due diligence commensurate with the risks associated with maintaining a relationship with a stablecoin issuer."¹² When establishing and maintaining relationships with stablecoin issuers, banks should ensure that they have established the appropriate internal controls and due diligence procedures for the course of the relationship.
- **Monitor cryptocurrency activity for BSA/AML compliance:** The bank must establish and maintain procedures "reasonably designed to assure and monitor its compliance with the BSA and its implementing regulations, including but not limited to customer due diligence requirements under the BSA (Bank Secrecy Act) and the customer identification (CIP) requirements under section 326 of the USA PATRIOT Act."¹³ Banks should ensure that they have policies and procedures in place to mitigate money laundering and terrorist financing risk of virtual currencies. These include customer due diligence requirements under the BSA, customer identification requirements, identification and verification of the Beneficial Owners of legal entity customers, and suspicious activity reporting. Banks will need to understand their virtual currency customer base (e.g., whether banks have institutional or peer-to-peer virtual currency customers) and take inventory of the controls in place to identify customers. Banks will also need to understand how their institution interacts with emerging payment systems and assess the tools available to identify and report suspicious activity.
- **Establish appropriate contractual arrangements:** "A bank may also enter into appropriate contractual agreements with a stablecoin issuer governing the terms and conditions of the services that the bank provides to the issuer [...] Such agreements should include mechanisms to allow the bank to verify the number of outstanding stablecoins issued by the issuer."¹⁴ In this regard, the bank should establish and monitor service level agreements and maintain ongoing third-party oversight procedures relative to the issuer's activities and business operations.
- **Recognize that reserves associated with stablecoins could entail significant liquidity risks:** The OCC expects banks to manage their liquidity risks. By way of example, the OCC states the bank "should verify and ensure that the deposit balances held by the bank for the issuer are always equal to or greater than the number of outstanding stablecoins issued by the issuer."¹⁵ Given the variability with the amount of reserves deposited and being withdrawn on a daily basis combined with a potential situation where a bank has a concentration of stablecoin issuers customers, liquidity is an important risk for banks to manage. During a period of market stress, this situation could create a deposit run of sorts on the bank's available liquidity, since the reserves—by nature—do not represent a core deposit or stable funding source.

Longer-term implications for US banks holding stablecoin reserves:

- **The OCC interpretative letter is limited to stablecoins backed by a single currency.** While the letter would seemingly permit the single currency stablecoins, it would not permit multi-currency options or other industry coins based upon commodities.
- **The interpretation is also limited to hosted wallets.** Hosted wallets are subject to the BSA requirements per the Financial Crimes Enforcement Network's (FinCEN) May 2019 guidance *Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies*, implying lower anti-money laundering risks for the bank.¹⁶ Since unhosted wallets are not subject to the BSA, it is unclear whether banks will be allowed to hold reserves for unhosted wallets in the future.

Special tax considerations:

The OCC notes that recent public independent auditors' statements of several stablecoin issuers indicate reserve funds are placed as deposits with US banks. While there remain many uncertainties regarding the tax treatment of digital assets, many stablecoin issuers depend upon this relationship with a bank to hold all funds associated with issued stablecoins as a key factor in their tax treatment. It should be noted that the tax treatment of each stablecoin and its use in business activities requires careful analysis as it relates to revenue recognition and informational reporting.

How should US banks prepare for what's next?

In addition to continuing to monitor the US and global regulatory agendas, financial firms should consider immediate and tangible steps toward managing innovation risk, including:

- Performing independent, comprehensive assessments and operating effectiveness testing of BSA/AML programs, notably those of firms hosting digital currency wallets;
- Considering and incorporating relevant evolving risk management guidance published by the OCC and other federal banking regulators, by both the banks and third-party firms within a bank's operating ecosystem; and
- Building and maintaining dynamic compliance and risk management expertise.

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Closing

The OCC interpretive letter is the latest development highlighting the importance regulators have placed on observing marketplace innovation, understanding the risks, and realizing how the regulatory and supervisory environments will need to adapt in order to support future innovation and US economic competitiveness.

Deloitte has been at the forefront of engaging with regulators and financial services firms on these important matters, including helping

leaders think through innovative ways to strengthen and effectively manage financial innovation risks.

This is part of a new series on how technology and innovation are shaping US financial regulatory initiatives and the impact these developments may have on the future of the banking and financial industries.

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Endnotes

1. Office of the Comptroller of the Currency (OCC), "[Federally Chartered Banks and Thrifts May Engage in Certain Stablecoin Activities](#)," Chief Counsel Interpretative Letter #1172, accessed on October 5, 2020.
2. Securities and Exchange Commission (SEC) Strategic Hub for Innovation and Financial Technology, "[SEC FinHub Staff Statement on OCC Interpretation](#)," accessed on October 5, 2020.
3. The OCC notes that "[f]or purposes of this letter, we consider a "stablecoin" to be a unit of cryptocurrency associated with hosted wallets that is backed by a single fiat currency and redeemable by the holder of the stablecoin on a 1:1 basis for the underlying fiat currency upon submission of a redemption request to the issuer. We are only opining on those facts and circumstances at this time."
4. Office of the Comptroller of the Currency (OCC), "[Federally Chartered Banks and Thrifts May Engage in Certain Stablecoin Activities](#)," Interpretative Letter #1172, accessed on October 5, 2020, 2020.
5. Ibid.
6. OCC, "[National Bank and Federal Savings Association Digital Activities: Advance Notice of Proposed Rulemaking](#)," OCC Bulletin 2020-59, accessed on October 5, 2020.
7. OCC, "[Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers](#)," Interpretive Letter #1170, accessed on October 5, 2020.
8. OCC, "Fiscal Year 2021 Bank Supervision Operating Plan," accessed on October 5, 2020.
9. Federal Reserve Board (FRB) Governor Lael Brainard, "[Digital Currencies, Stablecoins, and the Evolving Payments Landscape](#)," accessed on October 5, 2020; Governor Lael Brainard, "[Update on Digital Currencies, Stablecoins, and the Challenges Ahead](#)," accessed on October 5, 2020
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12. OCC, "[National Bank and Federal Savings Association Digital Activities: Advance Notice of Proposed Rulemaking](#)," OCC Bulletin 2020-59, accessed on October 5, 2020.
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16. Financial Crimes Enforcement Network (FinCEN), "[Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies](#)," FIN-2019-G001, accessed on October 5, 2020.



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