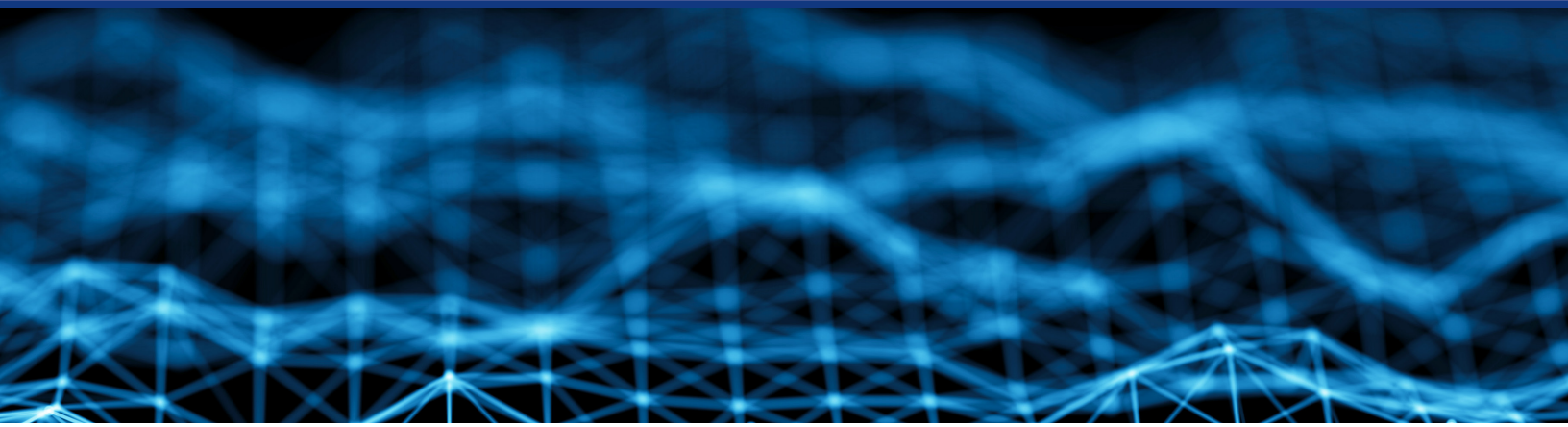

OCC Lays Groundwork for Payment Innovation and Digital Assets Activities for National Banks

The Office of the Comptroller of the Currency (OCC) on January 4 issued a third major interpretive letter with significant implications for payments process innovations that can both benefit customers and enhance future business opportunities of national banks in connection with digital assets activities.[1] This letter builds upon the OCC's recent interpretive letters regarding cryptocurrency custody[2] and authority for national banks to hold stablecoin reserves.[3]

Through these interpretations, the OCC clarifies that, beyond custody of cryptocurrencies and holding reserves for fiat-backed stablecoins, national banks can also **buy**, **sell**, and **issue** stablecoins and operate stablecoin networks of their own. Notably, this third OCC interpretive letter not only signals that national banks may incorporate independent node verification networks (INVNs) into their own payments and liquidity processes through fiat-backed stablecoins, but also suggests that additional forms of digital asset use cases leveraging these structures will also be in scope for national bank activities. Importantly, all three issuances are in the form of legal interpretations of national banks powers under the National Bank Act by the OCC chief counsel and are meticulously supported by precedents, making any reversal of these positions highly unlikely.

As Promontory has previously observed, OCC interpretations around permissible digital activity has the potential to accelerate wider adoption of digital assets by traditional financial services participants. This most recent OCC interpretation highlights that institutions' use of stablecoins could generate significant revenue streams and provide cost savings, so long as the institution can effectively manage stablecoins' unique risks and compliance issues. In doing so, national banks also enter an emergent supervisory space where they will be taking on not only typical bank and custodian duties, but also responsibilities as a network administrator and financial market utility, with corresponding risks and regulatory requirements.

In this article, we:

- Describe potential opportunities
- Outline operational considerations and key risks
- Discuss how Promontory can help

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1. "OCC Chief Counsel's Interpretation on National Bank and Federal Savings Association Authority to Use Independent Node Verification Networks and Stablecoins for Payment Activities." Office of the Comptroller of the Currency, 4 Jan. 2021, https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-2a.pdf. For detailed summaries of the previous two interpretive letters, please refer to Promontory's 15 Oct. 2020 article, "What the OCC Interpretive Letter on Stablecoins Means for Banks, Issuers, or Users," https://www.promontory.com/our-expertise/article/5f876b030a034708ef979a88; and Promontory's 6 Aug. 2020 article, "What the OCC Interpretive Letter on Cryptocurrency Custody Means for Banks and Digital Assets Firms," https://www.promontory.com/our-expertise/article/5f2c00b434357b08e137b701.
2. "Interpretive Letter #1170, Authority of a National Bank to Provide Cryptocurrency Custody Service for Customers." OCC, 22 July 2021, https://www.occ.treas.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1170.pdf.
3. "Interpretive Letter #1172, OCC Chief Counsel's Interpretation on National Bank and Federal Savings Association Authority to Hold Stablecoin Reserves." OCC, 21 Sept. 2020, https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1172.pdf.

Stablecoin Networks as a Growth Opportunity for National Banks

Stablecoin networks and INVNs (including, but not limited to distributed ledger technology (DLT)) at a high level refer to the underlying organization and technical models a stablecoin uses.[4] Stablecoin networks typically consist of an issuer (or network administrator) as well as a number of third parties that support or interact with the network. These can include blockchain node operators, network participants that issue or redeem stablecoins or "on/off-ramp" between the stablecoin and fiat currency, and users that interact within the stablecoin network ecosystem. We've seen stablecoin adoption growing quickly, and billions of dollars of stablecoin trade globally. The latest OCC interpretation posits: "Among the potential benefits is the fact that INVNs may enhance the efficiency, effectiveness, and stability of the provision of payments." In our experience, fiat-backed stablecoin networks have a number of use cases. We highlight three potential use cases for national banks:

Illustrative Use Cases for Bank Stablecoin Networks

Internal Network	A national bank could design, develop, and issue its own stablecoin, with specific network design criteria suited to internal business needs. For example, the bank could build a stablecoin to supplement or replace cash management and internal treasury functions, with the "users" of the stablecoin being internal participants, such as the bank's own departments or affiliates. Benefits to this approach include faster payments designed to meet regulatory requirements around reporting, recordkeeping, and liquidity. In other words, it could serve as an internal substitute for existing payment networks with domestic or international application.
Semi-Permissioned Network	In this case, the above considerations could still apply; additionally, the bank may also offer these services to its own customers for near-instantaneous transfer with the bank (or between customers). This approach raises additional risk and compliance issues for safekeeping and access (e.g., customer onboarding, due diligence, and considerations around on/off-ramps for stablecoins).
Open Networks	A bank may create a more "open" representation of a digital dollar, accessible outside of the bank's own networks. In this sense, the stablecoin could be a diffuse means to transfer value digitally across networks. Economies of scale and network effects could create significant revenue potential. Through its recent issuance, the OCC notes the permissibility for this approach; however, it presents significant operational and compliance concerns (among others), given global reach with near-instantaneous flows.

As banks assess their own processes and proposed customer journeys, they may design stablecoin networks across multiple phases, incorporating additional features or network participants (including other banks) within the "gated" ecosystem.

Our view is that banks will need to establish appropriate governance and controls, including network access criteria based on network design (and business case). As the industry matures, there will likely be many stablecoin use cases for national banks, and second-order effects building on these technologies. Given the broad application of INVNs (e.g., building stablecoins backed by commodities, other assets, or possibly other use cases), national banks could consider significant long-term opportunities building on these initial steps.

4. "OCC Chief Counsel's Interpretation on National Bank and Federal Savings Association Authority to Use Independent Node Verification Networks and Stablecoins for Payment Activities." Office of the Comptroller of the Currency, 4 Jan. 2021, https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-2a.pdf.

Risks and Compliance Challenges for Stablecoin Issuance

The OCC interpretations refer to certain "guardrails" around permissible activity that must be considered. Stablecoins have some corollary representations with other "fiat-based" activities, but also present unique and significant stablecoin network design-dependent risk factors (and controls). These include:

- **Stablecoins Reserves and Auditability.** The OCC interpretation regarding stablecoin reserves highlighted the importance of reserve management, including the need to conduct daily verification to verify that "reserve account balances are always equal to or greater than the number of the issuer's outstanding stablecoins."[5] In addition to reserves, or collateralization of reserves, the interpretation indicates that banks should have processes in place to segregate funds from daily operations, as well as tools to identify, measure, and monitor stablecoin flows. For example, reports of the composition and current market value of stablecoin reserves should be made available daily. We believe banks will likely need to engage qualified third-party auditors to validate stablecoin reserve periodically to ensure transparency.
- **Bank Secrecy Act/Anti-Money Laundering (BSA/AML) and Market Manipulation.** Stablecoin design and issuance require banks to manage specific BSA/AML compliance considerations that scale considerably depending on network design. Among others cited in the most recent OCC interpretation[6] and a recent statement by the President's Working Group on Financial Markets (PWG),[7] such controls include Financial Crimes Enforcement Network (FinCEN) registration, recordkeeping and reporting requirements, detection of unusual activity, and a tailored sanctions compliance program. Given recent guidance and enforcement activity from FinCEN and the Office of Foreign Assets Control (OFAC), for recordkeeping and IP address verifications, we believe the risks can be considerable, not least if the network design allows for so-called unhosted wallets.[8] Similarly, a bank will need clear processes to verify that its network is not enabling market manipulation or fraud.
- **Operational and Information Technology (IT) Risks.** The most recent OCC interpretation[9] rightly cites the decentralized nature of stablecoins as a benefit for operational resiliency, but our view is that in practice, there are significant operational risk and IT challenges in developing and maintaining a stablecoin network. Chief among these include safekeeping of private keys (including technology infrastructure and technical controls), considerations around source code of the stablecoin itself and how it interacts with its underlying INVN (e.g., due to network changes), and an array of cyber and IT risks unique to digital assets. Network and node operations also require a specific skillset, which depending on approach (e.g., networks that rely on or support use of smart contracts) could raise challenges in maintaining resources, including specialized personnel.
- **Liquidity.** The second OCC interpretation highlighted that banks holding stablecoin reserves "manage liquidity risk with sophistication equal to the risks undertaken and complexity of exposures," including via "contractual agreements with a stablecoin issuer governing the terms and conditions of the services that the bank provides to the issuer."[10] As banks assess liquidity risk management, they will have to account for stablecoin-specific risk factors, such as its account segregation model. We believe it is essential that banks incorporate requirements on reserve management and auditing, capital buffer, and contingency funding planning into its framework, with processes in place to meet contractual and supervisory obligations.

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5. "Interpretive Letter #1172, OCC Chief Counsel's Interpretation on National Bank and Federal Savings Association Authority to Hold Stablecoin Reserves." OCC, 21 Sept. 2020, https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1172.pdf.
6. "OCC Chief Counsel's Interpretation on National Bank and Federal Savings Association Authority to Use Independent Node Verification Networks and Stablecoins for Payment Activities." Office of the Comptroller of the Currency, 4 Jan. 2021, https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-2a.pdf.
7. "President's Working Group on Financial Markets Releases Statement on Key Regulatory and Supervisory Issues Relevant to Certain Stablecoin." U.S. Department of the Treasury, 14 Dec. 2020, https://home.treasury.gov/news/press-releases/sm1223.
8. Recent activity includes: "First Bitcoin 'Mixer' Penalized by FinCEN for Violating Anti-Money Laundering Laws." FinCEN.gov, 19 Oct. 2020, https://www.fincen.gov/news/news-releases/first-bitcoin-mixer-penalized-fincen-violating-anti-money-laundering-laws; "Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets." U.S. Department of the Treasury, FinCEN, https://public-inspection.federalregister.gov/2020-28437.pdf; and "Report of Foreign Bank and Financial Accounts (FBAR) Filing Requirement for Virtual Currency." FinCEN.gov, https://www.fincen.gov/sites/default/files/shared/Notice-Virtual%20Currency%20Reporting%20on%20the%20FBAR%20123020.pdf.
9. "OCC Chief Counsel's Interpretation on National Bank and Federal Savings Association Authority to Use Independent Node Verification Networks and Stablecoins for Payment Activities." Office of the Comptroller of the Currency, 4 Jan. 2021, https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-2a.pdf.
10. "Interpretive Letter #1172, OCC Chief Counsel's Interpretation on National Bank and Federal Savings Association Authority to Hold Stablecoin Reserves." OCC, 21 Sept. 2020, https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1172.pdf.

- **Legal Risk.** In our view, banks will need to depict carefully the actual and expected usage of the stablecoins, and how their approach aligns within existing (and evolving regulatory framework(s). Treatment of stablecoins, for example, as a monetary instrument versus a security could have regulatory costs and impact and implications for deposit insurance.
- **Third-Party Risk Management.** In our view, if banks decide to partner with third parties for critical functions (e.g., digital asset custodial services or use of third-party stablecoin networks), they face significant third-party risk given the novelty of such technology processes and business-related controls, particularly within a bank context.

How Promontory Can Help

Promontory has developed a digital asset-specific advisory approach based on our work with supervisory bodies, banks, and digital asset firms, as well as our relationships with digital asset analytics and other service providers. This experience coupled with our deep regulatory expertise provides us with a unique understanding of the appropriate risk and regulatory guardrails for digital assets activities, including for stablecoin networks. We:

- **Develop risk and compliance programs specific to stablecoins and digital assets that meet regulatory expectations of safety and soundness.** Promontory's experts have worked directly with several regulatory agencies (including the Wyoming – Division of Banking) to develop digital asset-specific supervisory frameworks, including risk and compliance principles for different stablecoin models. We have advised digital asset market participants on how to address BSA/AML, key management, information security, operational resilience, payment system risk, and custody and fiduciary services obligations. Through IBM, we can also help accelerate banks along their digital assets journey, including through our industry-leading Hyper Protect hybrid cloud platform for safekeeping of digital assets, and by leveraging our experience in building blockchain-based payment networks.
- **Help banks and digital assets firms assess unique risks and challenges for different digital asset use cases, including stablecoin issuance.** Promontory has advised firms in North America, Europe, and Asia working on digital asset custody, digital asset trading, peer-to-peer payments, blockchain infrastructure, settlement, token issuance, smart contracts, and other digital assets use cases. Promontory can help banks identify and address risks and opportunities they may face when considering integrating stablecoin activities within existing or proposed business models, as well as help banks in crafting a vision for their go-forward approach around digital assets.
- **Help firms perform due diligence of potential acquisitions, partnerships, and outsourced digital assets activities.** Promontory has assisted banks in evaluating potential partners' technology capacities and compliance processes to meet the bank-grade requirements.

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PROMONTORY
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Promontory Financial Group, an IBM Company, excels at helping clients resolve critical issues, particularly those with a regulatory dimension. Promontory professionals have unparalleled regulatory experience and insight, and provide our clients with frank, proactive advice informed by best practices and regulatory expectations. Founded in 2001 by Chief Executive Officer Eugene A. Ludwig, former U.S. comptroller of the currency, Promontory became a wholly owned subsidiary of IBM in 2016.

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