

5 Ways Fed Crypto Statement Affects State Member Banks

By **Grant Butler, Robert Tammero and Andrew Hinkes** (February 27, 2023)

The Board of Governors of the Federal Reserve System recently issued a policy statement[1] limiting the activities of state member banks and their subsidiaries to those that are either permissible for national banks or otherwise permissible for state-chartered banks under federal law.

The policy statement continues the trend of banking regulators restricting activities related to cryptocurrency assets. Although driven by concerns about crypto-asset activities, the policy statement also affects the permissibility of activities of uninsured state member banks, such as trust companies, and may even affect the noncrypto activities of insured state member banks.

1. The policy statement aligns state member bank permissible activities with those of national banks.

With the policy statement, the FRB is using the broad authority granted to it under Section 9(13) of the Federal Reserve Act[2] to expressly limit the powers of state member banks to permissible activities of national banks or those activities permitted for state banks under federal law.

When engaging in permissible activities of national banks, state member banks and their subsidiaries will be required to comply with the terms, conditions and limitations placed on national banks with respect to such activity by the Office of the Comptroller of the Currency.

If an activity is not permissible for a national bank, state member banks may look to other authority under federal law, such as activities permitted to insured state banks by the Federal Deposit Insurance Corp. pursuant to Title 12 of the Code of Federal Regulations Part 362.[3]

With this interpretation, the FRB seeks to ensure that the same bank activity, presenting the same risks, should be subject to the same regulatory framework, regardless of which agency supervises the bank.[4]

If an activity is not permissible for a national bank or under federal law, the state member bank or its subsidiary must obtain the FRB's prior permission under Regulation H. The policy statement creates a rebuttable presumption that such activities are prohibited for state member banks and their subsidiaries to engage in as principal.

The presumption may be rebutted through showing a clear and compelling rationale for the FRB to allow a deviation in regulatory treatment among federally supervised banks, and that the bank or its subsidiary has robust risk management plans for such proposed activity.

Legal permissibility is not enough to engage in an activity — safety and soundness considerations also must be met. Given the FRB's rationale of preventing regulatory arbitrage, it will likely be very difficult for a state member bank to demonstrate a clear and compelling rationale to engage in an activity that is not permitted by the FDIC or OCC for other charter types of banks.



Grant Butler



Robert Tammero



Andrew Hinkes

2. Crypto-asset activities of state member banks are tightly restricted.

The policy statement follows closely on the heels of the interagency "Joint Statement on Crypto-Asset Risks to Banking Organizations".[5] The FRB and other federal banking regulators continue to refine their thinking and guidance on banks engaging in the crypto-asset sector, and as they do so, they continue to take a skeptical and conservative approach to crypto-asset activities.

The policy statement continues this trend of limiting the types of crypto-asset activities in which banks and their affiliates may engage as principal.

Under the policy statement, state member banks and their subsidiaries will presumptively not be allowed to hold crypto-assets as principal. The narrow exception to the prohibition is that the OCC has permitted national banks to hold stablecoins to facilitate payments subject to the conditions of OCC Interpretive Letter 1179.[6]

Any state member bank seeking to issue a dollar token, i.e., stablecoin, would need to adhere to all the conditions placed on such activity for a national bank.

Moreover, it would have to demonstrate, to the satisfaction of FRB supervisors, that the bank has controls in place to conduct the activity in a safe and sound manner, and the bank will need to receive an FRB supervisory nonobjection before commencing such activity.

The bar for receiving the supervisory nonobjection prior to engaging in such activity will likely be very high, and any bank wishing to issue a dollar token should carefully and extensively prepare its submission for nonobjection, including robust discussion of the risk management around such activity, the vendors and counterparties involved, the operational integrity of such activity, the impact on the bank's capital and liquidity from such activity, and the means to control cybersecurity and anti-money laundering risks.

The FRB reiterated its position that issuing tokens on open, public or decentralized networks, or similar systems, is highly likely to be inconsistent with safe and sound banking practices. This differs from initial OCC guidance suggesting that a national bank could transact on public blockchains, an interpretation the OCC has seemingly been limiting in its "careful and cautious" approach to crypto-asset activities.[7]

Given these concerns, a state member bank would likely not be able to issue a token on a public blockchain such as bitcoin or ethereum.

However, it appears that a private blockchain that is overseen in accordance with the governance expected of traditional financial systems, including contracts that establish roles and responsibilities, cybersecurity safeguards, mechanisms for recovery of lost or trapped assets, and that screen out so-called illicit finance may be deemed by the FRB as a safe and sound method of issuing tokens.

3. Custody and traditional banking services are not limited by the policy statement.

There is much concern in the crypto-asset community that it is being shut off from traditional finance.

In some ways, the policy statement furthers this concern. However, the policy statement

does not prohibit a state member bank from providing safekeeping services in a custodial capacity for crypto-assets if such activity is conducted in a safe and sound manner and in compliance with anti-money laundering, anti-terrorist financing and consumer laws.

Banks offering custody services for crypto-assets will face a high bar for appropriate conduct and compliance. The FRB has elevated expectations for systems to monitor and control risks for crypto-asset activities, and it will expect banks to be able to demonstrate an effective control environment related to such activities.

Any state member bank wishing to custody crypto-assets should make sure it has robust operational systems and procedures in place for maintaining such assets in a custodial capacity given some of the novel issues presented by safekeeping crypto-assets in comparison to other traditional asset types.

The policy statement also does not affect the ability of state member banks to offer traditional banking products and services, such as deposit or lending products, to crypto-asset companies. However, the joint statement cautioned banks from having business models or exposures that are concentrated in the crypto-asset sector, which has had a chilling effect on some banks in serving crypto-asset customers.

Before engaging in any crypto-asset activities, a state member bank should consult with the FRB and its state regulator. Banks should expect extensive conversations regarding any proposed crypto-asset activities, as the regulators will want to thoroughly understand every aspect of the proposed crypto-asset activity.

Accordingly, the bank should be prepared to discuss in robust detail the permissibility of the activity, the operational processes for conducting such activity, and the risk management and compliance framework that will be implemented to ensure that the crypto-asset activity is conducted safely and soundly.

4. The policy statement affects uninsured state member banks, including Federal Reserve member trust companies.

For an uninsured state member bank, including a trust company that is a member of the Federal Reserve System, the policy statement restricts activities to those similar to an insured state member bank.

This is a significant change for uninsured state member banks, which previously were governed by the permissibility of activities under state law and did not need to consider FDIC or OCC requirements.

Uninsured state member banks will need to review their activities to make sure they conform to the guidance under the policy statement. In light of the FRB's recent denial of Custodia Bank's application to join the Federal Reserve System due to concerns regarding its novel business model,[8] this could prove problematic for uninsured banks that have novel business models or engage in novel activities.

5. The statement could affect noncrypto activities of subsidiaries of insured state member banks.

Although the issuance of the policy statement was clearly driven by inquiries by state member banks hoping to engage in novel activities such as crypto-asset activities, this guidance may have broader impacts on state member bank activities.

For insured state member banks, the policy statement may not have a significant impact because under Section 24 of the Federal Deposit Insurance Act, the activities of an insured state member bank should already be either permissible for a national bank under the National Bank Act or authorized under other federal law, including Title 12 of the Code of Federal Regulations Part 362.

However, the policy statement could affect activities of the subsidiaries of insured state member banks that are in a bank holding company structure. Under Regulation Y, a state-chartered bank may acquire or retain a company that engages solely in activities in which the parent bank may engage subject to certain limitations.

Specifically, a state-chartered bank or its subsidiary may, without the FRB's prior approval, acquire or retain all — other than directors' qualifying shares — of the securities of a company that engages solely in activities in which the parent bank may engage, at locations at which the bank may engage in the activity, and subject to the same limitations as if the bank were engaging in the activity directly.[9]

Now that the policy statement has been adopted, state member banks that were relying on this provision to own subsidiaries engaged in activities that are permissible under state law but not necessarily under federal law will presumably need to review the activities of such subsidiaries to ensure that the activities are permissible for a national bank or otherwise under federal law.

This may also result in the subsidiaries of state member banks being required to receive approval from the FRB for novel activities when prior to the policy statement such approval would not have been required.

Grant F. Butler, Robert M. Tammero Jr. and Andrew M. Hinkes are partners at K&L Gates LLP.

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[1] Policy Statement on Section 9(13) of the Federal Reserve Act; 12 C.F.R. § 208.112.

[2] 12 U.S.C. § 330.

[3] Under Part 362, the FDIC has determined that certain equity investment and other activities do not pose significant risk to the Deposit Insurance Fund and thus are permissible for insured state banks. Additionally, under Part 362, an individual insured bank may apply for the FDIC's consent to engage in an activity that is not permissible for national banks. A state member bank wishing to engage in any activity that the FDIC has only permitted under Part 362 for a specific bank would need to seek specific FRB approval.

[4] This rationale was foreshadowed in comments by FRB Governors and staff in the months preceding the issuance of the Policy Statement. See, e.g., Testimony of Vice Chair Michael Barr before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Nov. 15, 2022). The FRB states that this principle of equal treatment is intended to both provide

competitive equality between banks of different charter types and federal regulators and mitigate the risks of regulatory arbitrage.

[5] Joint Statement on Crypto-Asset Risks to Banking Organizations issued by the FRB, FDIC and OCC on January 3, 2023.

[6] See OCC Interpretive Letter No. 1174 (Jan. 4, 2021); OCC Interpretive Letter No. 1179 (Nov. 18, 2021).

[7] See OCC Interpretive Letter No. 1174 (Jan. 4, 2021).

[8] FRB Press Release "Federal Reserve Board announces denial of application by Custodia Bank, Inc. to become a member of the Federal Reserve System" (January 27, 2022).

[9] 12 C.F.R. § 225.22(e)(2)(ii).