

Effective Regulation of Crypto Assets: The Community Bank Perspective

The Independent Community Bankers of America, representing community banks across the nation with nearly 50,000 locations, appreciates the opportunity to provide this statement for the record for today's hearing: "Crypto Crash: Why Financial System Safeguards are Needed for Digital Assets."

Recent, spectacular and damaging crypto crashes have focused policy makers and the public on the significant risk posed by crypto assets. While the collapse of FTX dominated headlines and raised public awareness, it must not overshadow the numerous, lower-profile crypto crashes that illustrate the ongoing danger posed by unregulated crypto. The risk is no longer theoretical. We hope this hearing will address the emerging investor and systemic risk created by a proliferation of unregulated crypto assets.

Proposals to regulate crypto assets are currently before Congress, and we urge this committee to play an active role in ensuring that regulatory solutions are effective. We appreciate the focus of this committee on the application of existing securities law to crypto assets. This is a good place to start. We must not be satisfied with incomplete measures replete with loopholes that would only delay more comprehensive efforts. The true test of any crypto regulation is its effectiveness in preventing contagion of the traditional financial system.

Rapid Expansion of Cryptocurrencies

Crypto advocates seek to expand their products from a niche investment class to function as means of payment and store of value. Limited regulation and oversight applied to the crypto asset marketplace and transactions expose consumers and investors to significant risks, including highly volatile fluctuations in value. Cryptocurrencies also present several operational risks and concerns, including flaws in smart contract programming and loss of cryptographic keys that can jeopardize users' assets.

Especially concerning are the efforts of certain crypto firms to market themselves as the equivalent of chartered and insured banks offering bank-like services without the protections offered by regulated banks. Recent events have shown that depositors may abruptly lose confidence in a crypto firm and demand their funds in what amounts to a "bank run" that shakes confidence across the crypto industry. Unlike these crypto firms, banks are subject to deposit insurance, comprehensive oversight and examination, and capital requirements, among other safeguards which are designed to ensure customer access to funds under adverse economic circumstances.

Stablecoins Among the Highest Risk Forms of Cryptocurrency

While FTX has captured headlines, we must not lose sight of the substantial threat posed by private stablecoins issued by nonbanks, including the potential to erode monetary authority and disrupt financial stability. Many stablecoins of these are anything but stable. Inadequate capitalization and hacks have caused a number of nonbank stablecoins to collapse in value beginning with UST-cum-USTC (Terra/TerraClassic), which lost its dollar peg nearly a year ago and fell to just ten cents, and USDT (Tether), the largest stablecoin by market capitalization, which also lost its dollar peg due to concerns about its opaque reserves. Terra faced a precipitous loss in value as investor confidence collapsed, which spread to Tether, the largest stablecoin by market cap, as users grew more concerned about Tether's assets. Because stablecoins are used in the exchange of other cryptocurrencies, the collapse of a stablecoin creates a ripple effect through the broader crypto market.

Decentralized Finance (DeFi) Magnifies Risks Created by Unregulated Crypto Assets

Far from a solution to the cycle of crisis, DeFi is by its nature plagued by vulnerabilities. DeFi's opaque and complex governance structures facilitate illicit transactions. In a prime example, Tornado Cash was used to launder \$450 million before being sanctioned OFAC. Further, "smart contracts," or automated programs, are vulnerable to coding flaws that can be nearly impossible to correct.

The Federal Reserve Bank of Atlanta has recognized the high degree of leverage across DeFi applications, recently warning that “a sparking event that undermines confidence in the levered positions might generate a financial crisis.”

A Caution Regarding Crypto Proponents’ Diversions Arguments

The crypto industry, facing an abrupt reversal of fortune following FTX’s collapse, has begun to advance misleading and diversionary arguments in its defense. FTX, we are told, was an aberration that should not slow the industry’s expansion and access to the broader traditional financial system.

Crypto advocates have argued, for example, that continued exclusion of crypto firms from Federal Reserve master accounts, will create a “bifurcated financial system.” This is a muddled argument at best. Crypto advocates have effectively *sought* bifurcation through the creation of an alternative to fiat currencies. As the risks and vulnerabilities of crypto have become too obvious to ignore, proponents now seek the legitimacy afforded to highly regulated banks without the same regulatory constraints and oversight. Integration with the traditional financial system, without addressing inherent risks, would only remove firewalls to contagion that must instead be strengthened. Our imperative must be to first safeguard the integrity of the official system on which consumers and our economy depend. These concerns are recognized and articulated in the Federal banking agencies’ recent Joint Statement on Crypto-Asset Risks to Banking Organizations. ICBA appreciates the balanced and cautious approach described in the Joint Statement, seeking to ensure that any bank involvement in crypto activities is consistent with safety and soundness, consumer protection, and other important considerations.

Crypto advocates have further argued that a bifurcated system will compromise monetary policy. The opposite is more likely true. By marginalizing banks and reducing deposits, widespread adoption of crypto currencies would likely erode the Federal Reserve’s ability to conduct monetary policy and interest rate control.

These are merely several examples of recent diversionary, crypto-proponent arguments that do not withstand scrutiny and must be rejected by policy makers entrusted with protection against systemic and consumer risk.

State-Chartered Non-Bank Crypto Firms

Crypto advocates have argued that state-chartered institutions should be granted powers equivalent to those currently reserved for federally insured and regulated financial institutions, including access to Federal Reserve master accounts.

ICBA supports the Federal Reserve’s denial of Custodia Bank’s application for a master account. Custodia, which is subject to neither comprehensive regulatory oversight nor federal deposit insurance, proposed to engage in high-risk crypto activities. Master account access would provide a direct and dangerous path to broad contagion, introducing crypto volatility into the broader, traditional banking system. The payment system must be protected to ensure financial stability and economic well-being.

Further, ICBA supports the Federal Reserve’s recent policy statement that would limit state member banks to engaging as principal in only those activities that are permissible for national banks unless such activities are expressly permitted for state banks by federal statute or Federal Deposit Insurance Corporation regulations. The state charter must not be allowed to circumvent federal regulation which is needed to ensure uniformity and a level playing field. Inconsistent oversight would leave consumers vulnerable. Banks must comply with federal regulations governing all aspects of their operations, putting them at a competitive disadvantage to novel, state-qualified, non-bank issuers.

Effective Regulation of Crypto Assets

Inadequate, partial “solutions” favored by the crypto industry would act to legitimize crypto while leaving investors and the financial system vulnerable. Effective, comprehensive regulation and oversight – including more robust and transparent

capitalization, investor protection, anti-money laundering, and cyber security requirements – is needed to balance the risks and benefits of this emerging technology. Incomplete regulation would only create dangerous loopholes and leave the most vulnerable crypto assets unregulated. Effective regulation must:

- Include capital adequacy and reserves; activity restrictions; due diligence; information security and privacy; business resiliency; ownership and control of data; anti-money laundering and anti-terrorist financing; reporting and maintenance of books and records; consumer protections; safeguarding customer information; vendor and third-party management; and ongoing examination.
- Provide a coordinated regulatory approach by banking and market regulators, including the Securities and Exchange Commission and the Commodity Futures Trading Commission.
- Ensure no crypto access is granted to a Federal Reserve master account and the payment system.
- Appropriate regulation of DeFi to address the systemic and illicit finance risks it creates.
- Preserve the long-standing separation of banking and commerce which is critical to the impartial allocation of credit and the vitality of the American economy.

Closing

Thank you for convening today’s hearing to highlight the significant risks created by the rise in cryptocurrencies. ICBA encourages the Senate Banking Committee to continue to play an active role in creating a comprehensive regulatory framework for crypto assets.