FedFin Client Report

Wednesday, September 21, 2022

FedFin Analysis: Treasury Sees Few Crypto Benefits, Much Risk to Contain and Control

Client Report: CRYPTO32

Executive Summary

We follow our prior in-depth analysis of Treasury's CBDC and payments report (see *Client Report* **CBDC14**) with a detailed assessment of the Department's assessment of overall cryptoasset policy. We noted on Friday key recommendations and turn here to a more in-depth assessment of Treasury's reasoning, recommendations, and likely action. This section of the response to the President's executive order (see *Client Report* **CRYPTO26**) is notably uncharitable to cryptoassets, observing that broader use cases beyond trading and lending within the crypto verse have yet to materialize and may never do so. Even were this to occur, Treasury posits an array of risks that call for rapid regulatory and market-based action to ensure that greater crypto adoption does not come with still more risk, especially to vulnerable consumers and investors. As we noted last week, this report does not rely on statutory revisions, instead urging regulators – now including the CFPB and FTC – to use their existing authority to engage in tough enforcement and to set an array of new rules. These conclusions put more pressure on the FRB, OCC, and FDIC to work together to craft new prudential standards, working cooperatively with the CFPB in cases such as the actions taken to threaten crypto companies that apply FDIC coverage (see FSM Report **DEPOSITINSURANCE113**). The report takes no stand on the jurisdictional battle between the SEC and CFTC (see *Client Report* **INVESTOR20**), but all of the issues on which it wants regulatory intervention suggest that the CFTC's preferred "light-touch" approach to consumer protection will not pass Treasury muster if legislation to achieve it were seriously to advance.

Analysis

While more than skeptical about use cases for cryptoassets and cryptocurrency in the deposit, lending, trading, and investment arena, Treasury details numerous potential advantages to use of DLT and digital assets to speed settlement and clearing across the trading and payments sectors, noting how regulated institutions are developing use cases with considerable potential to reduce intermediation costs, increase speed, and enhance both efficiency and inclusion.

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1. Conduct Risk

The report concludes that cryptoasset offerings pose the following conduct risks:

- fraud, with risks exacerbated over other financial activities due to irrevocability and information asymmetry;
- the largest form of fraud in this area, scams;
- theft; and
- association with other crimes (e.g., drug trafficking).

To combat these, it urges:

- stringent enforcement and effective monitoring;
- mandatory investor- and consumer-protection disclosures that include information on conflicts of interest;
- SEC registration;
- suitability standards; and
- market manipulation restrictions and enforcement.

2. Prudential Risks

These include:

- insufficient collateral and liquidity;
- inadequate resolvability;
- unique operational risk detailed in the report;
- generalized features and insufficient governance creating conflicts of interest between users and developers;
- smart-contract operational and structural risk;
- novel intermediation risks due in part to the fact that entities playing key roles (e.g., processing) lack the capabilities to handle negative externalities;
- run risk related to loss of market confidence, margin calls, or collateral liquidation; and
- custody risk due in part to poor internal controls and/or commingling.

Treasury thus calls upon federal and state agencies to use their existing authority to address all of these risks not only via enforcement, but also clear standards to ensure regulatory certainty.

3. Financial Inclusion

Although Treasury notes that digital assets in time may benefit vulnerable communities, it finds that the risks noted above may be particularly problematic, especially when considered in concert with unique hazards for these consumers. Noting that vulnerable households may

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not only include those in minority groups or with lower income and the elderly, Treasury urges "urgent" action addressing risks such as:

- higher transaction costs when cryptocurrencies are used for retail remittance payments given the adverse impact of these fees on lower-income consumers;
- targeted marketing obscuring risks and costs. Marketing aimed at service members, children, and the elderly requires particular attention; and
- privacy and surveillance threats, with certain crypto transactions providing far less anonymity than some consumers anticipate, posing risk to personal-data privacy.

The report also argues for immediate attention to increasing banking-system access addressing the "digital divide."

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