



FedFin Client Report

Tuesday, December 5, 2023

HFSC GOP Grills Regulators Over Novel Activities, Third-Party Risk Management Guidance

Client Report: FINTECH33

Executive Summary

At today's HFSC Digital Assets Subcommittee hearing on banking agency financial innovation, Republicans raised concerns about the Fed's novel activities guidance ([see FSM Report FINTECH32](#)), interagency guidance on third-party risk management ([see FSM Report VENDOR10](#)), and the SEC's predictive data analytics [proposal](#). Members on both sides of the aisle also focused on AI, crypto, and CBDC, with Republicans pressing for hands-off crypto policy while Democrats urged faster action to curb AI risk. Pointing to the OCC's recent hiring scandal, Subcommittee Chairman Hill (R-AR) suggested that more oversight might be necessary.

Analysis

Opening Statements

Subcommittee Chairman Hill called on regulators to facilitate rather than stymie financial services innovation, criticizing the agencies' innovation offices as impediments to innovation. Subcommittee Ranking Member Lynch (D-MA) called for more financial regulatory innovation and public-private partnerships to encourage financial inclusion while emphasizing that the U.S. must not fall behind on CBDC. Full Committee Chairman McHenry (R-NC) raised concerns that the agencies' innovation offices are not operating as intended and again accused the Biden Administration of "regulation by enforcement."

Testimony

Witnesses from the OCC, SEC, CFPB, FDIC, and NCUA generally defended their offices' fintech expertise and adaptiveness to emerging technologies while also pointing to emerging third-party relationships and AI risks. The head of supervision at the FRB, Michael Gibson, focused on the Fed's commitment to AI emerging practices and risk management and noted that his office is evaluating how the Fed can adopt leading industry technology to enhance

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supervision.

Q&A

- **Novel Activities and Practices Guidance:** Asked by Subcommittee Chairman Hill if he believes this standard fosters innovation, Mr. Gibson only emphasized that the Fed is focused on examiner training to ensure firms are appropriately managing risk. Chairman Hill also argued that bank boards of directors already have responsibility for items covered in the novel activities guidance under the CAMELS examination process, raising concerns that preauthorization for tasks not material to banks could be “overkill”; Mr. Gibson agreed that there is potential for this, but said the Fed intends to send skilled examiners to banks to prevent it from happening. Taking serious issue with the Fed’s January [denial](#) of Custodia Bank’s application, Rep. Davidson (R-OH) asked Mr. Gibson whether his office has done work to determine the risks of holding reserves “beyond the value of the assets”; Mr. Gibson only said the Board’s rejection was based on statutory factors. Rep. Flood (R-NE) raised concerns that the Fed lacks examiner bandwidth for its novel activities programs should banks increase their involvement in these services; Mr. Gibson disagreed.
- **Crypto:** Reps. Emmer (R-MA) and Steil (R-WI) also sharply criticized what they called the SEC’s “regulation by enforcement approach,” with Rep. Emmer grilling the SEC FinHub Director Valerie Szczepanik about whether her office has provided guidance to the agency clarifying how securities laws apply to crypto; Ms. Szczepanik only said that determining if a token is a security is based on facts and circumstances. Subcommittee Ranking Member Lynch (D-MA) asked Mr. Gibson how his office is evaluating bank risks resulting from fintech and crypto exposures; the Fed has seen risks materialize from complex arrangements between banks and fintech companies that obscure KYC and AML risks. Rep. Sherman (D-CA) asked if a loan secured by crypto is ever regarded as valuable; OCC Acting Deputy Comptroller for the Office of Financial Technology Donna Murphy only said there is very limited activity of this kind in the national banking system. Full Committee Ranking Member Waters (D-CA) asked Ms. Szczepanik how the SEC’s FinHub evaluates illicit activity in the crypto system; she emphasized that special resources are used to proactively scan the market. Raising concerns that crypto companies are making “huge” contributions to Members of Congress, Ranking Member Waters also urged Ms. Szczepanik to inform Congress about crypto’s pitfalls; Ms. Szczepanik said her office could provide technical assistance. Rep. Nickel (D-NC) raised concerns that the U.S. is falling behind China on digital assets and blockchain technology.
- **Third-Party Risk Management:** Chairman Hill asked Mr. Gibson if the Fed would ensure that smaller, “noncomplicated” banks can easily comply with the agencies’ guidance, criticizing what he said was a process of publishing guidance before preparing compliance resources; Mr. Gibson only said the agency hoped to publish something soon. Rep. Davidson also raised concerns with the FDIC’s approach to third-party risk management

and asked FDIC Deputy Chief Information Officer for Management Mark Mulholland how the FDIC's third-party risk management processes are being examined with respect to fintech; Mr. Mulholland said he would respond in writing.

- **CBDC:** Asked by Rep. Davidson for an update on the Fed's CBDC work, Mr. Gibson reiterated the Fed remains in a research and experimentation phase.
- **Predictive Data Analytics Proposal:** Reps. Lucas (R-OK) and Nickel argued that the SEC's predictive data analytics proposal applies an overly broad definition of covered technology and would pass costs onto investors.
- **AI:** Rep. Foster (D-IL) called for stronger deepfake scam protections via digital IDs while Rep. Casten (D-IL) raised concerns about the SEC data set integrity and future compliance burdens for future AI and climate-risk standards. Rep. Sherman raised concerns about ACH system wiring fraud, calling for payee matching to solve the problem and asking Mr. Gibson why this has not been addressed; Mr. Gibson only promised to work with Rep. Sherman on the matter.