INDEPENDENT COMMUNITY BANKERS of AMERICA®

ICBA BANCARD

Payments Executive Brief:

December 2020, Issue No. 14

Cryptocurrency Primer for Community Banks

Bitcoin's market cap is larger than the economies of some of the world's smaller nations. The prices of popular cryptocurrencies continue to soar to new heights. Meanwhile, several financial institutions and tech giants announced significant digital asset initiatives. These new developments signal a shift in attitudes toward digital currencies.

Digital assets are moving into the mainstream, and this means community banks need to understand what cryptocurrencies are and the impact of virtual currencies on their institutions and customers.

Why Now's the Time to Explore Crypto

Cryptocurrencies have been around for years with little market traction until recently. While estimates show only 8 percent of Americans own cryptocurrency, 81 percent are familiar with it, and recent developments are bolstering market awareness and adoption.

→ **Cryptocurrency is gaining ground with your customers.** 40 percent of Americans who have heard of cryptocurrency believe it will be widely accepted as a payment type in the next 10 years. What's more, 35 percent of Millennials familiar with crypto assets report having purchased them in the past year.

→ **Your competitors are embracing cryptocurrency.** PayPal recently announced that it will support cryptocurrency transactions. JPMorgan Chase created its own digital currency, JPM Coin. Notably, Visa also launched the Coinbase Visa debit card, which allows customers to spend digital assets anywhere Visa is accepted and in nine different cryptocurrencies. With all this activity, community banks should consider the impact of cryptocurrency on their payments strategy.

→ **Around the globe, central banks are considering digital currency.** Overall, the International Monetary Fund estimates more than 50 countries are researching or developing a central bank digital currency. For example, China trialed its DC/EP (digital currency/electronic payments) in three cities, and the Bahamas and Cambodia successfully launched central bank digital currencies.

→ **The Federal Reserve is exploring different forms of a Central Bank Digital Currency (CBDC).** The Federal Reserve Bank of Boston is collaborating with the Massachusetts Institute of Technology (MIT) to investigate the potential of a digital dollar.

Crypto Basics

Cryptocurrency, blockchain, and distributed ledgers are often confused and used interchangeably, though each is distinct. Understanding these and other related terms can help you navigate the financial services landscape in the digital age.

CRYPTOCURRENCY – Also known as digital assets, digital currency, virtual currency, and even digital money, cryptocurrency refers to a way to store and exchange value electronically. The "crypto" prefix refers to advanced mathematical codes used to store and transmit transactions in a secure format. Market demand and limited supply influence the price of digital currencies, making them volatile and highly speculative. While Bitcoin (BTC) remains the most recognizable digital asset, other popular cryptocurrencies in the U.S. include Ethereum (ETC), Tether (USDT), Ripple (XRT), and Litecoin (LTC).

BLOCKCHAIN – The backbone of some forms of cryptocurrency like Bitcoin is the blockchain. At its most basic level, blockchain refers to the "blocks" that get added to the "chain" of digital records (akin to a database). The chains provide a continuing list of records with data that can only be added; once validated, the information cannot be deleted or altered. The blockchain is a type of distributed ledger technology.

DISTRIBUTED LEDGER TECHNOLOGY (DLT) – Although a blockchain is a form of distributed ledger technology, distributed ledgers do not need to be in a chain like the blockchain. Put simply, a distributed ledger is a shared database that is spread across different computers or "nodes." A distinguishing feature of the DLT is it often restricts who can use, access, and operate as a node on the network. This "permissioned" model has become more popular with banks.

STABLECOIN – Pegged to a fiat currency like the dollar, a basket of currencies, or gold, stablecoins offer a less volatile form of cryptocurrency. One example, Tether, is the biggest stablecoin that is backed by the price of national currencies like the dollar, the euro, or the Japanese yen.

CENTRAL BANK DIGITAL CURRENCY (CBDC) – A central bank digital currency is a digital form of a fiat currency that is issued and regulated by a monetary authority of a country or region. In the U.S., this also has been coined the "digital dollar." ICBA explores this topic in a separate brief.

Cryptocurrency Risks & Rewards

Cryptocurrencies can seem mysterious and even controversial, but they are here to stay. Community banks can capitalize on cryptocurrency developments and should also consider its risks.

Community Bank Benefits

- *Response to Customer Demand* – More than half (55 percent) of Millennials familiar with cryptocurrency believe it will become very or somewhat widely accepted for legal transactions before 2030. They expect it to be a near-future payment option. Community banks can remain relevant in the crypto age by doing what they do best—helping to protect their customers' assets through education or considering a custodial role for account holders' digital assets.
- *Market Leader Status* – The global cryptocurrency market is projected to reach $5.5 billion by 2027. Early adopters of cryptocurrency-related services may be setting themselves up for market leadership in this area.
- *New Product Offerings* – From enhanced security and the potential for more efficient global transactions to an opportunity to serve the unbanked in a new way, cryptocurrency shifts the way we think about payments and may open doors to new opportunities.

Inherent Risks

- *Money Laundering* – "Mixing," "tumbling," "chain hopping," and other similar schemes facilitate criminal activities for fraudsters. Indeed, FinCEN fined Larry Dean Harmon of Helix and Coin Ninja $60 million for such activity.
- *Ransomware Attacks* – Beyond illicit activities like money laundering, cryptocurrencies have been used by bad actors for ransomware scams. Analysts estimate cryptocurrency demand has contributed to $1.4 billion in ransomware attacks.
- *Government Evasion* – Cryptocurrency has also been used by bad actors to sidestep regulators and subvert sanctions, making it a potential threat on a global scale.

5 Steps Community Banks Can Take Today to Prepare for Increased Cryptocurrency Use

1. **Educate yourself and your team on cryptocurrency.** While the impact on community financial institutions is currently limited, community banks should stay informed on digital assets. A knowledgeable team is a prepared team. Use ICBA resources to provide relevant background to your board, leadership, and employees. Stay tuned for future related educational content from ICBA.

2. **Conduct your due diligence.** With the rise in popularity of cryptocurrencies, chances are your customers are buying them with their bank accounts. Community banks need to monitor accounts for cryptocurrency activity. Engage your risk and compliance officers to establish a process to track and assess crypto asset activities and associated risks.

3. **Monitor regulatory and legislative developments.** As cryptocurrencies gain wider acceptance, they have caught the attention of regulators and legislators. More guidance and oversight will emerge requiring additional due diligence, ongoing monitoring, or additional controls to appropriately manage and control risk. For example, the IRS recently released guidance explaining that virtual currency is treated as property for federal income tax purposes. (See sidebar for additional developments.)

4. **Firm up your own long-term digital payments strategy.** Cryptocurrencies are part of a larger trend of digital transformation taking place across the financial services industry. Community banks can be best prepared for the shift by examining their digital strategy, including updating any systems to adapt and handle change. A helpful starting point is ICBA's interactive assessment tool and guide to determine if your tools and solutions are keeping pace with evolving customer demand.

5. **We want to hear from you!** Let us know about your experience with cryptocurrencies at your bank. How are you educating your account holders? Do you have any tips to share? Tell us how ICBA can better equip you to respond to this new dynamic.

Recent Cryptocurrency Regulatory Developments

In 2019, when Facebook announced its plans to introduce a global digital currency, Libra, the move prompted opposition from world leaders and scrutiny from U.S. lawmakers. As cryptocurrencies become more commonplace, regulatory bodies are now responding with more clarity and rules in a previously legally gray area.

The Department of Justice (DOJ)

The DOJ issued "Cryptocurrency: An Enforcement Framework" in October 2020 to address the increasing prevalence of cryptocurrencies. The framework is divided into three sections: 1) a comprehensive overview of the emerging threats and enforcement challenges of cryptocurrencies; 2) a summary of key laws and regulatory and enforcement partners, notably citing the DOJ's relationship with FinCEN, OFAC, OCC, SEC, IRS, and others in addressing cryptocurrency activities; and 3) an outline of the DOJ's current enforcement challenges and potential response strategies.

The Office of the Comptroller of the Currency (OCC)

Recognizing that the financial markets are increasingly becoming digitized, the OCC offered guidance in July 2020 to national banks and federal savings associations expanding the authority for banks to provide safekeeping services to include custodial services of cryptocurrencies. In doing so, the regulatory policy enhances banks' long history of safekeeping assets and ability to serve their customers' needs.

The Federal Reserve & Financial Crimes Enforcement Network (FinCEN)

The Federal Reserve and FinCEN are considering broadening the definition of money in its "Travel Rule" to include cryptocurrency to ensure the rule applies to domestic and cross-border transactions.