What Fed Supervision Letters Mean For Bank-Fintech Collabs

By **Jason Shafer, Crystal Kaldjob and Jeff Silberman** (October 13, 2023)

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On Aug. 8, the Board of Governors of the Federal Reserve System issued two supervision and regulation letters that lay out how the agency will supervise some cryptocurrency activities and the process that state member banks should follow to conduct certain stablecoin transactions.

These letters provide further information on how the Fed will supervise certain crypto-related activities by banking organizations. Notably, they identify partnerships between banks and fintech companies as a novel activity that will be subject to the oversight of a new supervisory program.

New Supervision Program for Crypto Activities

In SR Letter 23-7, the Fed announced the establishment of its Novel Activities Supervision Program. The program will focus on "novel activities related to crypto-assets, distributed ledger technology, and complex, technology-driven partnerships with nonbanks to deliver financial services to customers."[1]

The program will complement existing supervisory processes by partnering with existing supervisory teams to monitor and examine these novel practices. The program will be risk-based, meaning that the level and intensity of supervision under the program will vary based on the banking organization's level of engagement in novel activities.

The Fed notes that novel activities may involve unique questions about the ultimate permissibility of the activity, existing supervisory methods and how the activities may affect the financial system.

Banking organizations whose novel activities will be subject to examination through the program will be notified in writing.

Fed Preapproval Required For Certain Dollar Token Activities

In the second letter, SR 23-8/CA 23-5, the Fed describes "the supervisory nonobjection process for state member banks seeking to engage in certain activities involving tokens denominated in national currencies and issued using distributed ledger technology or similar technologies to facilitate payments," which are also known as dollar token activities.[2]

Before engaging in dollar token activities, including running any tests, the state bank must notify its lead supervisory point of contact about its intention. The bank cannot proceed until it receives a written notification of supervisory nonobjection.

To obtain supervisory nonobjection from the Fed, the bank must show that it has appropriate risk management controls in place to safely conduct the activity. When evaluating if a bank has the requisite risk management capabilities, the Fed will focus on risks related to operations, cybersecurity, liquidity, illicit financing and consumer compliance.[3] As part of its evaluation, "Federal Reserve staff also will assess whether the bank has demonstrated that it understands and will comply with laws that apply to the proposed activities."

The letter noted that state member banks that were engaged in dollar token activities prior to the letter's release could continue, but they should have notified their lead supervisory contact of those preexisting activities by Sept. 8. The Fed would then review the information and notify the bank "whether a supervisory nonobjection for the existing activities and any planned expansion [was] granted."

Key Takeaways

These letters build on, and are generally consistent with the skeptical tone of, existing issuances from federal banking agencies regarding banking organizations' crypto-related activities, including those related to stablecoin or dollar tokens.

Banking organizations subject to Fed oversight should take stock of any activities that may fall within the remit of the novel program, if they haven't already done so. Banks should be prepared to respond to targeted inquiries about those activities and their frameworks for managing related risks.

Perhaps the more notable aspect of the releases is the categorization of bank-fintech partnerships as a novel activity subject to the Fed's new supervisory program. While bank-fintech partnerships have been subject to closer scrutiny in recent years, categorizing these activities as "novel" and placing the supervision of these relationships under the purview of a new program may signal the Fed's concern with these activities.

However, an alternative takeaway is that including bank-fintech partnerships in the program is an acknowledgment by the Fed that these relationships present unique issues that traditionally trained supervisors are not well-positioned to evaluate. Under this interpretation, supplementing traditional supervisors with ones who better understand the underlying technology and the bank-fintech business model may represent a positive change for banks and fintech companies that are currently in, or wish enter, partnerships.

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[1] SR Letter 23-7 describes these bank-fintech partnerships as "complex and technology-driven partnerships where a nonbank serves as a provider of banking products and services to end customers, usually involving technologies like application programming interfaces (APIs) that provide automated access to the bank's infrastructure." https://www.federalreserve.gov/supervisionreg/srletters/SR2307.htm.

[2] According to the Fed, the term "stablecoin," as used by the Office of the Comptroller of the Currency, and the Fed's term "dollar token" are synonymous for purposes of OCC Interpretive Letter 1174. For purposes of the SR letter, any bank liabilities, including deposits, that meet the definition of dollar token are dollar tokens. https://www.federalreserve.gov/supervisionreg/srletters/SR2308.htm.

[3] These risks also were described in the Fed's Policy Statement on Section 9(13) of the Federal Reserve Act. The Fed may, in its discretion, consider additional risks. https://www.govinfo.gov/content/pkg/FR-2023-02-07/pdf/2023-02192.pdf.