November 3, 2022

United States Department of the Treasury
1500 Pennsylvania Ave NW
Washington, DC 20220

Re: Ensuring Responsible Development of Digital Assets; Request for Comment; 87 Fed. Reg. 57,556 (September 20, 2022)

Dear Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to provide comments on the above-captioned Request for Comment ("RFC")[2] regarding the national security risks that have been and may be introduced by the proliferation and increased usage of digital assets. We appreciate the efforts of the Department of the Treasury to solicit feedback on the national security issues related to illicit finance and anti-money laundering and countering the financing of terrorism ("AML/CFT"), but also we suggest there are other financial and macroeconomic risks for consideration as national security risks that we also highlighted in a previous comment letter to the Department of the Treasury.[3]

Digital assets and their "decentralized" platforms for executing financial transactions ("DeFi") have raised many issues and policy questions. They are designed to eliminate the need for involvement of a centralized managing organization (e.g., government entities for currencies), intermediary, or third party that in the current financial system issue currencies or securely facilitate and/or verify financial transactions. While seemingly a more efficient design, it ignores certain foundational principles of finance that are necessary but difficult to achieve – trust and security. That is, the decentralization model prioritizes efficiency over accountability. Not only is

---

[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

[2] Ensuring Responsible Development of Digital Assets; Request for Comment; 87 Fed. Reg. 57,556 (September 20, 2022).

[3] *See* Better Markets comment letter to the U.S. Department of the Treasury regarding the implications of development and adoption of digital assets and changes in financial market and payment infrastructures for United States consumers, investors, businesses (August 8, 2022), https://bettermarkets.org/wp-content/uploads/2022/08/Better_Markets_Comment_Letter_Ensuring_Responsible_Development_of_Digital_Assets.pdf.

it more difficult for consumers and businesses to verify the counterparty to their financial transactions, but also regulatory agencies have almost no visibility into financial transactions or ability to execute sufficient oversight or hold parties accountable.

That is exactly why fraudulent and illicit financial activities as well as AML/CFT issues have increased dramatically through the broader adoption of digital assets. Online scams, sanctions avoidance, and criminal enterprise financial transactions are just some of the examples of illicit behavior that has been facilitated through and made easier by digital assets. Allowing innovation and use of digital assets to continue to grow without appropriate controls, laws, and regulations in place would increase the amount of these activities and pose a serious threat to national security and the security of the American public.

Therefore, digital assets and their platforms must be appropriately and effectively regulated. Just because the activities conducted with digital assets are based on a new technology does not mean that users of digital assets should be able to circumvent our nation's laws, regulations, and consumer protections. There must be equal transparency, oversight, and accountability of digital asset transactions as with any other financial transaction. The agencies of the U.S. government should use existing authorities to ensure that is the case, and this RFC to solicit public feedback is an important step in the development of appropriate policies.

However, there are other national security risks that are not discussed in the RFC that should be considered. Digital assets also pose risks to the financial system that could grow to be material enough to be national security concerns. The stability and smooth functioning of our financial system are critical to our national security, especially if detrimental effects that are systemic and permanent are realized. Considering the novelty of digital assets, the macro-level risks associated with them could materialize in many ways, but there are two macro-level risks that would more likely materialize if the usage of digital assets by U.S. consumers and companies becomes a material portion of overall financial transactions.

First, increased usage of digital assets could decrease the amount of deposits in the banking system. That is, all else equal, if more money is invested in digital assets that are held in digital asset custody accounts or so-called digital wallets, then less money would be held in bank deposit accounts. This would reduce the amount of deposit-based funding that banks rely on to make loans and other investments that support the economy. Data from the Federal Deposit Insurance Corporation ("FDIC") shows that as-of the second quarter of this year, banks obtained about 82% of their funding from deposits.[4] Deposits are a relatively inexpensive source of funding, especially the deposits that are insured by the FDIC up to $250,000 per account – about half of deposits according to the most recent data.

Banks serve a special and important role in our economy and indeed in every developed economy. They provide access to financial services, credit and other financial products, and a robust payment system. That access is critical to the financial well-being of individuals and

[4] *See* Federal Deposit Insurance Corporation, *Quarterly Banking Profile (June 2022)*, https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2022jun/qbp.pdf.

businesses. Banking touches on every aspect of life, from helping people pay for groceries and other necessities, to enabling savings, to providing credit for home purchases that can be a significant source of personal wealth. If bank deposits decline materially, their classic role as intermediaries between savers and borrowers would also be reduced materially, undermining the ability of the U.S. banking system to serve one of its core functions. This risk was highlighted by Acting Chair of the FDIC Martin Gruenberg in a recent speech regarding payment stablecoins:

> "The development of a payment stablecoin could fundamentally alter the landscape of banking…possibly leading to forms of credit disintermediation that could harm the viability of many U.S. banks and potentially create a foundation for a new type of shadow banking."[5]

Importantly, in the intermediation between savers and borrowers, the banking model is critical to maximizing overall credit provision and support for the economy. That is because the banking model allows for the recognition and usage of deposits even though much of those deposits have been lent by banks to borrowers throughout the economy (by way of the so-called reserve requirement). That is, banks keep only a small portion of deposits on hand at any time, using most of them as funding for loans and other investments while still recognizing the existence of and customers' ability to use their deposits. This so-called money multiplier effect greatly expands the amount of credit that is available to support the economy. Again, if bank deposits decline materially, the money multiplier effect would be dramatically reduced, greatly affecting the provision of credit. Also, if credit provision becomes broadly disintermediated or more funding is in a crypto ecosystem that does not support the productive economy, this could ultimately increase the cost of credit and reduce our economic growth.

Banks' special role in the economy is recognized by providing them with special privileges. A key privilege is the FDIC deposit insurance discussed above. Combined with other factors, deposit insurance significantly reduces the probability of so-called bank runs, the most important factor in preserving the ability of the banking system to operate on a model of using a lower reserve requirement to maximize credit provision. Banks also can have special accounts with the Fed, use the Fed's national payment system to transfer funds, access the Fed's emergency lending programs in times of stress when they need emergency funding, and make substantial profits from the transactions conducted through their unique roles as market intermediaries for the Treasury and the Fed.

The special privileges banks enjoy appropriately come with increased expectations and scrutiny. Not only are banks subject to a host of consumer protection laws, but also they must comply with various regulatory requirements and engage in regular supervisory examinations, both of which are designed to promote their safety and soundness. The most important regulatory requirements in this regard are those around capital and liquidity – capital to allow a bank to

---

[5] Acting Chair of the FDIC Martin J. Gruenberg, *Remarks by FDIC Acting Chairman Martin J. Gruenberg at the Brookings Institution on The Prudential Regulation of Crypto-Assets* (October 20, 2022), https://www.fdic.gov/news/speeches/2022/spoct2022.html.

absorb losses and materially reduce the probability of failure and liquidity to continue to fulfil financial obligations and prevent an acceleration towards failure under stress conditions.

It may be tempting to reason that if stablecoins and crypto asset companies had the same regulations and privileges as banks, they would be able to operate like the banking system – an argument that has been pushed by the crypto asset industry. Lawmakers and regulators must reject requests by the crypto asset industry to give crypto assets an appearance of legitimacy beyond the legitimacy it deserves. Crypto assets are not fiat currencies. Crypto asset companies are not banks. If crypto asset companies were to offer the same products and services as banks, they would have the same fundamental risks associated with those products and services. But the level of those risks inherently would be much higher due to the nature and design of crypto assets, which compounds and complicates these risks.

Lending carries the credit risk of borrower defaults; financial obligations to clients, vendors, and counterparties carry liquidity risk; mark-to-market transactions carry market value, counterparty credit, and liquidity risks; and there are always the operational risks of possible mis-coded algorithms, cybersecurity incidents, or other events. Each of these risks would be exacerbated when involving crypto assets.

For example, volatility in crypto asset deposits that are then used to make loans can lead to exacerbated liquidity risks. The obvious case is when crypto asset values decline, and investors want to withdraw their assets to sell them for fiat currencies or purchase other assets to prevent further losses. On the other hand, if the value of the crypto assets appreciates, depositors may be incentivized to withdraw their deposits to convert the crypto assets to U.S. dollars or some other fiat currency to lock in their profits or to purchase other assets whose value depreciated relative to the crypto assets. That is, in either case, the crypto asset deposits are less stable than bank deposits, and crypto asset companies would much more frequently face liquidity issues. As for borrowers, if a loan is taken based on a particular crypto asset and payments are expected to be made in that crypto asset, appreciation in its value can put liquidity constraints on the borrower, increasing the probability of default.

Even stablecoins, touted by the crypto asset industry as the solution to the extreme volatility of crypto assets, are in essence a sham. This year during the dramatic crash of crypto assets, there were massive runs by investors on stablecoins, which as a result have proven to be unstable and unreliable. Also, as Federal Reserve Vice Chair for Supervision Michael Barr said in a recent speech, stablecoins "borrow" the trust of the assets on which they are based, such as the U.S. dollar or U.S. Treasury securities.[6] Stablecoins that are not entirely based on a fiat currencies (which no major stablecoin currently is and likely never will be considering the difficulty in maintaining such a business model) will always be prone to runs by investors. The value of the assets backing them can fluctuate, creating investor panic and resulting liquidity

[6] Federal Reserve Vice Chair for Supervision Michael S. Bar, *Managing the Promise and Risk of Financial Innovation* (October 12 2022), Board of Governors of the Federal Reserve System, https://www.federalreserve.gov/newsevents/speech/barr20221012a.htm.

issues for stablecoin companies. Runs can also be prompted by general declines in the markets for crypto assets, which is exactly what happened this year.

Clearly, crypto asset companies and activities are inherently much riskier than banks, and so crypto asset companies must not be allowed the same privileges of banks or to be treated as if they can conduct the business of banking equally. Also, they should not be allowed to grow to a size and level of interconnectedness with the traditional financial system that would lead to financial stability risks.

Second, all else equal, increased usage of assets that are not dollars and are not deposited at banks would complicate and potentially frustrate the execution and transmission of monetary policy. If banks have a diminished role in the financial system, then the concept of affecting overall interest rates in financial markets and at lending institutions by influencing inter-bank lending rates. That is, if banks have fewer deposits, are making materially fewer loans to the economy, and intermediating fewer financial transactions in financial markets, then the short-term borrowing cost for banks would not matter as much to the overall cost of borrowing in financial markets or the economy.

Therefore, policymakers must proceed cautiously and carefully and remain focused on the risks presented by crypto assets to the traditional financial system and American economy. Before any policies are considered, two key aspects must be determined: what the goal is and what the risks are. Importantly, frameworks must be in place to appropriate address the risks before allowing further development.

For example, stablecoins are essentially attempting to build a "system on a system" by borrowing the trust of the assets on which they are based and then offering the same products and services as the traditional financial system based on that trust. However, thus far stablecoins primarily have been used to facilitate trading in other crypto assets rather than more productive activities such as lending.[7] Even the most basic alleged advantage of stablecoins of faster and cheaper payments is countered by the introduction of the Federal Reserve's FedNow instant payment system that is expected to be active by the spring of next year.[8] And any advantages of the distributed ledger technology can be equally gained in the traditional financial system through the use of that technology by banks for their own products and services and perhaps even by the Federal Reserve.

So, the question must be asked – what are the goals and benefits stablecoins and digital assets more generally are trying to achieve that cannot be achieved through the current financial system? It seems there is no such goal. On the other hand, the risks of crypto assets are very apparent and have been realized in the recent crypto asset crash as well as through all the

---

[7] President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency Repot on Stablecoins, available at https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf.
[8] Federal Reserve Vice Chair Lael Brainard, *Progress on Fast Payments for All: An Update on FedNow* (August 29, 2022), https://www.federalreserve.gov/newsevents/speech/brainard20220829a.htm.

identified consumer protection issues. Those are the obvious risks, and they must be managed directly and forcefully using the authorities of the federal agencies. Additionally, the less apparent risks to our financial system, economy, way of life and standard of living and therefore our national security must be recognized and appropriately considered when designing future policy for the crypto asset industry.

CONCLUSION

We hope these comments are helpful as the Department of the Treasury and other federal agencies develop their frameworks for addressing the national security risks of digital assets.

Sincerely,

Phillip G. Basil
Director of Banking Policy

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464
pbasil@bettermarkets.org

http://www.bettermarkets.org