USDF CONSORTIUM

Statement for the Record

of the

USDF Consortium

for the hearing entitled

Understanding Stablecoins' Role in Payments and the Need for Legislation

of the

Subcommittee on Digital Assets, Financial Technology and Inclusion

of the

House Committee on Financial Services

April 19, 2023

Chairman Hill, Ranking Member Lynch, the USDF Consortium[1] appreciates the opportunity to submit this statement for the record for the hearing entitled "Understanding Stablecoins' Role in Payments and the Need for Legislation."

The topic of today's hearing is a timely one; distributed ledger technology holds tremendous promise to improve financial services, offering more efficient products and services that can help promote financial inclusion, drive economic growth, and support the role of the U.S. Dollar as the global reserve currency. We can only realize these benefits when innovation is delivered responsibly and regulatory guidelines are clear, certain, and consistently applied. We believe it is critical that banks and other regulated entities are empowered to deliver safe and responsible blockchain innovation to the market.

To date, most blockchain innovation has occurred outside of the regulated banking sector in novel cryptocurrency markets. These markets have provided testing grounds that have proven the efficiencies that blockchain technology can deliver. However, the volatile nature of these assets and the inconsistent regulation in these markets have limited the real-world impact of this technology and created unacceptable risk and loss.

Today, we see blockchain technology being used by banks of all sizes to improve the delivery of traditional banking services to the real economy. We believe that the best way to leverage the strengths of blockchain as a technology is to use it to support the delivery of safe, responsible, and regulated financial services. In many cases, use of blockchain technology will be transparent to customers, similar to the use of cloud technology today and other infrastructure.

[1] The USDF Consortium is a membership-based association of insured depository institutions. Our mission is to build a network of banks to further the adoption and interoperability of a bank-minted tokenized deposit (USDF™). We believe that blockchain technology can make payments more efficient and improve traditional banking, expanding access to safe and affordable financial services.

To leverage blockchain for real-world transactions, you first need a trusted and reliable way to make payments natively on blockchain. This need is what led to the rise of stablecoins and has driven the policy discussion around the creation of a "digital dollar" or central bank digital currency (CBDC).

As we debate how best to leverage blockchain to create a "digital dollar," it is important to remember the critical role that digital dollars play in our economy today. While we tend to think of paper money, the reality is that most money in the U.S. is already digital and exists in the form of bank deposits. Today, bank deposits represent 73% of money in our economy.[2]

Bank deposits are a cornerstone of our monetary and financial systems that support the dominance of the U.S. dollar around the world. They play a critical role in supporting credit availability that drives economic growth and social mobility. As we look to implement blockchain technology to improve payments, we should be careful to maintain the numerous protections and benefits that our banking system provides today.

The USDF Consortium and our member banks are working to build blockchain-based payment infrastructure that ensures banks can continue to play this critical role in a digital economy. USDF allows us to deliver the benefits of blockchain technology from within the established regulatory structure for digital money. USDF operates on a private, permissioned blockchain (the USDF Private Chain). In its initial implementation, bank customers will not engage directly with the blockchain, just as they do not interact directly with wholesale payments rails today.

When innovations are not delivered in a responsible manner, they create risks to consumers and the broader economy. The bank regulatory framework is designed to manage the risks associated with offering digital representations of money. Banks are subject to prudential regulation and supervision and robust consumer protections, which ensure deposits are safe and that consumers receive the appropriate protections.

Unfortunately, there is not currently a clear path for banks to act as the responsible providers of blockchain innovation. As highly regulated institutions, any new offering by banks is subject to scrutiny, but blockchain initiatives are held to a higher standard. Today, any bank wishing to undertake a blockchain project must receive formal regulatory approval, a process that does not exist when utilizing other technologies. Moreover, as the federal banking agencies have moved to address risks emerging from the non-bank crypto ecosystem, they have painted with a broad brush, making it difficult for banks to leverage this promising new technology.

Banks play a critical role in our economy. As more economic activity is supported by blockchain, it is critical that we create a clear and credible path for banks to play this same role on-chain. Failure to do so would push financial services activities outside of regulated markets and risk undermining the United States' leadership in financial services. Banks are eager to bring

[2] Money as measured by M1 (Federal Reserve H.6).

responsible innovation to market and look forward to working with Congress and regulators to safely deliver on the promise of blockchain.

1. It is important to separate blockchain from cryptocurrencies

Blockchain and crypto have been imprecisely conflated in the public discourse. While this may be understandable given the important role that blockchain played in facilitating the creation of crypto markets, it is important to clearly distinguish these concepts as policymakers consider appropriate regulation for these novel technologies and assets. By analogy, we do not regulate the internet, but instead regulate the numerous industries that leverage the internet to deliver their services. Similarly, a one-size-fits-all approach to blockchain that seeks to address the risks that have emerged from novel crypto markets may limit its use in other industries.

Policymakers are right to focus on the risks that have emerged from these novel crypto markets. Blockchain facilitated the creation of new financial services products that fall outside the perimeter of existing regulatory and supervisory structures. Many of these services resemble traditional financial services products but are not supervised for the same risks because they are offered by new kinds of businesses that do not fit under traditional licensing and supervisory regimes. Despite this, the risks presented by the use of blockchain are rarely novel. In many cases, existing banking regulation is well suited to manage these risks.

At its core, blockchain is a ledger technology that can facilitate a wide range of activities, each presenting a different risk profile. The risks associated with delivering a novel asset in an unregulated market are very different from the risks associated with a regulated financial institution offering a traditional product.

In banking, we believe that blockchain technology can provide efficiencies that lower the cost of offering financial services, allowing banks to reach more Americans with safe, affordable, and inclusive products. Blockchain on its own is not a silver bullet, but we believe that as a shared system of record, blockchain has a unique ability to break down silos, facilitating real-time collaboration between financial institutions. In particular, we believe that blockchain can facilitate the following activities:

- **Faster, cheaper payments.** As a shared system of record, blockchain can facilitate the near real-time transfer of value. USDF leverages a proof-of-authority model where trust is already established, eliminating the need for participants to undertake costly computing exercises to create skin in the game. This allows for rapid transactions at minimal cost. We believe this can be particularly valuable in supporting business-to-business transactions, which are still largely paper based today.

- **Programmable payments.** Blockchain can integrate smart contracts, enabling banks to automate the execution of complex payments based on real-world conditions. For example, smart contracts could be used to automate the payments process associated

with buying a home. Today, a buyer sends money to escrow, and an escrow agent calls individual banks and confirms wires to all of the various parties that participated in the transaction. With a smart contract, we can deliver each payment to the right party the minute a contract is signed.

- **Shared system of record.** Blockchain adds additional value when it is used as a system of record for other traditional banking assets (like loans). Today, banking infrastructure is a system of siloed proprietary databases. These silos create friction when a transaction requires moving assets in multiple systems at the same time. A buyer will not release funds until they are sure the asset has moved in a separate system of record.

  Blockchain allows for both payments and assets to be recorded on the same system of record. This allows a buyer to trade their dollars for an asset in real time without settlement risk because the transfer of money and the purchased asset move in the same block. This is a process often referred to as atomic settlement.

  Incorporating atomic settlement into traditional banking assets makes it easier to buy and sell those assets. By making these assets more liquid, we add new funding options that lower the cost of credit, expanding access to affordable financial products.

2. Bank deposits should play a central role in the creation of any digital dollar

Financial innovation only adds value when it helps facilitate real-world economic activity like buying capital goods, hiring employees, or purchasing a home. Before blockchain can make a positive impact on the real world, we need a safe, reliable, and trusted form of payments that exists natively on chain. This has led to demand for blockchain native “cash equivalents” that can be used as a means of payment and a store of value.

Many options that have been presented to meet this need would fundamentally reshape the way money exists in our economy today. While we believe there is room for many forms of digital money in a modern economy, commercial bank money (bank deposits) plays a critical role as the dominant form of money in our economy today.

Bank deposits are subject to a strong and tested regulatory regime and play a prominent role in supporting the availability of credit. Because of these benefits, bank deposits make up 73% of money in the U.S. economy today. We believe they will continue to play a dominant role as money is developed natively on blockchain.

In a recent speech Sir Jon Cunliffe, Deputy Director for Financial Stability at the Bank of England, notes that tokenized bank deposits “might offer some or all of the functionality and efficiency claimed for stablecoins, allowing bank deposits to compete better with non-bank payment

coins."[3] Given the important role that bank deposits play in our economy today, we believe it is critical that bank deposits are able to compete with novel forms of tokenized money.

Retail CBDCs have serious drawbacks that limit their utility

Some policymakers have suggested that the government should step in and offer an alternative to stablecoins in the form of a retail CBDC.[4] A retail CBDC would be a liability of the Federal Reserve that is widely available to the general public. The issuance of a retail CBDC would present a safer alternative to existing non-bank stablecoins because they would carry no credit risk.

A retail CBDC would undermine critical benefits that our banking system provides today. According to the Federal Reserve, a "widely available CBDC could serve as a close substitute for commercial bank deposits or other low-risk assets such as government MMFs and Treasury bills. A shift away from these assets could reduce credit availability or raise credit costs for households, businesses, and governments."[5]

Even if delivered through banks, a retail CBDC would ultimately be a liability of the Federal Reserve, not a private institution like a bank. The American Bankers Association estimates that 71% of bank funding is in deposits that would be put at risk by this model.[6] A flight of deposits to the Federal Reserve would undermine the deposit base that supports lending. Banks across the country rely on these deposits to fund the loans that support small businesses in their community and help families achieve homeownership.

An alternative path would be for the Federal Reserve to explore a wholesale CBDC.[7] In doing this, they could create modern blockchain-based payment infrastructure while maintaining the same two-tier system that exists today. While there are numerous tradeoffs to consider in this approach, a wholesale CBDC would reduce one of the largest risks of issuing a CBDC and ensure the private sector has the ability to innovate.

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[3] Bank of England. "The Shape of Things to Come: Innovation in Payments and Money – Speech by Sir John Cunliffe," April 18, 2023. https://www.bankofengland.co.uk/speech/2023/april/jon-cunliffe-keynote-speech-at-the-innovate-finance-global-summit.

[4] A "retail" CBDC means a liability of the central bank held directly by a member of the public, unlike a commercial bank deposit, which is a liability of the commercial bank owed to its customer.

[5] Federal Reserve Discussion Paper, Money and Payments: The U.S. Dollar in the Age of Digital Transformation (Jan. 2022), https://www.federalreserve.gov/publications/january-2022-cbdc.htm.

[6] American Bankers Association Comments on Federal Reserve Discussion Paper, Money and Payments: The US Dollar in the Age of Digital Transformation (May 20, 2022), https://www.aba.com/advocacy/policy-analysis/aba-comments-on-fed-discussion-paper-money-and-payments.

[7] A "wholesale" CBDC means a CBDC designed for use among financial intermediaries only.

Bank deposits are likely to remain the most attractive form of money regardless of technology

The existing U.S. monetary and financial system provides numerous benefits to consumers and the broader economy, and supports the important role that the U.S. dollar plays around the world today. There is little need to change this tested market structure as we implement new technology to upgrade these systems.

Bank deposits play a central role in our economy today as the dominant form of money. Tokenized deposits (sometimes referred to as deposit tokens or dollar tokens) allow us to bring the benefits of bank deposits on-chain by creating a representation of an existing bank deposit on blockchain. Tokenized deposits can take many forms; some might be held by the customers of the bank while others may only be used by financial institutions to create blockchain-native payments rails. In the initial implementation of USDF, no customers will engage directly with the blockchain just as they do not engage directly with existing payments rails today.

Banking regulation ensures that deposits are safe.

Bank deposits are backed by robust capital and are subject to a regulatory regime that ensures liquidity and solvency. For banks, the implementation of blockchain technology does not fundamentally change the nature of banking or how regulation controls for the risks associated with it. Banks are heavily supervised to ensure they deliver the numerous consumer protections associated with digital payments.

Moreover, the bank regulatory structure is designed to maintain important broader public policy objectives. For example, under the Community Reinvestment Act and other laws, banks have long demonstrated their unique ability to support underserved communities. This law is directly tied to bank deposits.; a transition to non-bank deposits would risk undermining these critical objectives.

Bank deposits support credit creation.

Banks play a critical role in our economy, engaging in maturity transformation. Banks take short-term assets in the form of deposits and use those funds to extend long-term assets in the form of loans.

When a bank makes a loan, it creates new money in the form of a deposit in the borrower's account that did not previously exist. That deposit in turn can be used to power additional lending. The amount of deposits that can be used to support additional lending is determined by the capital the bank must hold to support new loans. Today, the core capital (leverage) ratio for FDIC-insured institutions is near 8.7%.[8] This system, called fractional reserve banking, means that a $1 deposit can power more than $10 of lending. These loans allow businesses to invest in new employees or capital goods that create jobs and drive economic growth.

[8] FDIC Quarterly Banking Profile, FDIC QBP Graph Book, https://www.fdic.gov/analysis/quarterly-banking-profile/graph-book/2022mar/QREGCAP.html.

Non-bank instruments like stablecoins or CBDC would eliminate this important function. There are many forms of stablecoins, but the high-profile failure of Terra's UST has led to a push for fully collateralized stablecoins that hold one dollar in assets for every dollar of the stablecoin. This means that a $1 stablecoin could only ever support $1 in lending.

There simply isn't enough capital in the system to support fully collateralizing every financial asset. Today, there are nearly $200 trillion in U.S. financial assets supported by $18 trillion of commercial bank deposits.

The New York Federal Reserve staff reinforced the importance of this in a post titled *The Future of Payments Is Not Stablecoins*, in which the staff argued in favor of tokenized bank deposits.[9] The post notes, "The emergence of DLTs has led to a proliferation of new types of money, such as stablecoins.... In this post, we argue that if DLT platforms are the transfer mechanism of the future, then it seems worthwhile to find the best possible money that can be used on that transfer mechanism. We suggest that tokenized deposits might be a fruitful avenue to pursue."

The only scalable way to bring traditional financial assets on-chain is to leverage the banking system to support that by tokenizing existing bank deposits.

3. Congress should ensure there is a clear, credible path for regulated institutions like banks to offer responsible products

If policymakers want to realize the benefits of blockchain technology while maintaining critical protections and promoting efficiencies, they are right to look to the bank regulatory framework. Banks have a long history of bringing new technology to customers through a trusted and regulated channel. Bank regulation is flexible and well-equipped to manage the risks of integrating new technologies such as blockchain.

We offer the following recommendations and stand ready to work with Congress to advance policies that can promote responsible innovation:

Congress should urge the banking agencies to create a clear path for the approval of blockchain-based activities.

Banks are often slower to adopt new technologies than other industries. This is not for a lack of interest or skill but due largely to the fact that banks are so heavily regulated. Technology companies can bring nascent technologies directly to customers, iterating daily and fixing bugs after releases are made. Before releasing new products, banks must perform countless rounds of testing and ensure that their approach is aligned with regulatory expectations.

[9] Federal Reserve Bank of New York, The Future of Payments Is Not Stablecoins (Feb. 7, 2022), https://libertystreeteconomics.newyorkfed.org/2022/02/the-future-of-payments-is-not-stablecoins/.

While caution is warranted given the important role that banks play, the standard for approval for blockchain-based activities is putting banks at a competitive disadvantage. Currently, banks must obtain formal approvals from their regulators prior to offering any blockchain product, a standard that does not exist for any other technology.[10] To date, no clear set of expectations has been determined for regulatory approval and few approvals have been given.

Since creating these policies, the banking agencies have been careful to highlight that banks are "neither prohibited nor discouraged from providing banking services to customers of any specific class or type," but have put out a series of statements, rules and reports highlighting the risks when banks engage in crypto-related activates.

- Joint Statement on Crypto-Asset Risks to Banking Organizations (1/3/23): Highlights safety and soundness risks of holding cryptocurrencies or dealing with crypto clients.[11]

- Federal Reserve Policy Statement and Final Rule (1/27/23, 2/7/23): The Federal Reserve issued a policy statement,[12] which was later published as a final rule,[13] clarifying that banks cannot hold crypto as principal. The Federal Reserve highlights that banks may be able to issue dollar tokens but that they do not believe banks can meet their obligations on a public, permissionless, or decentralized blockchain.

- The Administration's Roadmap to Mitigate Cryptocurrencies' Risks (1/27/23): The National Economic Council released a statement highlighting its plan to reduce crypto risk. In the statement, the Council discourages policy that would allow "mainstream institutions" to dive headlong into crypto.[14]

[10] The OCC's Interpretive Letter 1179 requires OCC-regulated banks to obtain supervisory non-objection prior to engaging in any permissible crypto-related activity. OCC Interpretive Letter 1179 (Nov. 18, 2021), https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf. The FDIC's FIL-16-2022 requires banks to notify the FDIC for supervisory feedback prior to engaging in any crypto-related activities. FDIC FIL-16-2022 (Apr. 7, 2022), https://www.fdic.gov/news/financial-institution-letters/2022/fil22016.html. The FDIC's FIL-16-2022 requires banks to notify the FDIC for supervisory feedback prior to engaging in any crypto-related activities. FDIC FIL-16-2022 (Apr. 7, 2022), https://www.fdic.gov/news/financial-institution-letters/2022/fil22016.html.

[11] Federal Reserve, FDIC and OCC, Joint Statement on Crypto-Asset Risks to Banking Organizations (Jan. 3, 2023), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf.

[12] Federal Reserve, Policy Statement on Section 9(13) of the Federal Reserve Act (Jan. 23, 2023), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230127a1.pdf.

[13] 88 Fed. Reg. 7,848 (Feb. 7, 2023), https://www.govinfo.gov/content/pkg/FR-2023-02-07/pdf/2023-02192.pdf.

[14] National Economic Council, The Administration's Roadmap to Mitigate Cryptocurrencies' Risks (Jan. 27, 2023), https://www.whitehouse.gov/nec/briefing-room/2023/01/27/the-administrations-roadmap-to-mitigate-cryptocurrencies-risks/.

- Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities (2/23/23): Highlights heightened liquidity risks for deposits from crypto platforms involving customer funds or stablecoin reserves.[15]

These statements focus primarily on the real risks emerging from the broader crypto markets, but few address the use of blockchain for traditional banking. Despite this, the statements could be interpreted by the banking industry to set a tone that discourages banks from exploring these technologies.

We recommend that Congress engage to ensure that there is a clear path for regulated entities like banks to bring responsible blockchain innovation to market.

Stablecoin legislation should not restrict banks' ability to record deposits on blockchain.
Bipartisan stablecoin legislation has emerged in both the House and the Senate. This legislation is a timely response that addresses the risks that have been demonstrated by recent failures. A consistent theme of the legislation is ensuring that stablecoin issuers fully reserve against the stablecoins that have been issued. We believe this is a prudent step to ensure that stablecoins remain backed by high-quality assets.

The definition of stablecoin used in draft legislation is quite broad and risks capturing bank deposits recorded on blockchain. Banks are subject to stringent capital and liquidity standards that allow them to use deposits to fund loans. If banks are required to fully reserve against deposits recorded on blockchain, it would limit their ability to lend into the communities they serve.

We were pleased to see clarifying language in draft legislation that would ensure banks can continue to offer deposit products, but we would urge Congress to explicitly exempt tokenized deposits from any stablecoin legislation.

Congress should urge the FDIC not to restrict banks' ability to use blockchain to record deposits.
The FDIC recently proposed a rule to update the standards for signage and marketing of FDIC insurance.[16] The proposal is overbroad, and we have concerns that language in the proposed rule would limit banks' ability to record deposits on blockchain.

Technology has rapidly changed the way banking services are delivered. Today, most customers access their bank primarily through digital channels and the bank branch is no longer the main source of information in a banking relationship. Technology has also facilitated partnerships that allow for the delivery of banking services through non-traditional channels. With the

[15] Federal Reserve, FDIC and OCC, Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities (Feb. 23, 2023), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230223a1.pdf.

[16] 87 Fed. Reg. 78,017 (Dec. 21, 2022), https://www.govinfo.gov/content/pkg/FR-2022-12-21/pdf/2022-27349.pdf.

proliferation of new options, it is more important than ever that customers clearly understand when they receive the protections associated with banking regulation and FDIC insurance.

This need has become particularly apparent in the non-bank cryptocurrency space, where numerous companies have claimed to offer bank-like protections and, in some cases, falsely claimed FDIC insurance. We support the FDIC's work to address these dangerous misrepresentations and ensure consumers remain protected.

Despite this, we have concerns that the broad definition of "crypto-asset" in the proposal may limit banks' ability to implement blockchain for traditional banking applications. Specifically, it would inhibit banks from using blockchain as the system of record for recording bank deposits by labeling any asset recorded on a distributed ledger as an "uninsured financial product."

Like any other technology, blockchain presents risks that must be managed in its implementation. These risks vary greatly depending on the blockchain implementation being used. Existing banking regulation and compliance culture provide for the appropriate management of these technology risks. Blockchain technology does not present any unique risks that would warrant a new regulatory approach to managing this technology risk or inhibit its use in traditional banking applications. Congress should urge the FDIC to take a technology-neutral approach that addresses the risks inherent in any technology implementation, rather than prohibit banks' use of this technology.

Conclusion

Blockchain technology holds tremendous potential to improve financial services. When delivered responsibly, it has the potential to promote financial inclusion and help ensure that the United States remains a global leader. We believe the bank regulatory structure is well-equipped to manage the risks associated with this novel technology and that tokenized deposits are the best way to realize these benefits.

The USDF Consortium was created as a venue for banks to collaborate as they design blockchain infrastructure that will power the future of financial services. We are committed to delivering these innovations responsibly, ensuring that our customers receive the world-class safety and protections inherent in U.S. banking regulation. We are committed to working with Congress to help ensure an appropriate regulatory framework to enable this critical innovation.