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MEMORANDUM

TO: North Dakota State-Chartered Credit Unions

FROM: Department of Financial Institutions

SUBJECT: Guidance for Digital Assets/Virtual Currency

DATE: June 8, 2022

In response to many requests for information, the Department is providing this guidance to assist you when you consider providing digital asset and virtual currency services. This guidance is limited to address the most frequently asked questions we receive. This guidance is neither legal advice nor a comprehensive guide on all aspects of digital assets/virtual currencies[1]. The Department recognizes that this is a quickly evolving area and that Federal oversight, regulation, or additional guidance may be forthcoming[2]. Therefore, the Department may rescind or revise this guidance on short notice. The information herein is based on what is currently known and considered, and although the Department is aware of uncertainties involved, especially when it comes to Federal regulatory actions, the Department believes it is important to provide timely information to help state-chartered credit unions meet members' needs consistent with safe and sound principles. The Department does not encourage or discourage a credit union's involvement in the virtual currency market, rather we are issuing this guidance to help ensure risks are considered and mitigated. This document contains the Department's current understanding of these risks. Any credit union intending to engage in, or currently engaged in, activities involving or related to digital assets should consult its legal counsel and Federal regulator. As with any activity, credit unions must have procedures in place to appropriately measure, monitor, control, and mitigate potential risks.

Definitions:

Blockchain (also known as distributed ledger) technology: A distributed digital database shared among the nodes of a computer network. It is the underlying technology for cryptocurrency systems.

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1 For a comprehensive overview of digital asset due diligence and risk management principles, refer to the Wyoming Division of Banking's examination manual for Special Purpose Depository Institutions.
2 On March 9, 2022, President Biden issued an Executive Order directing federal agencies to coordinate efforts addressing the development of digital assets.

Cryptocurrency: A type of virtual currency that utilizes cryptography to validate and secure transactions that are digitally recorded on a distributed ledger, such as a blockchain. There are thousands of cryptocurrencies in existence.

Cryptography: A system used for encryption/decryption of messages that cannot easily be deciphered by other users.

Cryptographic key: A particular unit of cryptocurrency is assigned to a party through the use of a set of unique cryptographic keys. These keys are typically stored in a digital wallet and the keys allow for the transfer of cryptocurrencies between two parties. If a party loses their key, access to the cryptocurrency is also lost.

Digital assets: An electronic record in which an individual has a right or interest. The term does not include an underlying asset or liability unless the asset or liability is itself an electronic record[3]. In this document it is referring to crypto assets.

Digital currency: A form of currency that is available only in digital or electronic form. All virtual currencies are digital currencies (the opposite is not true).

Fiat currency: Currency issued by a government such as the U.S. Dollar.

Stablecoins: A type of cryptocurrency that is backed by an asset, such as a fiat currency or a commodity.

Virtual currency: A digital or electronic representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. Virtual currencies are neither issued nor guaranteed by any jurisdiction and do not have legal tender status in the U.S. Examples include Bitcoin, Ethereum, and Tether. A "convertible" virtual currency is a type of virtual currency which either has an equivalent value in real currency or acts as a substitute for real currency.

General Authority:

North Dakota state-chartered credit unions have long provided their members with a variety of financial services. North Dakota Century Code § 6-06 does not explicitly authorize crypto custody services. Credit unions that wish to offer their members crypto custody services must do so through a third-party service provider, as outlined below. Lending to members is an authorized power of a credit union. The means by which loans are secured generally, as well as whether loans may be secured with crypto assets, must fall within the contours of safe and sound business practices. Thorough due diligence and

3 Definition in The Uniform Fiduciary Access to Digital Assets Act North Dakota Century Code § 47-36.

considerations must be made when a credit union decides on what services to offer. Consistent with the NCUA's Letter to Credit Unions 21-CU-16, the Department expects that a credit union engaging in crypto activity "follow safe and sound business practices"[4].

Regulatory Expectations:

Any time a credit union is considering a new product or service, management should conduct thorough due diligence prior to implementation. A careful evaluation of the risks and necessary controls to sufficiently mitigate risk should be documented as part of the risk assessment process. The Board of Directors should ensure that appropriate policies and procedures are in place, as well as sufficient staffing and management expertise. Digital assets and virtual currencies are a newer and rapidly evolving area, and all risks may not be thoroughly understood. Prior to a credit union engaging in this area, it is paramount that staff has sufficient expertise and knowledge and that appropriate risk controls are in place, which includes adequate insurance coverage.

Due to the technical nature of virtual currency and legal limitations on credit unions custody services, a credit union may choose to establish a relationship with a service provider with expertise in handling virtual currency. Therefore, it is incumbent on the credit union to maintain a strong service provider oversight program that addresses risk in the service provider relationship from the first steps of due diligence through a potential termination of the service provider relationship[5]. The credit union also must be mindful that the service provider may also be subject to various state licensure requirements, and failure on the part of the servicer to meet their regulatory requirements may subject the credit union to increased risk.

Reputational Risk Considerations:

The credit union's members have numerous ways of investing or transacting with virtual currencies directly with digital wallets outside of the traditional financial system. However, due to credit unions' reputation for being safe and stable, if a credit union offers virtual currency access via a partner, members may be more inclined to engage in this activity through their credit union rather than on their own. Although there has been tremendous

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4 NCUA Letter to Credit Unions 21-CU-16 Relationships with Third Parties that Provide Services Related to Digital Assets | NCUA

5 More information on outsourcing technology services can be found in the Federal Financial Institutions Examination Council's IT Examination Handbook for Outsourcing Technology Services. The NCUA issued a Letter to Credit Unions 21-CU-16 related to third party digital asset service providers and general third party guidance in Letter to Credit Unions 07-CU-13 . The FFIEC April 30, 2020, Joint Statement on Risk Management for Cloud Computing Services will also provide helpful guidance. Finally NCUA's 22-CU-07 provides guidance on the use of Distributed Ledger Technologies

growth in this market and the products are easily accessible, that does not mean that members have a thorough understanding or knowledge of the products. The risks are prevalent and may not be thoroughly understood, and the credit union must be transparent about the level of risks it may expose its members to by facilitating access to these products. If the credit union offers any uninsured activities, even through third parties, the credit union should ensure solid agreements with members and proper disclosures are communicated. Due to the higher risk and volatility in these instruments, the credit union should safeguard its reputation and consider its member relationship if a member's investment value suddenly goes down or the member loses the investment. The credit union must consider the role of simply facilitating transactions versus promoting an investment or providing investment advice.

Bank Secrecy Act (BSA)/Anti-Money Laundering (AML) Considerations:

Credit Unions have the same compliance obligations for knowing its members, monitoring transactions, and reporting for virtual currency transactions as they do for fiat currency. In the FinCEN Advisory, FIN-2019-A003, May 9, 2019, FinCEN states that virtual currencies "may create illicit finance vulnerabilities due to the global nature, distributed structure, limited transparency, and speed of the most widely utilized virtual currency systems." Since virtual currency transactions are anonymous/pseudonymous, the ability for a credit union to monitor individual identities and transparency of transactions may require additional and different resources than what is currently deployed for fiat currency transaction monitoring. Similarly, Office of Foreign Assets Control (OFAC) compliance obligations also apply equally to transactions involving virtual currencies and those involving traditional fiat currencies. With virtual currencies' increasingly prominent role in the global economy, credit unions will have an increased exposure to sanctions risks. OFAC issued its compliance guidance in October 2021 addressing these concerns. Credit unions need to provide sufficient resources in staffing and procedures to fully comply with these laws. Although a credit union may outsource functions to third parties, this does not relinquish the credit union's BSA/AML and OFAC risks, obligations, and liabilities. The responsibility ultimately remains with the credit union to ensure transactions comply with the law.

Virtual Currency as Deposits:

Virtual currencies are not considered legal tender and can therefore not be taken as a deposit or membership share and placed on the credit union's balance sheet as such. The credit union may indirectly provide custody services as described below.

Virtual Currency as a Credit Union Investment:

North Dakota Administrative Code 13-03-22 does not authorize credit unions to invest credit union funds in virtual currencies. In addition, with the fluctuations in value and speculative nature of this market, virtual currency investments pose heightened liquidity, asset quality, and earnings risks and are therefore not a prudent investment for credit unions.

Virtual Currency as Collateral:

Although a credit union can accept virtual currency as collateral , there are numerous considerations to ensure the credit union is fully protected against undue risk. First off, the loans themselves must be made with fiat currency and must be repayable in fiat currency, even if the underlying collateral is virtual currency. Additionally, as an example, when a credit union makes a car loan, it will obtain and be in possession of the title to fully perfect the loan. To properly perfect a virtual currency loan, the credit union will need possession or exclusive control over the private key. It is possible a credit union could use a Uniform Commercial Code (UCC) filing; however, the credit union must consider the likelihood of successfully obtaining the private key and thus the collateral from the borrower in the event of foreclosure. While a credit union can theoretically obtain the private key through judgments from the courts, this is a new area of law, the collateral may be held in foreign jurisdictions, and this method of collecting will come with legal costs. The credit union should know where the virtual currency is held and what measures are in place to safeguard the collateral. As with any loan, failure to fully perfect the collateral may result in examiners treating the loan as unsecured and the virtual currency collateral as an "abundance of caution".

Another challenge using virtual currency as collateral is the volatility and quick changes in value. These loans could be treated similar to margin loans, requiring a periodic adjustment where the borrower adds collateral to ensure a specific loan-to-value limit is maintained. If the credit union uses this approach, credit unions should give thorough consideration for the collateral margin, frequency and calculation of margin calls, and understand that the appropriate margin limitation may differ depending on the type of virtual currency.

Loan documentation and borrowing agreements may differ from traditional loan agreements due to the different nature of the collateral and where the collateral is kept. Also, in the event of foreclosure, the credit union must consider how to take possession of the collateral, any system requirements for safeguarding, and fees for converting the collateral into fiat currency for loan repayment. A credit union would need to liquidate any crypto collateral following a foreclosure timely to extinguish the debt and to realize any losses.

<u>Virtual Currency as an Underwriting Consideration:</u>

A borrower's crypto activity can impact their overall financial condition. Whether a credit union actively engages in providing crypto services or not, all lenders need to be aware of the impact crypto assets can have on borrower equity and cash flow, even if the loan products offered are traditional consumer, agricultural, or commercial loans. When evaluating a borrower's financial condition, be mindful of the impact changes in crypto prices can have when virtual currency makes up a large share of a member's balance sheet. Crypto price changes and margin calls may have an impact on a borrower's cash flow position, even if the credit union's specific loan is not for, or secured by, the crypto assets.

<u>Virtual Currency Custody Services:</u>

As mentioned above, credit unions have no explicit authority in North Dakota Century Code 6-06 to provide members custody services with regards to crypto assets. Similarly, the federal credit union act also limits this authority. Any crypto custody services provided to a credit union member would need to be provided through a third party with these authorized powers.

Prior to offering crypto custody services through a third party, necessary controls must be in place prior to engaging in the activity. Comprehensive board-approved policies and procedures must be in place to properly safeguard the assets. The credit union must consider technical controls such as access controls and authentication, and the third party's physical controls such as protection of hardware and data specific to the virtual currency held. The credit union should also confirm the existence of adequate coverage with its insurance carrier and consult with knowledgeable legal counsel to understand the legal liabilities and risks to the credit union if something were to go wrong.