

MEMORANDUM

DATE: January 26, 2021

TO: House Industry, Business and Labor Committee

FROM: Lise Kruse, Commissioner

SUBJECT: Testimony Regarding House Bill No. 1267

Chairman Lefor and members of the House Industry, Business and Labor Committee, thank you for the opportunity to testify regarding House Bill No. 1267.

Mr. Chairman and members of the Committee, our Department does not take a position on House Bill No. 1267 but would like to address why the Department is included in the fiscal note and considerations we believe are important in regards to this bill.

In addition to banks and credit unions, the Department of Financial Institutions licenses over 7,000 consumer finance companies. Of these companies, 140 are money transmitters, and although virtual/digital currencies are not currently regulated under North Dakota law, some of our licensed money transmitters are also operating digital currency exchanges.

A digital currency exchange, or crypto exchange, is in many ways similar to exchanges such as the New York Stock Exchange, except that it only handles digital currency. A digital currency exchange allows customers to trade digital currencies for other assets. It is where customers can buy or sell digital currency and the exchanges can send cryptocurrency to a user's personal digital wallet, or

it can convert balances into prepaid cards, for example. A crypto exchange can be a subsidiary of a digital currency provider or it can be independent.

The Department of Financial Institutions is under N.D.C.C. § 6-09-29 tasked with the examination responsibilities of Bank of North Dakota (BND). As such, the safety and soundness of BND as an institution is of our utmost concern. We must have examiners capable of overseeing all of the bank's activities, and if the legislative body finds that the bank should become a digital currency exchange, we must have examiners specialized in this area. In the fiscal note we are requesting one FTE with funds for training. As a special funds agency, the source of these funds would be an additional assessment to BND, since other banks' assessments should not be used to subsidize activities unrelated to their specific industry. Although we do have crypto exchanges licensed with our Department, these are nationwide companies and therefore we leverage resources working with other state counterparts. Since the crypto exchange activity is not what the company has a license for in North Dakota, our examiners focus on the areas that require a license here. Since we are BND's sole regulator, we will now need to have this expertise in-house. This will require a substantial investment on the part of the Department to train, develop an examination program, evaluate the level of risk in the feasibility study, and monitor ongoing operational risks. I am unable to reallocate resources from our bank and credit union divisions at this time. In the midst of a pandemic facing an uncertain economic future, the focus of existing staff is on our banks and credit unions throughout North Dakota, since they are central to our communities and our economic recovery.

As BND's regulator, I am obligated to highlight regulatory and safety and soundness considerations. To protect against risk, a bank must have healthy capital levels – it is what prevents a bank failure. Since BND is an agency of the State of North Dakota, its capital level is what shields taxpayers from having to support the bank, and due to its healthy level, BND is today supporting the taxpayers. BND is a strong banking institution, which has been able to retain

capital while also contributing significant amounts to the general fund. The bank also steps up when our state is faced with a crisis, such as distressed agricultural conditions or the current pandemic. A bank's capital level should always be commensurate with its risk. Any new programs may pose additional risks, which requires a higher level of capital as a safeguard. One of the largest digital asset exchanges in the country reports over \$90 billion in assets on their platform. Therefore, I am confident BND's capital level must be a lot higher than their current level to support a digital asset exchange. What the appropriate capital level is for a bank acting as a digital asset exchange, is uncertain, and must be part of any study.

Operating a digital asset exchange will put BND in direct competition with private businesses which have access to private investors. Competing with large global exchanges will require significant investment to be successful. The risks must be thoroughly explored. Capital must be at a level to protect the institution and the North Dakota taxpayer if something goes wrong. Retaining the bank's capital will obviously limit what is available to support the general fund and other projects. I am not aware of any other state or government agency operating an exchange.

From a regulatory standpoint, some of the highest risks with currency exchanges are to ensure the company has secure IT systems and a robust anti-money laundering program. You may recall the Mt. Gox crypto currency exchange failure in 2014, where weaknesses in their technology infrastructure allowed theft of bitcoins, resulting in both the business failure of the crypto exchange and significant consumer losses. Also, protecting against money laundering and other illegal activities is a requirement of the Federal government. BND has a program in place for their current product offering to comply with these IT and anti-money laundering requirements. It is not clear what additional IT or anti-money laundering requirements would apply to a crypto exchange or what steps would be required to prevent a BND crypto exchange from being used to facilitate criminal activities.

Complying with these laws and regulations takes a considerable investment from any company engaging as an exchange, and consideration of the IT program and anti-money laundering program requirements and costs must be part of any proposed study.

You should also be aware that operating a currency exchange could subject BND to other jurisdictions unless it only serves North Dakota citizens. Many states and foreign governments require currency exchanges to have a license to be able to operate and serve their citizens. This will require BND to have bonding and may also need to be examined by other states or foreign governments for this activity. Other states may rely on our Department; however, when it comes to consumer protection, many states will find it necessary to also do their own due diligence to ensure the bank meets their specific state's requirements. The U.S. Securities and Exchange Commission may also require BND to register. Any study conducted must explore the above areas, the associated costs, risks and potential repercussions.

Mr. Chairman, thank you for the opportunity to provide this testimony. I would be happy to answer any questions the Committee may have.