Insight

# On the Appropriate Regulation of Stablecoins

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**Executive Summary**

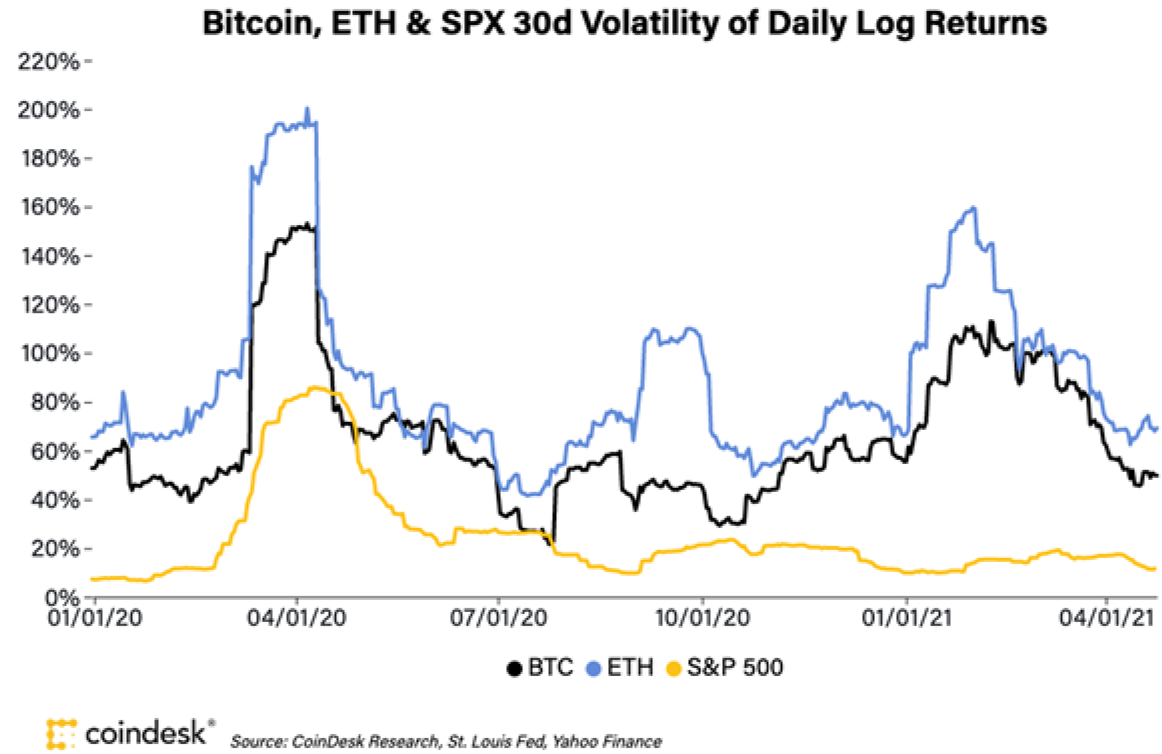

- The President's Working Group on Financial Markets has issued a report calling on Congress to develop legislation promoting a consistent and comprehensive federal approach to the regulation of stablecoins, a class of cryptocurrencies.
- The report calls on Congress to require that stablecoin issuers be regulated as banks, including the requirement for federally backed insurance and a full suite of prudential capital requirements; in addition, the federal financial regulatory agencies request that their existing powers and authorities be expanded to allow for better oversight of all actors in the stablecoin sector.
- While the report articulates clearly and concisely the challenges facing the federal agencies in regulating unique hybridized commercial actors in a new industry, relying on Congress to meet the enormous demands of providing direction in this sector remains wildly optimistic at best.


**Introduction**

The President's Working Group on Financial Markets (PWG) this week announced a report assessing the regulatory position of stablecoins, a class of cryptocurrency and $130 billion market. In its report, the PWG noted the risk that stablecoins present primarily to users of the cryptocurrency but also to systemic integrity, the financing of terrorism, and other financial crimes. The PWG made a number of policy recommendations, including that issuers of stablecoins become insured depository institutions and be regulated like banks. While the PWG noted a number of interim measures that the federal regulators are taking and will continue to take, the report authors called on Congress to develop a comprehensive federal prudential framework as a matter of urgency.

**What Is a Stablecoin?**

While bitcoin remains the most popular cryptocurrency on the market, and over $1 trillion of the $2.6 trillion total market value of all cryptocurrency, one of its most significant drawbacks remains its high volatility (technically a measure of dispersion around the mean value of a security, but more generally rapid or significant fluctuations in value as defined by the market). The graphic below shows the daily log return (a calculation of return on equity) of the first and second most significant cryptocurrencies, bitcoin and Ethereum, by comparison to the average volatility of the S&P 500.




While many in the industry like to speculate that bitcoin volatility is decreasing as the asset moves out of the "price discovery" phase, bitcoin remains a risky speculation and, more important, unsuitable as a currency for wide use given the uncertain nature of its purchasing power. The hypothetical volatility of a cryptocurrency, however, decreases significantly when the price of that cryptocurrency is "pegged" to another asset; this is doubly so where that separate asset is not correlated to the crypto market, and exponentially so when the pegged asset is something as stable as a fiat-controlled currency such as the U.S. dollar.

The largest stablecoin by market capitalization (and the fifth largest cryptocurrency on the market) is Tether, valued at over $70 billion. Tether is a fiat-controlled stablecoin pegged to the U.S. dollar at a 1-1 ratio, although notably Tether does not provide a right of redemption that would permit the exchange of "Tethers," or Tether dollars for U.S. dollars.

The PWG report does not draw obvious distinctions between the risks posed by stablecoins specifically and the risks posed by cryptocurrency generally. Most cryptocurrencies (as, indeed, most currencies) are at risk of a "run" on the currency if public confidence is lost and the currency is dumped on the market. The PWG report, however, does note that stablecoins could suffer a unique run in that a cycle of redemptions and fire sales of assets could be self-reinforcing. Unclear terms – and in particular confusion as to the availability or terms of redemption – likewise apply to all cryptocurrencies, although by being pegged to an external asset stablecoins could lead investors to believe that redeemability is supported (the U.S. dollar conjures up an image of reliability).

The PWG report also speaks at some length as to the operational and cybersecurity risks related to the collection, storage, and maintenance of customer data, in particular by "digital wallets" that serve as third-party intermediaries and for the storage of cryptocurrencies.

At least two risks raised by the report are unique to stablecoins: the choice of volatile or illiquid reserve assets, and a failure to maintain reserve assets. The former fundamentally undercuts the purpose of a stablecoin but do exist, most obviously in the form of stablecoins backed by other cryptocurrencies. The latter was the subject of highly publicized legal difficulties for Tether in January 2018 when the company could not provide evidence of daily reserve audits. The PWG report notes the relatively small size of the stablecoin market by comparison to the cryptocurrency market total market capitalization but suggests that stablecoins have the potential for rapid growth due to the highly scalable nature of the business model. While the market capitalization of stablecoins is only $130 billion, this represents an increase of over 350 percent from a market capitalization of $28 billion in January of *this year*. From this potential for scalability, the PWG report suggests that stablecoins could pose systemic risk (an idea the report barely touches) or a hypothetical concentration of excessive economic power as a result of either an individual actor becoming too big to fail, or a combination of issuer and servicer, or the related concern of concomitant anti-competitive effects on, for example, pricing.

**What Does the Report Recommend?**

The PWG itself was established in 1988 under President Reagan and comprises of the Treasury, the Board of Governors of the Federal Reserve, the Securities Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC). The PWG report on stablecoins was released however in conjunction with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC), representing the input and implied support of all the federal financial regulators. At its core the report authors request that Congress enact legislation "to ensure that payment stablecoins and payment stablecoin arrangements are subject to a federal framework on a consistent and comprehensive basis." While this legislation would complement existing agency authorities, the PWG makes three policy recommendations for Congress, as outlined below.

*Legislation should require stablecoin issuers to be insured depository institutions.*

Stablecoin issuers, including Tether and Circle, are not regulated as banks, but represent examples of the recent evolution of fintech firms providing financial services that can seem extremely similar to those performed by banks, such as the provision of loans or returns on deposits. Despite this, fintechs are not protected by federal insurance via FDIC nor regulated and overseen as heavily as banks. Were Congress to expand bank-like requirements to fintechs, the risk posed to the economy by fintechs would significantly decrease (fintechs would likely, for example, have to hold capital against shock and undergo stress testing). The necessary corollary of this is that fintechs would suddenly have a greatly enhanced regulatory burden that not every fintech would have the experience, manpower, or capital to meet, crippling the industry and deterring innovation. In particular, by levelling the regulatory playing field the PWG may have the unanticipated side effect of making it easier for the traditional banking sector to enter the market and provide cryptocurrency offerings in what would be a fatal blow to a nascent industry and surely a far greater concern as to the excessive concentration of economic power.

*Legislation should require custodial wallet holders be subject to federal oversight.*

In this the PWG is once again simply calling for the financial intermediaries to be appropriately regulated as actors in the financial ecosystem (as, for example, clearinghouses are). The lack of an immediate and obvious comparison in the existing financial ecosystem makes this request significantly more vague. The PWG also notes that Congress could simply invest this authority in the relevant agency supervisor.

*Legislation should address systemic risk and economic concentration concerns by restricting the ability of stablecoin issuers to affiliate with commercial entities.*

To accompany this measure the PWG also requests that the federal agencies be given the power to mandate standards promoting stablecoin interoperability.

Outside of these immediate requests, the federal financial agencies commit to continuing efforts to address these issues as an “interim measure” within the scope of existing powers. The financial regulators were, however, at pains to stress that an expansion of these authorities by Congress would be required such that the agencies could provide appropriate oversight. In the absence of congressional action, the federal financial regulatory agencies suggest that the Financial Stability Oversight Council (FSOC) take up the mantle. In that FSOC does not have any more legal force than the PWG, it is difficult to imagine that the same recommendations from a different source would compel Congress to act.

**Conclusions**

We know these things to be true: the cryptocurrency market has the potential for explosive growth with systemic implications; fintechs providing banking services are wildly underregulated for the services they provide; and the U.S. legislative and regulatory apparatus does not have a cohesive or unified approach to deal with this brand-new industry. The PWG report, while addressing what remains a still-niche corner of the cryptocurrency market, gets to the heart of many of these concerns but ultimately refers the issue to Congress—where these questions will ultimately languish, if they aren’t already. Without a top-down directive, a federal holistic approach to crypto regulation seems impossible. This is not in and of itself necessarily a bad thing, and the explosion of the market capitalization of stablecoins over the last year demonstrates the fertile grounds and possibility for innovation. Yet it is perhaps not best to linger too long in setting the safety rails for an industry that represents 10 percent of U.S. gross domestic product and has the potential to transform the entire payment industry.