The Regulation of Stablecoins: Origins, Status and Prospects

Written by Dominic Hobson, Co-founder and Editorial Director of Future of Finance

The following is The Summary and Conclusion to the Paper which will be launched by Future of Finance mid-February

To pre-order a copy please contact Wendy Gallagher on
wendy.gallagher@futureoffinance.biz

Contents

Boxes

Charts and Tables

1.0 Summary

In May 2022 the Terra algorithmic Stablecoin collapsed, prompting a run on some Stablecoins and a flight to quality alternatives. Other algorithmic Stablecoins also failed. The episode undermined confidence that Stablecoins in general, and algorithmic Stablecoins in particular, could be *stable*.

In reality, even the most conservative, asset-backed Stablecoins rest on an inescapable tension. They must invest the cash subscribed by their holders in income-producing assets, but those assets may be issued by issuers that fail, or prove hard to sell in a crisis, when holders want their cash back.

This tension means Stablecoins are more like banks than investments. Since they also act as a form of payment and can be used to generate credit and so create commercial bank money in the same way as a bank, some argue Stablecoins should be regulated in the same way as banks.

Conservatively managed asset-backed Stablecoins, which invest in various combinations of government bonds and bills, and bank deposits, exhibit much lower levels of volatility than Stablecoins backed by inherently volatile cryptocurrencies, even though these are expensively over-collateralised.

The most vulnerable Stablecoins remain the algorithmic variety. This is because they rely not on investing cash in assets to back the peg to a currency but solely on the activities of arbitrageurs to reduce the supply of the Stablecoin when the price falls and increase it when the price rises.

Stablecoins were in fact invented chiefly for the benefit of professional traders. They rely on them to park winnings without incurring the costs of converting them into fiat currency through the banking system; to switch between blockchain networks; and to lend and borrow assets for profit.

Restoring currency pegs, by collecting as profit the discount or premium, is not the primary activity of traders, condemning the arbitrage mechanisms of algorithmic Stablecoins to reliance on limited numbers of buyers and sellers. Experience shows that, when confidence fails, buyers are absent.

The parallel with a bank run is too obvious to ignore, reinforcing the case for regulation. But regulators have shown little interest in regulating algorithmic Stablecoins, as too small and unstable to warrant their attention. They are, however, focused on asset-backed Stablecoins.

Regulators identified the cryptocurrency markets – and Stablecoins as a core component of them - as a conduit for laundered money and terrorist financing early. Since 2018, Stablecoin issuers have had to check users are not financial criminals, but enforcement is slow and lax.

What triggered serious regulatory interest in Stablecoins was the announcement by Facebook in June 2019 that it was planning to issue a global Stablecoin called Libra. By undermining the funding and payments businesses of banks, Libra represented a threat to the entire established financial system.

Measures were taken to ensure that non-bank Stablecoin issuers such as Facebook should not escape the onerous regulatory, risk management, recovery and resolution and capital and liquidity obligations laid on banks.

The 2019 G7 Working Group on Stablecoins report emphasised the need for legal certainty for issuers and users, proper governance and assurance about the quality and whereabouts of reserve assets. It was highly sceptical about over-reliance on DAOs, smart contacts, algorithms and arbitrageurs.

Subjecting Stablecoins to the full panoply of regulations that govern banks and financial market infrastructures (FMIs) – credit, collateral, liquidity, operational, cyber and data risk management - regulators successfully crushed the possibility of any non-bank Stablecoin disrupting the status quo.

Libra in particular was at first heavily constrained, and eventually sunk altogether by lack of regulatory endorsement, chiefly because its progenitor Facebook posed a global systemic threat to the status quo that no other Stablecoin could match.

But outright hostility to Big Tech Stablecoins, and a determination to bring other Stablecoins within the regulatory perimeter, was coupled with an appreciation that Stablecoins might also help to redress a problem Stablecoins had highlighted.

The problem is the high costs and slow speeds of making payments across national borders. Regulation, it was argued, might permit better designed Stablecoins that facilitate something regulators want: cheaper, faster, transparent and accessible cross-border payments services.

Central banks have considered whether the issuance of central bank money alternatives to Stablecoins – namely, Central Bank Digital Currencies (CBDCs) – might also play a part in making cross-border payments cheaper, through intermediaries or linking of central bank settlement systems.

CBDCs were also seen by central banks as the ultimate solution to the threat of a global Stablecoin emerging outside their control. They would almost certainly displace Stablecoins as the solution to the problem Stablecoins were invented to solve – the need for cash on blockchain networks.

But no major jurisdiction has yet issued a CBDC. Instead, regulators are focused on bringing Stablecoins within the scope of regulation. Regulators in the United States, the European Union, the United Kingdom and Japan are following a single model outlined in the work of the G20 and the G7.

The model leaves algorithmic Stablecoins outside regulation; aims to restrict issuance of Stablecoins to regulated banks; insists reserve assets must consist of the highest quality domestic money market instruments, and that they be fully disclosed; and demands issuers be soundly governed.

The net result is an invitation to regulated banks to experiment with Stablecoin-based services which some banks have accepted. It is as yet unclear what the less favoured regulatory status of non-bank Stablecoins implies for investor protection and financial stability.

For now, non-bank Stablecoins remain essential to the cryptocurrency, DeFi and tokenised markets which bank-issued Stablecoins have yet to penetrate. As these markets merge with the traditional financial markets, the regulatory mantra of "same business, same risk, same rules" will apply.

23.0 Conclusion

The regulation of Stablecoins remains a work-in-progress, but the outlines of the future structure are now clear. Regulators see Stablecoins as a threat to the established payments and banking systems and have concluded that the best way to contain the risk without destroying the incentive for market participants to innovate is to privilege bank issuers over non-bank issuers. This division is unlikely to prove stable, however.

The worlds of cryptocurrency and fiat currency are converging. Stablecoins are part of that convergence, by providing a link between the two worlds. But wider forces are at work. The distinction between private and public blockchains is blurring, with supranational issuers and regulated banks now prepared to use pubic blockchains. Trading is increasingly round-the-clock, creating a constant demand for cash to cover the cash leg of transactions.

A cryptocurrency innovation - tokenisation – is disrupting the established equity, debt, fund and privately managed asset markets, and creating a demand for tokenised forms of cash to settle the cash leg of tokenised transactions.

Exchanges, brokers and technology vendors are emerging to make it easier for investors to switch quickly and cheaply between cryptocurrencies, tokens and traditional markets – in large part because regulation is in place in security token markets already and expectations that regulation will be extended to the cryptocurrency markets are likely to be fulfilled.

Meanwhile, appreciation of the most powerful feature of digital forms of money – its programmability – is spreading. When borrowers and lenders can agree what event or data triggers a payment, and programme it into smart contract embedded in a token, there are potentially massive savings in liquidity and capital to be gained.

Governments too are persuaded of the value of digital money for the unbanked, and in making cross-currency payments cheaper and more efficient, and they are now investigating whether programmable money can deliver conditional welfare payments more efficiently.

CBDCs are the customary answer to the demands for both reliable and stable on-chain cash and programmable money. But no major convertible currency is yet fully committed to issuing a CBDC and, even if one or more jurisdictions were, the introduction of a CBDC is years away.

Stablecoins, issued by regulated banks and backed by reserve assets denominated in major fiat currencies, managed by regulated asset managers and held in custody by regulated banks, are likely to remain the solution for the short and the medium term.

The unresolved question is whether bank issued Stablecoins will drive out non-bank-issued Stablecoins. The answer to that question will unfold as the traditional financial markets gradually merge with the tokenised markets that are now coming into being. Importantly, that convergence is not merely a case of adopting common techniques. It will also be a case of adopting a common set of regulations, well-captured in that regulatory motto: "Same business, same risk, same rules."

Written by Dominic Hobson, Co-Founder and Editorial Director at Future of Finance