Stablecoins and Future Safeguards

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Pending regulation could cause major challenges for Banks and other Financial Institutions.

Stablecoins are quickly joining the global conversation about cryptocurrencies, but what exactly are they and what does their pending governmental regulation mean for issuers and others involved in the industry? Stablecoins are a type of digital asset that are designed to maintain a stable value relative to a national currency or other fiat. Currently, stablecoins are primarily used to facilitate trading of other digital assets, but there is recognition that they could become more widely used in the future by individuals and businesses.[1]

The growth of stablecoins in the last year has been exponential, with a nearly 500 percent increase in 2021 alone.

Stablecoins, as a form of digital currency, maintain a number of distinct characteristics that may result in more widespread commercial use cases in the global economy. Stablecoins are generally backed by a single fiat currency and, in some cases, can be redeemed at par value to the underlying fiat currency. This results in a price that is generally far less volatile than cryptocurrencies and may allow for adoption to support a wide range of commercial and economic activity. Algorithmic stablecoins, which are not tied to a reserve currency and rely on complex mathematical models and trading strategies to support price parity with a fiat currency, have proven to be much more volatile than those backed by a reserve currency, as demonstrated by the recent collapse of terraUSD.

Due to the relatively stable nature of stablecoins' value, central banks around the world are beginning to consider the creation of stablecoins formally backed by central bank reserves as an alternative to traditional fiat currency. The Eastern Caribbean Central Bank ("ECCB") is currently piloting DCash, which involves the secure minting of a digital version of the Eastern Caribbean dollar ("DCash") as legal tender.[2] The ECCB notes the pilot is being launched to address the following:

- The relative high cost of current payment methods and banking services;
- Inadequacy of banking services in addressing the needs of various customers; and
- Inefficient methods of settling cheque transactions, which slow the pace of commerce.

1. President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, Report on Stablecoins, Nov., 2021.
2. ECCB Digital EC Currency Pilot, at https://www.eccb-centralbank.org/p/what-you-should-know-1.

Regulatory Approach

Globally, industry leaders and regulators recognize the likelihood of stablecoin (and their associated risks) being incorporated into the mainstream financial system and the ensuing risks. Governments are considering implementing their own central bank digital currencies, similar to the ECCB. Major regulators, such as the HKMA, HM Treasury, and MAS, have published consultation papers, requesting industry feedback and providing initial thoughts and guidance to the burgeoning industry.[3] While most regulators have not yet issued definitive requirements (and many are waiting for legislation before acting), there is a clear trajectory towards stablecoins becoming a fully regulated industry. There has, however, been an increased focus recently from both domestic and international regulators to protect investors in stablecoins by mandating the quality of stablecoin reserves and documented redemption policies to ensure that investors have proper access to their stablecoin holdings and are able to redeem them at par in a timely manner to limit losses and maintain liquidity.

The New York Department of Financial Services ("DFS") recently issued Guidance on the Issuance of U.S. Dollar-Backed Stablecoins which emphasizes certain requirements that apply to stablecoins backed by the U.S. dollar and are issued under DFS oversight.[4] This includes standards for stablecoin issuers and exchanges:

- Being fully backed by a Reserve of assets of USD cash or approved cash-equivalent securities,
- Having clear policies that allow holders to redeem units of stablecoin in a timely fashion at par, and
- Ensuring the assets in Reserve are segregated and held in custody with regulated depository institutions or custodians.

Stablecoin issuers must also agree to be subject to regular examination of these requirements on at least a monthly basis.

Similarly, Japan's parliament recently passed legislation introduced by Japan's Financial Services Agency ("FSA") providing clarity around the definition of stablecoins, which will now be considered digital money and must be linked to the yen or another legal tender, guaranteeing holders the right to redeem them at face value.[5] In addition, the legislation introduced the requirement that stablecoins can now only be issued by licensed banks, registered money transfer agents and trust companies, with the aim of further protecting investors and restoring confidence in digital assets.

3. Hong Kong Monetary Authority, Discussion Paper on Crypto-assets and Stablecoins, Jan. 2022; HM Treasury, UK regulatory approach to cryptoassets and stablecoins: Consultation and call for evidence, Jan. 2021; Monetary Authority of Singapore, Consultation of the Payment Services Act 2019: Scope of E-money and Digital Payment Tokens, Dec. 2019.
4. New York Department of Financial Services, Guidance on the Issuance of U.S. Dollar-Backed Stablecoins , June 2022, https://www.dfs.ny.gov/industry_guidance/industry_letters/il20220608_issuance_stablecoins.
5. Singh, Amitoj (June 2022). Japan Passes Landmark Stablecoin Bill for Investor Protection: Report, https://www.coindesk.com/policy/2022/06/03/japan-passes-landmark-stablecoin-bill-for-investor-protection-report/.

The Federal Reserve Bank of NY ("FRBNY") recently issued a discussion paper on Stablecoins and the Growth Potential and Impact of Banking, which notes that "With appropriate safeguards and regulations, stablecoins have the potential to provide a level of stability that is on par with traditional forms of safe value."[6] The Office of the Comptroller of the Currency ("OCC") has issued three interpretive letters in 2020 and 2021 providing that banks may provide digital currency custody services, hold dollar deposits serving as reserves backing stablecoins, and may engage in certain stablecoin activities to facilitate payment transactions on a distributed leger, provided the bank can demonstrate that it has the controls in place to conduct the activity in a safe and sound manner.[7]

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Additionally, global organizations such as Basel and FATF have provided guidance that stablecoin arrangements should observe international standards for payments, clearing, and settlement systems.[8]

Future Impact

While the stablecoin regulatory landscape is still in its infancy, there is a strong likelihood of additional major market stablecoin legislation in 2022 or 2023 that will greatly impact market participants. Stablecoin market participants include the cryptocurrency exchanges that issue and exchange stablecoins, as well as the commercial banks and savings associations that hold stablecoin currency reserves and use stablecoins for payment activities through participation in independent node verification networks (INVNs). Since most cryptocurrency exchanges are currently regulated as money services businesses (MSBs) and broker-dealers, any major market regulatory actions or rulemaking that would force cryptocurrency exchanges to become nationally chartered banks to support the issuance and exchange of stablecoins could have a profound impact on the extent of their compliance obligations.

Commercial banks and savings associations connecting to INVNs to permit the use of stablecoins for

6. Liao, Gordon Y. and John Caramichael (2022). "Stablecoins: Growth Potential and Impact on Banking," International Finance Discussion Papers 1334. Washington: Board of Governors of the Federal Reserve System, at 11, https://doi.org/10.17016/IFDP.2022.1334.

7. Office of the Comptroller of the Currency, Interpretive Letter #1170, July 2020, https://www.ots.treas.gov/news-issuances/speeches/2022/pub-speech-2022-37.pdf; Office of the Comptroller of the Currency, Interpretive Letter #1172, Oct. 2020, https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1172.pdf; Office of the Comptroller of the Currency, Interpretive Letter #1174, Jan. 2021, https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-2a.pdf.

8. Bank for International Settlements, Committee on Payments and Market Infrastructures, Board of International Organization of Securities Commissions, Consultative report: Application of the Principles for Financial Market infrastructures to stablecoin arrangements, Oct. 2021.

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payments activity also exposes these financial institutions to novel operational and compliance risks, including money laundering and terrorist financing risks associated with traditional third-party payments activity, but now occurring through platforms outside the purview of their existing transaction monitoring and sanctions screening systems. Current and future stablecoin market participants will therefore need to remain aware of potential regulatory actions which could increase compliance obligations and associated compliance costs, as well as changes required to existing systems and governance mechanisms to account for the new risks posed by participation in the stablecoins market.

Survey

Exiger conducted a survey of market participants to gain an understanding of what they consider to be the biggest challenge in the next 12 months when it comes to new regulatory requirements. One third of participants were most concerned about the misalignment of requirements across regulators. The next two largest concerns were the uncertainty of the timing and the extent of future regulations and the systematic and/or operations risks. Finally a little more than 10 percent of participants noted increased operational costs as being the biggest challenge going forward.

Indeed, Acting Comptroller of the Currency, Michael J. Hsu recently spoke to the uncertainty of the further of digital assets and the need for strong collaboration across governments, but notes that "there appears to be an emerging consensus that rules-of-the-road and safeguards are needed today to protect people and balance the risks and benefits of blockchain technology as it continues to evolve."[9]

9. Michael J. Hsu, Remarks Before the Institute of International Economic Law at Georgetown University Law Center, Thoughts on the Architecture of Stablecoins, April 8, 2022, https://www.ots.treas.gov/news-issuances/speeches/2022/pub-speech-2022-37.pdf.

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