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President's working group issues report calling for stablecoin regulation and paving the way for immediate action by non-banking regulators

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On November 1, 2021, the President's Working Group on Financial Markets (PWG), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) released a report (PWG Report) calling for urgent legislative action to limit the issuance of stablecoins to insured depository institutions and to enable prudential regulation of stablecoins to address the risks to the broader financial system.

Background on stablecoins

Stablecoins are a type of digital currency, or cryptocurrency, whose value is tied to an external reference that is viewed as stable, in many cases a national currency. A stablecoin issuer issues stablecoins to a user in exchange for a currency such as U.S. dollars, typically at a one-to-one exchange rate. The issuer often promises the stablecoin user the right to redeem the stablecoin at par, or the same one-to-one exchange rate, upon request.

Although stablecoins are currently used primarily in transactions involving other digital currencies, there is potential for them to gain wider use in retail transactions, particularly as household names like Visa continue to explore and offer services relating to them.

Stablecoins are backed by reserve assets designed to assure the stablecoin user that the issuer will have the funds to redeem them at par on demand. Reserve assets may be high quality, liquid assets like deposits at insured depository institutions or U.S. treasuries but sometimes consist of riskier assets like commercial paper, corporate and municipal bonds, or even other digital assets.

Transactions in stablecoins occur within a decentralized, peer-to-peer financial system, generally on a distributed ledger known as a public blockchain. The blockchain constantly grows as new sets of data, or blocks, are added to it.

Anyone can join and become an authorized node to create blocks for transactions requested on the network. The nodes receive incentives to do so, such as small amounts of cryptocurrency like stablecoins. Transactions are added to the ledger through a process known as consensus that involves node operators communicating and validating transactions and agreeing on a new version of the ledger. This leads to greater security for personal and financial data but also can create lengthy transaction processing times.

The PWG Report calls on Congress to pass legislation on an urgent basis addressing the risks it identifies with stablecoin arrangements.

Proponents of stablecoins laud them for offering the benefits of digital currencies without the associated volatility. Those benefits include greater security, more inclusive access to financial services, and lower transaction costs than are associated with traditional banking services, as well as real-time availability of funds.

Critics caution that these benefits may attract bad actors seeking to evade the protections associated with more regulated industries, such as anti-money laundering (AML) and countering the financing of terrorism (CFT). Critics also have raised investor protection concerns about lack of visibility into the reserve assets backing stablecoins and lack of clarity regarding redemption rights.

Regulatory focus on stablecoins

U.S. regulatory focus on stablecoins is not new, nor is it surprising. The market in stablecoins is growing rapidly — up to nearly $130 billion as of the end of October from closer to $23 billion at the same time last year, a greater than fivefold increase.

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The PWG — which is composed of the Secretary of the Treasury and the chairpersons of the Board of Governors of the Federal Reserve System (Federal Reserve), Securities and Exchange Commission (SEC), and Commodity Futures Trading Commission (CFTC), or their designees — first raised regulatory and supervisory issues related to stablecoins in a December 2020 statement. Stablecoins have been the focus of remarks by the chairmen of the SEC and the Federal Reserve, among others, throughout 2021.

Risks and regulatory gaps identified by PWG Report

The PWG Report identifies a number of risks associated with increased use of stablecoins and corresponding gaps in existing regulation to address them:

Potential for loss of confidence in the stablecoin leading to a run on stablecoins through mass redemptions and resulting fire sales of reserve assets by issuers. The PWG Report identifies potential causes for such a loss in confidence as (i) a fall in price or illiquidity of reserve assets, (ii) failure of an issuer to safeguard reserve assets or provide clarity regarding redemption rights, and (iii) operational risks related to cybersecurity and data protection measures. The PWG Report recognizes the potential for a run on a stablecoin to quickly escalate and impact the broader financial system, depending on the volume and type of reserve assets sold and the underlying condition of the economy and financial markets.

Payment system risks of the same kind that exist in centralized payment systems (operational, settlement, and liquidity risks), which may manifest in new ways or be amplified in the distributed ledger network. For example, the PWG Report identifies potential operational risks from (i) a failure of participants in the network to respond to demand for processing transactions, despite incentives, and (ii) the lack of accountability for risk management in the decentralized environment. The PWG Report further cites the consensus-based settlement methods as giving rise to a risk of uncertainty and unreliability of settlements.

Risks of scale for both individual stablecoins and the industry generally leading to systemic risk and concentration of economic power. The PWG Report describes this risk as the potential for significant impact to the financial system from both (i) the failure of an issuer or another key participant, such as the provider of a digital wallet required to hold stablecoins, and (ii) widespread transition from retail deposits with insured depository institutions to stablecoins. The PWG further describes a risk of partnerships between stablecoin issuers or wallet providers and commercial firms leading to excessive concentrations of economic power which impact competition.

Recommendations of PWG Report

The PWG Report calls on Congress to pass legislation on an urgent basis addressing the risks it identifies with stablecoin arrangements. The proposed legislation has two interrelated aspects: (i) limiting issuance of stablecoins to insured depository institutions, which are already subject to substantial supervision and regulation, and (ii) establishing a federal prudential framework to reach other participants in stablecoin arrangements.

The legislation would also subject custodial wallet providers that hold stablecoins on behalf of customers to federal oversight and risk management standards. In particular, the PWG Report recommends federal oversight and associated risk management, capital and liquidity, and activity restriction requirements for digital wallet providers, who serve as custodians of, and facilitate transactions in, digital currencies. The PWG Report further calls for legislation to provide flexibility to regulators in addressing future stablecoin developments and regulating other critical participants.

It also calls on the Financial Stability Oversight Council, in the absence of legislative action, to use the tools available to it to subject certain stablecoin arrangements to prudential standards and supervision.

The PWG Report describes existing authority on which relevant agencies can draw to address the identified risks while they are awaiting legislation. The report focuses on the authority residing with the SEC and CFTC to regulate stablecoins, or aspects of their arrangements, that are securities, commodities, and/or derivatives, as well as the transactions in stablecoins that occur over digital asset trading platforms.

It also calls on the Financial Stability Oversight Council (FSOC), in the absence of legislative action, to use the tools available to it to subject certain stablecoin arrangements to prudential standards and supervision. These tools include designation of qualifying activities in a stablecoin arrangement as systematically important payment, clearing, and settlement activities under Dodd-Frank, or even potentially of participants in that arrangement as systematically important financial market utilities or financial institutions.

The PWG Report also notes the authority of (i) the Department of Justice to consider issues relating to affiliation between commercial entities and stablecoin participants under the Glass-Steagall Act, (ii) the Consumer Financial Protection Bureau (CFPB) to enforce legislation providing safeguards for payment activities, and (iii) the Financial Crimes Enforcement Network to apply AML/CFT obligations to stablecoin arrangements that offer money transmission services under the Bank Secrecy Act.

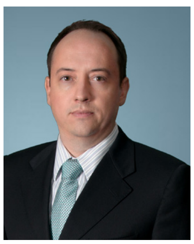
Next steps

The prospect of legislation being enacted with the urgency conveyed by the report seems remote, given competing legislative priorities and closely divided chambers in Congress. As a consequence, prudential regulators may take a backseat to other government authorities as the market develops. The PWG Report acknowledges that even where a regulated institution is involved in a stablecoin arrangement, the ability of the banking regulators to reach all aspects of that arrangement, namely third-party services, may be limited.

As shown by the responses from other agencies in the hours following release of report, other authorities are willing to fill the void. The chairman of the SEC quickly detailed the commitment of the SEC and CFTC to "deploy the full protections" of the laws within their remit.

The director of the CFPB similarly released a statement detailing the steps the CFPB would be taking, including enforcement of federal consumer protection laws prohibiting unfair, deceptive, or abusive acts or practices. The CFTC also recently announced a settlement with entities affiliated with the U.S. dollar tether token (USDT) stablecoin of charges that the entities made misrepresentations regarding the reserve assets backing USDTs.

About the authors



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