

**MEMO# 33886**

November 8, 2021

## **Federal Regulators Issue Report on Stablecoins**

[33886]

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TO: ICI Members

Investment Company Directors SUBJECTS: Alternative Investments

Anti-Money Laundering

Bank Regulation

Derivatives

Financial Stability

Operations

Settlement

Trading and Markets RE: Federal Regulators Issue Report on Stablecoins

The President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (the "Agencies") recently released a 23-page report on stablecoins ("report").<sup>[1]</sup> Stablecoins are digital assets designed to maintain a stable value relative to a national currency or other reference asset. They enable users to store and transfer value associated with digital assets within a distributed ledger environment.<sup>[2]</sup> Although stablecoins primarily are used to facilitate trading of other digital assets, retail investors and businesses eventually could use them more widely as a means of payment for goods and services. The report notes that, with a market capitalization that has increased nearly fivefold over the preceding twelve months to more than \$127 billion as of October 2021, stablecoins and their related activities could present a variety of risks that current laws and regulations do not address.

The report provides background on stablecoins, describes their various risks and regulatory gaps, then recommends legislation and interim measures. It focuses on "payment stablecoins"—certain stablecoins that are designed to maintain a stable value relative to a fiat currency and, therefore, have the potential to be used as a widespread means of payment—and urges Congress to promptly enact legislation that subjects payment stablecoins and payment stablecoin arrangements to a federal prudential framework. The report also states that, depending on their structure, stablecoins or certain parts of stablecoin arrangements may be securities, commodities, and/or derivatives subject to the jurisdiction of the Securities and Exchange Commission or the Commodity Futures Trading Commission but does not provide guidance on making such determinations. We briefly

summarize the report below.

## **Background**

The report begins with background on stablecoins. Stablecoins generally are created in exchange for fiat currency that an issuer receives from a user or third-party. They often are advertised as being backed by a variety of "reserve assets" but there are no standards regarding the composition of such assets, and information about those assets is not consistent. In addition, the reserve assets may range from deposits at insured depository institutions or in US Treasury bills to commercial paper, corporate and municipal bonds, and other digital assets.

To maintain a stable value relative to fiat currency, many stablecoins offer redemptions at par upon request but those redemption rights vary in terms of both who may present a stablecoin for redemption and whether there are minimum quantities that must be redeemed. In addition, some issuers may postpone redemption payments for seven days or even suspend redemptions at any time. A user's claims also vary, with some issuers providing a claim on the issuer and others providing no direct redemption rights. The report contrasts these riskier redemption rights to demand deposits held at an insured depository institution, which are claims on the issuing bank that provide a depositor with the right to receive US dollars upon request. Moreover, unlike stablecoin redemption rights, demand deposits are insured up to certain amounts and are entitled to depositor preference in resolution.

The report continues by briefly describing how stablecoins are transferred and stored, typically "on the books" of a custodial wallet provider<sup>[3]</sup> or on the distributed ledger; activities and participants in stablecoin arrangements; and how stablecoins are used. It devotes several pages to discussing digital asset trading platforms and decentralized finance ("DeFi"),<sup>[4]</sup> including risks associated with both areas and the regulatory jurisdiction of the SEC and CFTC. The report says that these areas raise "broader questions about digital asset market regulation, supervision, and enforcement" that are not addressed by the report but are under "active consideration" by the SEC and CFTC.

## **Risks and Regulatory Gaps**

The report discusses three key risks associated with payment stablecoins: 1) loss of value/run risk; 2) payment system risk; and 3) risks of scale, along with regulatory gaps in the current system.

- "Loss of value/run risk" refers to the risk that users may lose confidence in the value of a stablecoin or that the stablecoin may not perform according to expectations, potentially causing a "run" on the stablecoin. The report states that, for an instrument to be reliable as a means of payment or store of value, there has to be confidence in it, which could arise from its redeemability and the belief that its redeemability is supported by a stabilization mechanism that will function effectively during normal periods and periods of stress.<sup>[5]</sup> In addition, the report states that the mere prospect of a stablecoin not performing as expected could result in a "run" on that stablecoin. Runs then could spread contagiously from one coin to another, or even to other types of financial institutions that are believed to have similar risk profiles. A run occurring under strained market conditions may have the potential to amplify a shock to the economy and the financial system.

- "Payment system risk" refers to the risks that many traditional payment systems face, such as operational risk,[\[6\]](#) settlement risk,[\[7\]](#) and liquidity risk. These risks have the potential to manifest in novel ways as a result of a stablecoin arrangement's use of different technologies, transaction processes, and governance structures, among other factors.[\[8\]](#)
- "Risks of scale" refers to the potential for rapid growth in a stablecoin. The potential for an individual stablecoin to scale rapidly raises three sets of policy concerns. First, a stablecoin issuer or a key participant in a stablecoin arrangement could pose systemic risk through failure or distress of that entity. Second, the combination of a stablecoin issuer or wallet provider and a commercial firm could lead to an excessive concentration of economic power that could have detrimental effects on competition and lead to market concentration in various sectors. Third, a stablecoin that becomes widely adopted as a means of payment could present concerns about anti-competitive effects, for example, if users of that stablecoin face undue frictions or costs to switch to other payment products or services. Furthermore, beyond an individual stablecoin scaling, the aggregate growth of stablecoins could also have important implications for the financial system and the macroeconomy (e.g., the reserve assets that back stablecoins do not support credit creation).

After discussing the three key prudential risks, the report then briefly touches on regulatory gaps in the current framework, explaining that there is currently no consistent set of regulatory standards that addresses the risks discussed. In addition, the number of key parties that may be involved in an arrangement, and the operational complexity of these arrangements, pose challenges for supervisory oversight.

## Recommendations

The report concludes with recommendations in two categories: legislation and interim measures. In terms of Congressional action, the report urgently recommends legislation that addresses the three key risks discussed above.

- To address "loss of value/run risk," the report recommends:
  - Requiring stablecoin issuers to be insured depository institutions, which are subject to appropriate supervision and regulation, at the depository institution and the holding company level.
- To address "payment system risk," the report recommends:
  - Requiring custodial wallet providers to be subject to appropriate federal oversight.
  - Providing the supervisor of a stablecoin issuer with authority to require any entity that performs activities critical to the functioning of the stablecoin to meet appropriate risk-management standards.
- To address "risks of scale," the report recommends:
  - Requiring stablecoin issuers to comply with activities restrictions that limit affiliation with commercial entities.
  - Authorizing supervisors to implement standards to promote interoperability among stablecoins.
  - Limiting custodial wallet providers' affiliation with commercial entities or on custodial wallet providers' use of user transaction data.

Given the significant and growing risks stablecoins raise, the report states the Agencies'

commitment to taking action to address risks falling within each Agency's jurisdiction and to continued coordination and collaboration on issues of common interest across the federal financial agencies. The report provides examples of these actions, ranging from banking agencies seeking to ensure that charter applicants address the risks outlined in the report; to applying the federal securities laws and the Commodity Exchange Act to stablecoins that are securities, commodities, and/or derivatives to provide important investor and market protection, as well as transparency benefits; to triggering obligations under the Bank Secrecy Act for certain stablecoin arrangements offering money transmission services.

In the absence of Congressional action, the Agencies recommend that the Financial Stability Oversight Council consider steps available to it to address the risks outlined in this report. The report states that such steps may include the designation of certain activities conducted within stablecoin arrangements as, or as likely to become, systemically important payment, clearing, and settlement activities. Designation would permit the appropriate agency to establish risk-management standards for financial institutions that engage in these activities, including requirements in relation to the assets backing the stablecoin, requirements related to the operation of the stablecoin arrangement, and other prudential standards.

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#### **endnotes**

[1] See PWG, FDIC, and OCC, Report on Stablecoins (November 2021), *available at* [https://home.treasury.gov/system/files/136/StableCoinReport\\_Nov1\\_508.pdf](https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf).

[2] A distributed ledger is a type of database in which transactions are simultaneously maintained at multiple nodes throughout a network. In a distributed ledger, each node processes and verifies every transaction, thereby generating a record of every transaction and creating a consensus on each transaction's veracity.

[3] Digital "wallets" provide a variety of services to users, including facilitating the transfer of stablecoins between users. A "custodial wallet provider" is a wallet provider that users may rely on to hold stablecoins on their behalf.

[4] "DeFi" broadly refers to a variety of financial products, services, activities, and arrangements supported by smart contract-enabled distributed ledger technology. This technology can reduce the use of traditional financial intermediaries and centralized institutions to perform certain functions, although the degree of decentralization across DeFi differs widely. In some cases, despite claims of decentralization, operations and activities within DeFi are highly concentrated in and, governed or administered by, a small group of developers and/or investors. Stablecoins are central to the functioning of DeFi, as

they often are used in DeFi arrangements to facilitate trading or as collateral for lending and borrowing.

[5] The report states that confidence in stablecoin may be undermined by several factors, including: (1) use of reserve assets that could fall in price or become illiquid; (2) a failure to appropriately safeguard reserve assets; (3) a lack of clarity regarding the redemption rights of stablecoin holders; and (4) operational risks related to cybersecurity and the collecting, storing, and safeguarding of data.

[6] The report states that "operational risk" is the risk that deficiencies in information systems or internal processes, human errors, management failures, or disruptions from external events will result in the reduction, deterioration, or breakdown of services.

[7] The report states that "settlement risk" is the risk that settlement in a payment system will not take place as expected.

[8] For example, while stablecoin arrangements face many of the same operational risks as existing payment systems, they also can face novel operational risks related to validation and confirmation of stablecoin transactions. Stablecoins also may have issues with settlement risks when the arrangements do not clearly define the point at which settlement is final in their rules and procedures, leading to heightened uncertainty and liquidity pressures. Finally, a stablecoin arrangement may raise liquidity risks from misalignment of the settlement timing and processes between stablecoin arrangements and other systems, causing temporary shortages in the quantity of stablecoins available to make payments. Further, risks may also arise from the complexity and number of different key parties that may be involved in a stablecoin arrangement.