

Financial Services

Stabilizing Stablecoins— Can Regulation Stimulate Growth?

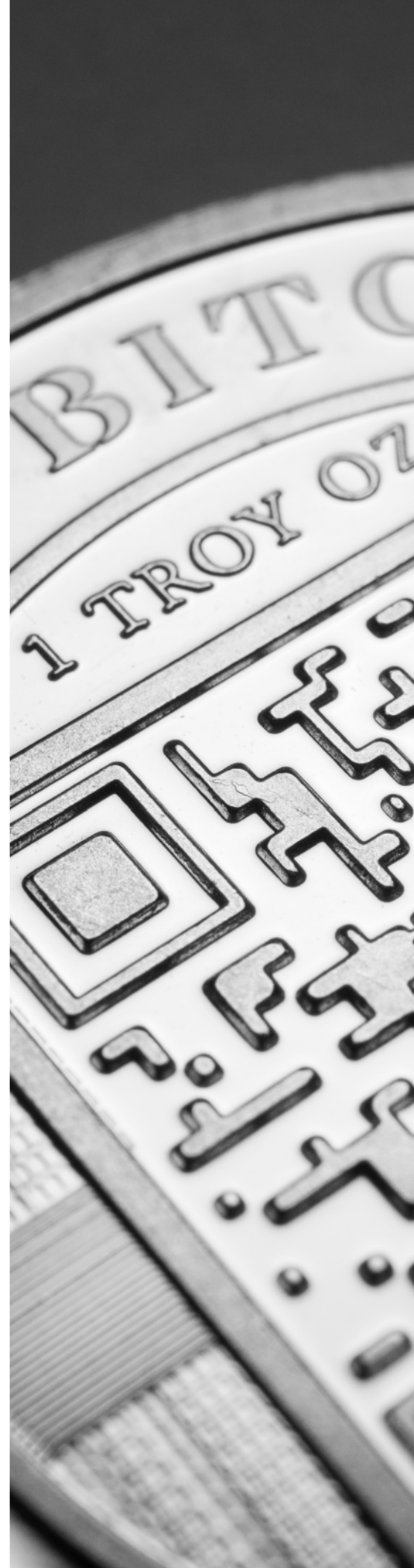
By Spyridon Antonopoulos

Stablecoins are the fuel of the crypto economy, enabling seamless movement in and out of fiat currencies and providing capital for lending, borrowing, and derivatives markets on decentralized finance (DeFi) platforms. Stablecoin growth, by any number of key metrics, has exploded in 2021, and several nonbank financial institutions currently issue products tied to stablecoins. Some regulators and lawmakers have signaled growing anxiety with this class of digital assets, which, in their view, poses novel risks to consumers and the wider economy. Industry proponents, responding to both rhetoric from regulators and **proposed** legislative action, have warned that one-size-fits-all regulations may stunt innovation and harm the very consumers they are designed to protect. This article explores perceived stablecoin risks, tracks recent regulatory activity, and outlines areas of risk to consider for both crypto startups and incumbent financial institutions, even while regulatory clarity may be months or years away.

Money at the Speed of the Internet

In 2008, Satoshi Nakamoto **introduced** Bitcoin as “a peer-to-peer electronic cash system.” Since then, Bitcoin has grown to roughly \$1 trillion in market capitalization and spawned the proliferation of hundreds of thousands of new digital assets. Yet cryptocurrency skeptics maintain that the promise of Bitcoin as “electronic cash” has remained aspirational, citing slow transaction speeds, relatively high fees, and historical volatility. While Bitcoin’s utility in underserved markets across the globe has been **well documented**,¹ and there is vigorous **debate** with respect to its core value proposition, one development is clear: Bitcoin’s volatility created an opportunity for the rise of stablecoins—digital assets designed to maintain a stable value relative to a reference asset. Today, stablecoins are the primary means by which users of cryptocurrency transition between fiat currencies and cryptoassets like bitcoin, non-fungible tokens, or DeFi applications.

1. This has been accelerated by improvements in [layer 2 networks](#) like Bitcoin’s Lightning Network.





While stablecoins have been around since at least 2014, demand for them has exploded in the past few years. DeFi's first use case—lending digital assets—demanded a stable asset as collateral, and thus stablecoin supply grew rapidly during **DeFi Summer** of 2020, only increasing in velocity since then (Figure 1). In Q2 of 2021 alone, stablecoins facilitated nearly \$1.7 trillion in transactions globally, a year-over-year increase of more than 1,000% (Figure 2).

Figure 1: Stablecoin Searches and Supply (Source: Coinmetrics.io)

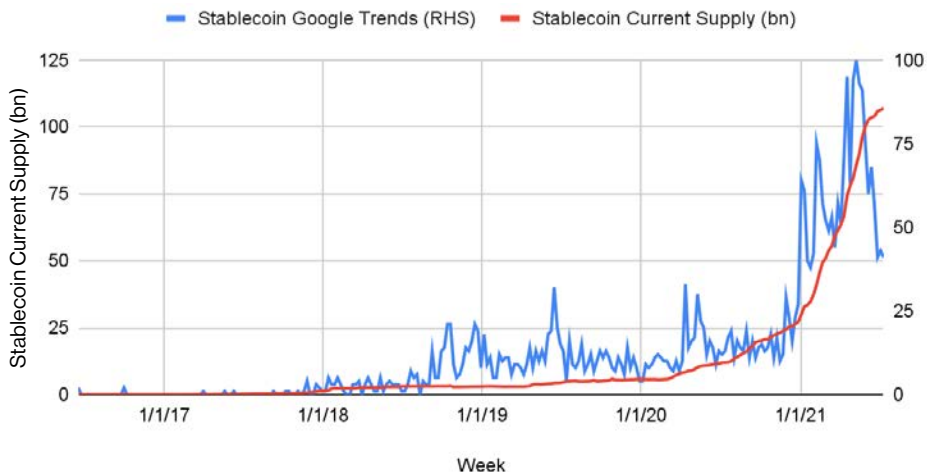
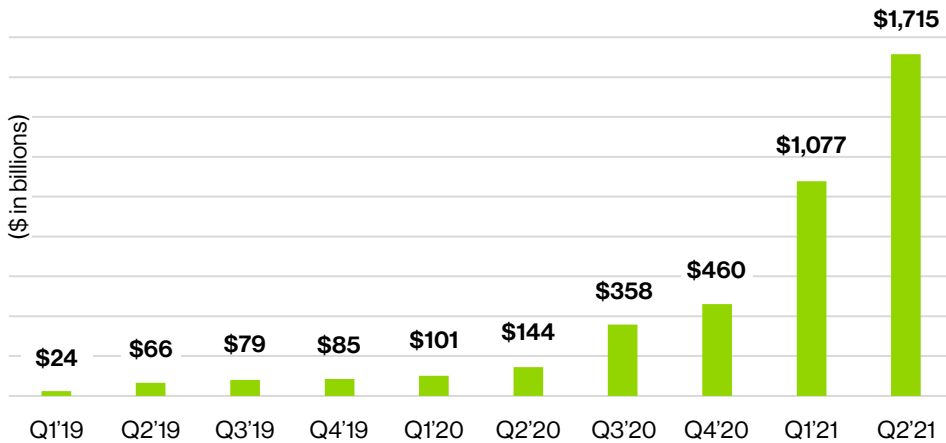


Figure 2: Stablecoin Transaction Volume Growth (Source: Messari.io)

Stablecoins Quarterly Transaction Volume

Stablecoin transaction volume exploded to start 2021. Stablecoins facilitated \$1.7 trillion in Q2 and are on pace for \$5.5 trillion in 2021



Data as of: Jun. 30 2021
Source: Messari

Stablecoins are endowed with many of the well-known benefits of other cryptocurrencies: they are natively digital and therefore inherently borderless; funds can be sent at the speed of the internet; and they are secured by an immutable ledger and are thus publicly auditable. But, unlike other cryptocurrencies, they maintain a stable value. Stablecoins are therefore useful for consumer payments, merchant services, payroll, supplier payments, loan collateralization, and myriad other financial use cases. Stablecoins have the potential to transform payments and financial services, perhaps even more fundamentally than cryptocurrencies like bitcoin.

Not All Stablecoins are Equal

Stablecoins maintain their stability through collateralization or by design. Algorithmic stablecoins are designed to programmatically modify the number of outstanding tokens based on market conditions such as supply and demand, with user incentives often layered into the design in order to minimize volatility.² Although algorithmic stablecoins play a meaningful role in DeFi, they are not explored further in this article.³

Collateralized stablecoins maintain a stable price target by virtue of being backed by a fiat currency, commodity, or basket of cryptocurrencies. These are issued by centralized companies, like Circle, Paxos, TrueCoin, and Gemini, or by decentralized entities like the MakerDAO Foundation with its stablecoin DAI. The majority of collateralized stablecoins maintain a hard peg to the US dollar (USD) and are, at least in theory, backed by a combination of USD or USD equivalents (e.g., short-term treasuries). A smaller but growing class of centralized stablecoins are backed by commodities like gold.

Importantly, issuance and redemption of dollar-backed stablecoins are managed by “trusted” entities. And therein lies the problem: absent federal oversight, regulators argue, assurances by stablecoin issuers are, at best, uneven. Tether, the largest stablecoin issuer by volume, recently **published** the results of an accounting audit as part of an \$18.5 million settlement with the New York attorney general. The collateral reserves reported comprised ~50% mixed-grade commercial paper and ~3% cash.⁴ On the other hand, Paxos, which **has obtained** state-level regulatory supervision by the New York State Department of Financial Services (NYDFS), reports holding 96% of its reserves in cash or cash equivalents. Meanwhile, cryptocurrency companies like Celsius, BlockFi, and Nexo offer products providing returns of 6%-12% on customer stablecoin deposits, and Facebook’s Diem project seems primed to issue its own multi-currency stablecoin to billions of users.

Changing Regulatory Winds

Naturally, this confluence of market trends, actors, and new financial products has caught the attention of lawmakers and regulators. We have **previously written** about the Office of the Comptroller of the Currency’s favorable guidance toward stablecoins in early 2021, in an interpretive letter clarifying that US banks could conduct payment activities and “other bank-permissible functions” with USD-backed stablecoins. Since then, a series of statements and enforcement actions by federal and state regulators has changed the conversation. Multiple state regulators have issued cease-and-desist orders to cryptocurrency companies that offer products with aggressive yields on customer stablecoin deposits. Gary Gensler, chair of the US Securities and Exchange Commission (SEC), has famously quipped that “many” stablecoins currently in circulation “may be [unregistered] securities.”⁵ Most recently, the SEC is reported to have issued an investigative subpoena to Circle, the issuer behind the dollar-backed stablecoin USDC, which has intentions of going public, according to regulatory filings. The Federal Reserve (Fed), for its part, has publicly stated that the private issuance of stablecoins introduces consumer protection and financial stability risks because of their “potential volatility and the risk of run-like behavior.”

2. For example, the stablecoin Ampleforth (AMPL) maintains its price peg of \$1 by automatically contracting or expanding supply of all AMPL token holders.

3. The following [primer](#) provides a comprehensive overview of Ethereum-based algorithmic stablecoins.

4. In May 2021, the New York attorney general reached an \$18.5 million [settlement](#) with Tether and the cryptocurrency exchange Bitfinex, alleging that Tether misrepresented its reserves, covered up the loss of customer funds, and commingled customer and operational funds. Since this article was written, the Commodity Futures Trading Commission [ordered](#) the entities associated with Tether to pay a \$41 million civil monetary penalty for making misleading or false statements about its stablecoin.

5. In [remarks](#) to the Aspen Security Forum, Gensler referred to stablecoins as “stable value coins,” leading pundits to speculate that he was asserting the authority of the SEC over the stablecoin asset class.



Systemic risk

Lawmakers and regulators have been focused on three interrelated risks associated with stablecoins. The first is the potential systemic risk resulting from intermingling stablecoin assets with the traditional financial system. Recent meeting notes published by the Fed note the “fragility and lack of transparency associated with stablecoins...” and the need to “monitor them closely... and to develop an appropriate regulatory framework to address any risks to financial stability associated with such products.”⁶

While the \$125 billion stablecoin ecosystem is a fraction of the \$9.7 trillion mortgage-backed securities market that sent the US economy into recession in 2008, stablecoins’ rapid growth arguably presents a financial stability risk for two reasons. First, stablecoin issuers do not adhere to consistent capital reserving and reporting requirements, as regulated commercial banks do. Therefore, certain issuers could be subject to illiquidity during periods of heightened redemption activity. Second, there is more leverage in the DeFi ecosystem than appears at face value due to rehypothecation, or the re-use of digital assets as collateral to fund additional loans. Simply put, it is possible that there are multiple claims on the same \$1 of USDC spread across different DeFi protocols. Due to the rapid proliferation of new DeFi protocols and forks of existing protocols, it is challenging to measure the total exposure of a given digital asset.

Consumer risk

Second, some lawmakers and regulators have focused on the consumer risks of the so-called “shadow economy” of privately issued stablecoins, comparing the current environment to the US’s “Wildcat” banking era of the 19th century.⁷ While this comparison has been contested by economic historians⁸, it is true that consumers and businesses who deposit or borrow against dollar-backed digital assets are doing so without the assurances of the federal payments system or the guarantees of the Federal Deposit Insurance Corporation. Regulators have warned that consumers face the risk of losing funds due to issuer defaults. Lawmakers have questioned whether stablecoin issuers, with their aggressive returns and disparate mix of reserve assets, look more like money market funds without the reporting requirements and investor protection obligations of the latter. Furthermore, regulators and lawmakers have warned that there are limited consumer fraud protections built into many of these lightly regulated issuers of stablecoins.

While harsh rhetoric has dominated the headlines, many prominent companies in the industry have stated that they would welcome the establishment of consistent rules for capital reserving requirements and consumer protections. Regulatory clarity would level the playing field across issuers, while enabling them to continue offering the services and capabilities demanded by customers: faster payments—especially across borders—and an efficient and affordable bridge between the fiat and crypto ecosystems.

Competitive risk

Finally, regulators may be concerned with the consequences of competition between private stablecoins and a potential Fed-issued Central Bank Digital Currency (CBDC). Today, USD-backed stablecoins do not represent claims to dollars at the Fed, whereas a Fed-issued CBDC could represent exactly that, either issued directly to citizens (retail) or issued to banks or payment providers as intermediaries (wholesale). Two competing systems could create confusion for customers between money that looks the same but has different levels of assurance, according to the **Fed**. Jerome Powell, chairman of the Fed, has gone so far as to state that stablecoins and cryptocurrencies would be made obsolete “if you had a digital US currency.”

Proponents of CBDCs cite their ability to enable safe, cheap, and fast payments. Critics, however, note that privately issued stablecoins already have these capabilities and worry that CBDCs may expand the surveillance capabilities of the state. The Swiss National Bank outlined a promising **whitepaper** describing a privacy-preserving type of CBDC, but language from a number of other central banks points to a type of digital currency that can be programmed and tracked down to the recipient, amount, and transaction. China has experimented with a digital yuan that has such features. In **one pilot**, 10 million yuan were given away to 50,000 “winners,” who had to spend the digital currency within a limited time frame at a specified number of participating retailers in the district of Shenzhen.

China’s history of caution with respect to cryptocurrency is well documented. Most recently, China banned Bitcoin mining and soon thereafter cryptocurrency transactions, effectively mirroring its Great Firewall policy of internet regulation. Stablecoin proponents have suggested that the US has an opportunity to distinguish itself from this model of prohibition, drawing parallels to the late 1990s, when US policies led to rapid innovation and growth of the nascent “information superhighway.” Today, cryptocurrency and blockchain technologies are at an inflection point. In Q2 2021 alone, there were more than 500 cryptocurrency venture capital deals totaling more than \$6 billion. In all likelihood, different jurisdictions’ varying approaches will influence future flows of capital investment and talent.

6. From the joint meeting of the Federal Open Market Committee and the Board of Governors of the Federal Reserve System, which was held by videoconference on July 27-28, 2021.

7. See, for example, Elizabeth Warren’s [testimony](#) for the U.S. Senate Banking, Housing, and Urban Affairs Committee’s Subcommittee on Economic Policy, Wednesday, June 9, 2021.

8. The historical context behind the revival of the “Wildcat” banking trope is discussed in George Selgin, *The Fable of the Cats*, Alt-M (July 6, 2021), <https://www.alt-m.org/2021/07/06/the-fable-of-the-cats/>.

Future Regulatory Directions

Rep. Tom Emmer (R-Minnesota), in a bipartisan letter addressed to Powell, questioned the Fed chairman's suggestion that a CBDC could render an entire class of new technologies "obsolete," emphasizing the need for a regulatory framework that encourages private sector digital asset innovation. Joining a chorus of voices from industry, Emmer outlined the many consumer-driven financial use cases supported by cryptocurrencies and stablecoins, including improving financial access to historically underserved communities (a point recently made [here](#)). This view was **amplified** by SEC Commissioner Hester Peirce, who suggested that regulators ought to focus less on jurisdictional jockeying and, in taking any regulatory steps, must consider that stablecoins are "not uniform in operation, peg, underlying reserves, or transparency."

Despite the robust support for stablecoins across industry members, retail consumers, and legislators from both political parties, recent regulatory activity at the state and federal levels signals coming regulations and increased oversight. Recently, the Biden administration **reportedly urged** Congress to introduce legislation to create special-purpose bank charters for private stablecoin issuers. Behind the scenes, certain stablecoin companies have been reportedly pursuing this outcome, including lobbying for accounts with the Federal Reserve, while other cryptocurrency companies have received **narrow bank charters** issued by states such as Wyoming. If successful, this legislative action may preempt a recommendation by Treasury to launch an examination by the Financial Stability Oversight Council on certain stablecoin issuers, which could result in more stringent oversight recommendations. Either outcome may push a few stablecoin issuers offshore but is unlikely to kill the robust stablecoin industry outright. What remains to be seen is further regulatory clarity (either through mandate or enforcement) on exchanges and fintechs that support stablecoins or stablecoin products.

How Guidehouse Can Help

Guidehouse can help financial institutions, fintechs, and technology companies that transact in stablecoins identify and mitigate their risks associated with:



Processes and controls for reporting assets under management across multiple stablecoins and cryptocurrencies.



Stablecoins, including native DeFi tokens, which may represent securities with additional compliance requirements.



Other operational, compliance, and legal risks associated with financial products tied to stablecoins.

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