Spotlight on stablecoins and CBDCs: Part 2

March 16, 2022

This is the second installment in a series exploring stablecoins and central bank digital currencies (CBDCs). In the first installment, we discussed fundamental similarities and differences between these two novel financial instruments.

In this article, we focus on stablecoins – the risks they pose and the regulatory frameworks proposed by governments and regulatory bodies to address such risks.

The global financial system recognizes that cryptocurrencies can no longer be dismissed as fad. As such, regulators are trying to enact legislative frameworks that protect investors. In developing their proposed frameworks, regulators contend with a number of serious challenges posed by the rise of stablecoins.

The risks

Investing

A financial instrument can only be viable and reliable when there is widespread confidence and consensus as to its value. For stablecoins, such confidence is rooted in the asset to which the stablecoin is pegged, and its redeemability.

Fundamentally, the reliability of a stablecoin is only as strong as its underlying asset. If, for example, the U.S. dollar experienced a significant shift in value, there could be a "run" on stablecoins pegged to U.S. dollars, such as Tether's USDT (which has a market cap of roughly US$80 billion).

In a "run," holders seek to redeem their stablecoins by exchanging them for the underlying asset (*e.g.*, U.S. dollars). This would require the stablecoin issuer, like Tether, to provide fiat on a one-to-one basis. However, not all stablecoin issuers keep an equivalent amount of U.S. dollars (or any other applicable pegged asset) in reserve. On a large scale, such an event could severely disrupt the financial system and broader economy.

Payment

For stablecoins to become a widely accepted form of payment, operational issues disrupting the validation of transactions and settlement issues preventing the secure transfer of funds must be avoided. Otherwise, the public's trust and confidence will evaporate.

This risk is not unique to stablecoins, but it may manifest in novel ways. In traditional payment systems, the central payment operator and direct participants in those networks manage this risk. But in a decentralized system, there is no single point of accountability in the event of operational or settlement malfunctions.

Regulatory gaps

Most jurisdictions recognize that the need to regulate the stablecoin space is unavoidable, and that failure to do so could result in that jurisdiction becoming a hub for illicit stablecoin activity.

Despite the fact that stablecoin risks posed are similar across the globe, there are few cross-jurisdictional similarities in proposals to regulate them.

Hong Kong

On Jan. 12, 2022, the Hong Kong Monetary Authority (HKMA), its central banking institution, released a discussion paper detailing its proposed expansion of Hong Kong's regulatory regime to capture the particularities of stablecoins. The HKMA set out to address the above risks, while recognizing that any new framework needs to be agile, risk-based and proportionate.

The HKMA specifies that priority for any new framework should be to regulate the activities surrounding payment-related stablecoins, which pose an immediate threat to its financial system. While the framework should be agile enough to lend itself to other types of stablecoins, the HKMA accepts that payment-related stablecoins are more likely to be incorporated into global financial markets in the near future, and should therefore be regulated first.

The range of stablecoin activities the HKMA proposes to regulate is expansive, and includes the issuing/destruction of stablecoins, the management of reserve assets (to which the value of a stablecoin may be tied), the validation of stablecoin transactions, and ensuring the efficiency of executing stablecoin transactions. Interestingly, the HKMA has signalled that only entities incorporated in Hong Kong will be able to carry out regulated activities. This means that foreign companies seeking to provide stablecoin-related services in Hong Kong will have to incorporate a subsidiary within that jurisdiction and apply for a licence.

European Union

The European Union (EU) released what is arguably the most broad and comprehensive study of stablecoin regulation to date.

On Nov. 19, 2021, the EU published its 400-page *Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypo-assets* (MiCA), which aims to regulate a broad swath of crypto-related products. The publication of MiCA marked the arrival of the next step in the European legislative adoption process, whereby adoption of the regulation will now be negotiated between EU's primary regulatory bodies.

Interestingly, MiCA creates two distinct classes of stablecoins. First, it defines "asset-referenced tokens" as crypto assets that "purport to maintain a stable value by referring to the value of […] one or several commodities." Second, MiCA separately defines "e-money tokens" as crypto assets primarily used as a means of payment, and which maintain a stable value by specifically referencing itself to the value of a currency (as opposed to "asset-referenced tokens," which can reference any kind of asset). Regulating these two instruments is a key focus of MiCA.

MiCA establishes a number of regulations regarding Crypto Asset Service Providers (CASPs), including solvability/capital requirements for various kinds of CASPs (Article 55), imposing a duty to act honestly and professionally (Article 59), and standardizing the rules for exchanging crypto assets for fiat currencies (Article 69). MiCA's scope is expansive, aiming to cover not only stablecoins (*i.e.*, "asset-referenced" and "e-money" tokens), but also "utility" tokens, which are issued to provide the holder with access to a given DeFi application, service or resources, and even specific rules governing the acquisition of CASPs.

United States

The President's Working Group on Financial Markets (PWG), composed of representatives from the Treasury, the Federal Reserve, the Securities and Exchange Commission, and the Commodify Futures Trading Commission, published its *Report on Stablecoins* on Nov. 1, 2021.

The PWG report offers little in the way of concrete proposals, but bears some similarities to the HKMA's proposal in that it prioritizes creating a framework to regulate payment-based stablecoins, and adjusts that framework as necessary to respond to future developments in the stablecoin market.

The report also sets out priority objectives for any eventual stablecoin regulation, including:

1. Limiting stablecoin issuance to entities that are insured depositories under U.S. law (such as banks and savings associations, whose deposits are insured by the federal government);
2. Promoting interoperability between stablecoins; and
3. Imposing risk management standards for the entities charged with the functioning of stablecoin settlement/payment mechanisms.

Stablecoin regulation in the U.S. faces a number of impending roadblocks. In addition to the partisan deadlock, there is uncertainty within the federal government as to the appropriate entity to take the lead on stablecoin regulation between the Treasury, the Securities and Exchange Commission and the Federal Reserve.

In our next and final installment, we explore the status of CBDC development around the world.

Reach out to any of the authors or key contacts below if you have questions about stablecoin regulations.

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