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The Silver Lining In The Biden Administration's Defense Of Its Stablecoin Report

Norbert Michel
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On Tuesday, the Biden administration sent Nellie Liang, Treasury's Under Secretary for Domestic Finance, to testify before the House Financial Services Committee. Liang had the unenviable task of defending the administration's November report on Stablecoins.

As I wrote in November, that report left much to be desired. It provided zero clarity on what regulators should do in the absence of congressional action, provided no substance on how agencies might use their existing authorities, and recommended that Congress pass an anti-competitive law so that only federally insured banks could issue stablecoins.

Given that the administration believes there is an urgent need "to address the prudential risks inherent in payment stablecoins," and to prevent stablecoins from leading to "an excessive concentration of economic power," requiring that they *only* be issued by federally insured banks is rather strange.

Worse, as my colleague George Selgin points out in this briefing paper, if the administration's stablecoin proposal is adopted along with the Federal Reserve's preferred central bank digital currency (CBDC) plan, "participation in the digital currency market would be limited to insured banks and the Fed itself."

So, according to the Biden administration, the concentration of economic power is bad, but not when the federal government orchestrates it and forces taxpayers to cover any losses. Likewise, competition is a good thing, but not when it comes to financial services and payments.

The silver lining from the hearing is that Liang agreed that narrow stablecoin issuers who back tokens with ultra-low risk securities (such as short-term Treasuries) and cash do *not* need to be heavily regulated as if they are commercial banks. (See the exchange with Rep. Trey Hollingsworth (R-IN) starting around the 3:22 mark). In this sense, Liang's views closely align with Cato's policy proposals.

It would make even more sense, of course, to exempt these types of stablecoin issuers from deposit insurance, but there's still time for the administration to see the light.

Even better, perhaps the administration will come around to the fact that there is no good reason to believe that federal banking regulators know how to "address" systemic risks from stablecoins. There are many reasons, in fact, to doubt that regulators can design U.S. financial markets so that they are simultaneously robust and vibrant with no systemic risks.

Historically, federal regulators have an excellent track record for messing up financial markets.

Money market mutual funds, for instance, have never really recovered from the SEC's 2010 and 2014 rules. Sadly, those funds are no longer the major source of funding for commercial paper that they once were, and it is easy to see that those new rules failed to reduce incentives to redeem shares (the problem that the rules were supposed to fix).

The problem is much bigger, though.

As I explain in this briefing paper (and, with even more detail in this Alt-M working paper), the federal financial regulatory framework has been expanding in the wrong way, based on the wrong premise, for the better part of a century.

The 2008 financial crisis was just the latest example of using instability to expand regulatory power, but it is truly mind blowing how much wool federal officials pulled over Americans' eyes in the wake of that crisis.

The conventional story about the 2008 crisis is that the unregulated Wall Street shadow banks made excessively risky bets with derivatives. Then, after the housing bubble burst, contagious panic ensued, nearly destroying the financial system and the economy. Had it not been for the heroic efforts of the federal government, the story, goes, the recession would have turned into another Great Depression. The way forward, of course, was to heavily regulate the so-called shadow banks like the traditional banking sector, the highly regulated depository institutions with federally insured deposits.

There are so many problems with this story that it is difficult to pick a starting point. It is clear, though, that most of this risky financial activity took place with the explicit blessing of federal banking regulators.

Commercial banks, it turns out, have always been heavily involved in the asset securitization process. In 2012, a Federal Reserve report affirmed that "banks are by far the predominant force in the securitization market," and that banks were "a significant force in these shadow banking segments related to securitization all along."

Commercial banks have also been heavily involved with commercial paper and money market mutual funds (two supposed purveyors of shadow banking activities) for decades. In 2007, just prior to the onset of the financial crisis, commercial banks accounted for 74 percent of the outstanding asset-backed commercial paper, and most of that amount was concentrated in the largest depository institutions.

Separately, bank-sponsored prime institutional MMFs grew from “a negligible percentage of the industry in 1986” to almost half of all prime institutional MMF assets by the year 2000. They further increased to 52 percent by the end of 2007. As with commercial paper, banks were regularly providing explicit guarantees for their conduits that create MMFs.

It is easy to see why *banking* regulators were so nervous when shareholders started redeeming their MMF shares. Aside from any problems that may have caused for the banking sector, banks—especially the largest ones—engage in exactly nothing unless federal regulators explicitly bless it. It is untrue that any of this activity took place in the shadows.

There’s much more, of course, that demonstrates the dismal failure of federal regulators (and Congress) to protect markets from a meltdown. So much so, that it makes little sense to expand the federal financial regulatory framework at all, much less to stablecoin issuers.

The greatest risk for most stablecoin holders is whether the issuing entity has the reserves that it claims to have. And if the issuers use ultra-low risk assets to back their tokens, there is very little to worry about.

As my colleague Jennifer Schulp and I argue in this Cato Institute briefing paper, and my colleague George Selgin argues in this one, there are simple, sensible alternatives for regulating these risks. And since a high-ranking Treasury official seems to agree, there’s still hope that the federal government will allow the stablecoin market to flourish.

Norbert J. Michel is vice president and director of the Cato Institute’s Center for Monetary and Financial Alternatives, where he specializes in issues pertaining to financial markets and monetary policy.