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Why Washington Worries About Stablecoins

The Federal Reserve, Treasury and other regulators are worried that a technology that pledges stability will actually be a source of turmoil.

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Stablecoins might be the most ironically named innovation of the cryptocurrency era, at least in the eyes of many Washington regulators and policymakers.

These digital currencies promise to maintain their value, which is generally pegged to a government currency like the dollar or euro, by relying on stable financial backing like bank reserves and short-term debt. They are exploding in popularity because they are a practical and cheap way to transact in cryptocurrency. Stablecoins have moved from virtual nonexistence to a more than \$120 billion market in a few short years, with the bulk of that growth in the past 12 months.

But many are built more like slightly risky investments than like the dollars-and-cents cash money they claim to be. And so far, they are slipping through regulatory cracks.

The rush to oversee stablecoins — and the industry’s lobbying push to either avoid regulation or get on its profitable side — might be the most important conversation in Washington financial circles this year. How officials handle sticky questions about a relatively new phenomenon will set the precedent for a technology that is likely to last and grow, effectively writing the first draft of a rule book that will govern the future of money.

The debate over how to treat stablecoins is also inescapably intertwined with another hot conversation: whether the Federal Reserve ought to offer its own digital currency. A Fed offering could compete with private-sector stablecoins, depending on its features, and the industry is already bracing for the possibility.

Below is a rundown of what stablecoins are, why they may be risky, the possible regulatory solutions and the government’s likely next moves when it comes to policing them.

What is a stablecoin?

A stablecoin — stablevalue coin, if you’re feeling proper — is a type of cryptocurrency that is typically pegged to an existing government-backed currency. To promise holders that every \$1

they put in will remain worth \$1, stablecoins hold a bundle of assets in reserve, usually short-term securities such as cash, government debt or commercial paper.

Stablecoins are useful because they allow people to transact more seamlessly in cryptocurrencies that function as investments, such as Bitcoin. They form a bridge between old-world money and new-world crypto.

But many stablecoins are backed by types of short-term debt that are prone to bouts of illiquidity, meaning that they can become hard or impossible to trade during times of trouble. Despite that somewhat shaky backing, the stablecoins themselves promise to function like perfectly safe holdings.

That makes them the type of financial product “macroeconomic disasters usually come from,” said Morgan Ricks, a professor at Vanderbilt University Law School and former policy adviser at the Treasury Department. “The stakes are really, really high here.”

That said, some people — including George Selgin, director of the Center for Monetary and Financial Alternatives at the Cato Institute — argue that because stablecoins are used as a niche currency and not as an investment, they may be less prone to runs in which investors try to withdraw their funds all at once. Even if their backing comes into question, people will not want the potential taxes and paperwork that come with changing stablecoins into actual dollars.

Given that the technology is so nascent, it is hard to know who is correct. But regulators are worried that they may find out the hard way.

Are they all equally risky?

Stablecoins are not all created equal. The largest stablecoin, Tether, says it is roughly half invested in a type of short-term corporate debt called commercial paper, based on its recent disclosures. The commercial paper market melted down in March 2020, forcing the Fed to step in to fix things. If those types of vulnerabilities strike again, it could be difficult for Tether to quickly convert its holdings into cash to meet withdrawals.

Other stablecoins claim different backing, giving them different risks. But there are big questions about whether stablecoins actually hold the reserves that they claim.

The company Circle had said its U.S.D. Coin, or U.S.D.C., was backed 1:1 by cashlike holdings — but then it disclosed in July that 40 percent of its holdings were actually in U.S. Treasuries, certificates of deposit, commercial paper, corporate bonds and municipal debt. A Circle representative said U.S.D.C. will, as of this month, hold all reserves in cash and short-term U.S. government Treasuries.

The New York attorney general investigated Tether and Bitfinex, a cryptocurrency exchange, alleging in part that Tether had at one point obscured what the stablecoins had in reserve. The companies’ settlement with the state included a fine and transparency improvements.

Tether, in a statement, noted that it has never refused a redemption and that it has amended its disclosures in the wake of the New York attorney general’s investigation.

The common thread is that, without standard disclosure or reporting requirements, it is hard to know exactly what is behind a stablecoin, so it is tough to gauge how much risk it entails.

It is also difficult to track just how stablecoins are being used.

Stablecoins “may facilitate those seeking to sidestep a host of public policy goals connected to our traditional banking and financial system: anti-money-laundering, tax compliance, sanctions and the like,” Gary Gensler, who heads the Securities and Exchange Commission, told Senator Elizabeth Warren in a letter this year.

What can regulators do?

The trouble with stablecoins is that they slip through the regulatory cracks. They aren’t classified as bank deposits, so the Fed and the Office of the Comptroller of the Currency have limited ability to oversee them. The S.E.C. has some authority if they are defined as securities, but that is a matter of active debate.

State-level regulators have managed to exert some oversight, but the fact that significant offerings — including Tether — are based overseas could make it harder for the federal government to exercise authority. Regulators are looking into their options now.

What are the government’s next steps?

Treasury, the Fed and other financial oversight bodies have a few choices. It’s not obvious what they will choose, but the issue is clearly top-of-mind: The President’s Working Group on Financial Markets, anchored by Treasury, is expected to issue a report on the topic imminently. An upcoming Fed report on central bank digital currencies could also touch on stablecoin risks.

A few of the top regulatory options include:

- **Designate them as systemically risky.** Because stablecoins are intertwined with other important markets, the Financial Stability Oversight Council could designate them a systemically risky payments system, making them subject to stricter oversight.

While the market may not be big enough to count as a systemic risk now, the Dodd Frank Act gives regulators the ability to apply that designation to a payments activity if it appears to be poised to become a threat to the system in the future. If that happened, the Fed or other regulators would then need up to come up with a plan to deal with the risk.

- **Treat them as if they were securities.** The government could also label some stablecoins securities, which would bring bigger disclosure requirements. Mr. Gensler told lawmakers during a recent hearing that stablecoins “may well be securities,” which would give his institution broader oversight.
- **Regulate them as if they were money market mutual funds.** Many financial experts point out that stablecoins operate much like money market mutual funds, which also act as short-term savings vehicles that offer rapid redemptions while investing in slightly risky assets. But money funds themselves have required two government rescues in a little more than a decade, suggesting their regulation is imperfect.

“Stablecoins don’t look new,” said Gregg Gelzinis, who focuses on financial markets and regulation at the Center for American Progress. “I see them either as an unregulated money market mutual fund or an unregulated bank.”

- **Treat them as if they were banks.** Given flaws in money fund oversight, many financial regulation enthusiasts would prefer to see stablecoins treated as bank deposits. If that were to happen, the tokens could become subject to oversight by a bank regulator, such as the Office of the Comptroller of Currency, Mr. Gelzinis said. They could also potentially benefit from deposit insurance, which would protect individuals if the company backing the stablecoin went belly up.
- **Try to compete with central bank digital currency.** Jerome H. Powell, the Fed chair, has signaled that outcompeting stablecoins could be one appeal of a central bank digital currency — a digital dollar that, like paper money, ties back directly to the Fed.

“You wouldn’t need stablecoins, you wouldn’t need cryptocurrencies, if you had a digital U.S. currency. I think that’s one of the stronger arguments in its favor,” Mr. Powell said during testimony this year.

But how a central bank digital currency is designed would be critical to whether it succeeded at replacing stablecoins. And industry experts point out that since stablecoin users prioritize privacy and independence from the government, a new form of government-backed currency might do little to supplant them.

- **Cooperate internationally.** If there’s one point everyone in the conversation agrees on, it’s that different jurisdictions will need to collaborate to make stablecoin regulation work. Otherwise, coins will be able to move overseas if they face unattractive oversight in a given country.

The Financial Stability Board, a global oversight body, is working on establishing stablecoin-related standards and plans for cooperation, aiming for final adoption in 2023.