Stablecoin Regulations Are Coming Down the Pike. What Will They Look Like?

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The Biden administration is signaling to the crypto community that it's looking into regulating stablecoin issuers like banks, according to a Wall Street Journal report.

There are no details yet on what exactly this means for the numerous non-bank entities currently churning out stablecoins, which have become a lynchpin of the crypto ecosystem, but the language does offer a hint of what kind of rules federal regulators may be cooking up.

The stablecoin sector has a combined market capitalization of about $112 billion, according to CoinCodex, a crypto data analytics platform, and regulators have publicly fretted in recent months over the potential systemic risk that such a large, unregulated market could bring to the world economy, especially given stablecoins' connections to fiat currency markets.

For background, stablecoins are blockchain-based cryptocurrencies that are pegged to the value of an underlying asset, in most cases a fiat currency like the U.S. dollar.

The biggest issuers in the world, like Circle (USDC) and Tether (USDT), are both pegged to the dollar. Others, like Dai and Wrapped Bitcoin, are pegged to other cryptocurrencies or baskets of cryptocurrencies, while some, like GSX, are backed by commodities such as gold.

Their use-value is that by being pegged to an asset outside of crypto markets, buyers and sellers can move in and out of cryptocurrencies such as bitcoin and ethereum much more easily.

That's why crypto exchanges are where stablecoins have proven most useful, and why multiple major exchanges, such as Gemini and Coinbase, have issued their own coins. Rather than having to exchange their crypto for cash — a sometimes cumbersome process — investors can use stablecoins to get in or out of trades while staying entirely within the blockchain.

It's a rather niche use really, but it plays a crucial role in providing liquidity to crypto markets.

As crypto trading and derivatives have exploded, stablecoins have helped grease the market.

Maintaining the Peg

Where things get tricky is the quality of the pegs that are backing stablecoins' value.

Stablecoin issuers — which, again, are not technically banks — maintain their peg by either keeping reserves of the underlying asset, like cash or cash equivalents, or by algorithmically increasing or decreasing the supply of their stablecoins as prices rise or fall.

The former is a little similar to how traditional banks keep reserves to back their lending activity, while the latter is similar to how a central bank might manipulate the money supply.

The algorithmic approach brings its own host of pros and cons, but for regulators at least, their biggest concern is with issuers who maintain their peg with fiat-backed reserves.

Think about it: digital assets worth billions are flooding into the market, while the process for ensuring the value of those assets is inherently opaque at best and intentionally shadowy at worst.

Some issuers, including Tether and Circle, have started volunteering for public audits, providing semi-regular updates on what exactly is in their reserves, but the process is hardly formalized.

That's where potential bank-like regulations could help establish set rules for not only auditing reserves but creating requirements for what those reserves should look like.

Indeed, even champions of stablecoins see some kind of bank-like regulatory framework as crucial to building trust and confidence in the crypto sector.

"Having that type of framework and external process would definitely help push more institutions and individuals to have the confidence to actually use these assets as a medium of doing business," said Sean Stein Smith, an assistant professor of economics at CUNY's Lehman College, who serves on the advisory board of the Wall Street Blockchain Alliance.

'Leverage and Digital Assets Do Not Mix'

One thing that separates stablecoin issuers from regular banks, however, is the sheer speed — or monetary velocity to use a technical term — of the digital assets they issue.

In the first quarter of 2021, for instance, the monetary velocity of the U.S. dollar was 1.12, meaning the dollar was transferred that many times in the past year.

For comparison, stablecoin velocities mostly range from 25 to 50, according to a recent report from CoinMetrics and Bitstamp.

What does this mean for pegs? Basically, it's more important that issuers be prepared for sudden and huge shifts in the supply of their stablecoin.

This has led some to call for a strict 100 percent one-to-one peg with the dollar.

"Every single asset or coin issued would have to be 100 percent reserved, and any borrowing or lending done by that institution would have to be done a) carefully and b) in a manner that doesn't undermine that 100 percent reserve banking," Smith said.

As Caitlin Long, founder and CEO of Avanti Bank and Trust, one of the few crypto-native companies to receive a special banking charter from the state of Wyoming, wrote in a recent essay for the Cato Institute: Leverage and digital assets do not mix.

"Digital assets generally settle in minutes and with settlement finality, which means leveraged financial institutions that handle them could quickly find themselves in trouble if they don't manage the liquidity risk well — digital assets move fast," she wrote.

In other words, fractional reserve banking, in which banks lend out multiple times what they actually have in reserves, is not an option in the stablecoin space.

Sen. Cynthia Lummis (R-Wyo.), a champion of crypto nationally and in her home state, made a similar point earlier this week in a speech before the Senate.

"Stablecoins are highly liquid and have higher monetary velocity than other forms of the U.S. dollar," she said. "However, stablecoins also present certain novel risks to the United States economy. In particular, stablecoins must be 100 percent backed by cash or cash equivalents, and this should be audited regularly."

Lummis also expressed concerns that stablecoin issuers lack transparency and may not be backed by appropriate assets, and hinted that perhaps only banks should issue them.

"It may be the case that stablecoins should only be issued by depository institutions or through money market funds or similar vehicles," she said, even as she stressed the need to make sure new regulations didn't tamp down on innovation in the sector that is making "payments faster, cheaper, and more inclusive."