Stablecoins face industry-defining regulatory guidance

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By Yizhu Wang
Market Intelligence

U.S. regulators considering oversight of stablecoins will have to balance the need for greater security against the risk of stifling innovation in a fast-growing corner of the cryptocurrency market.

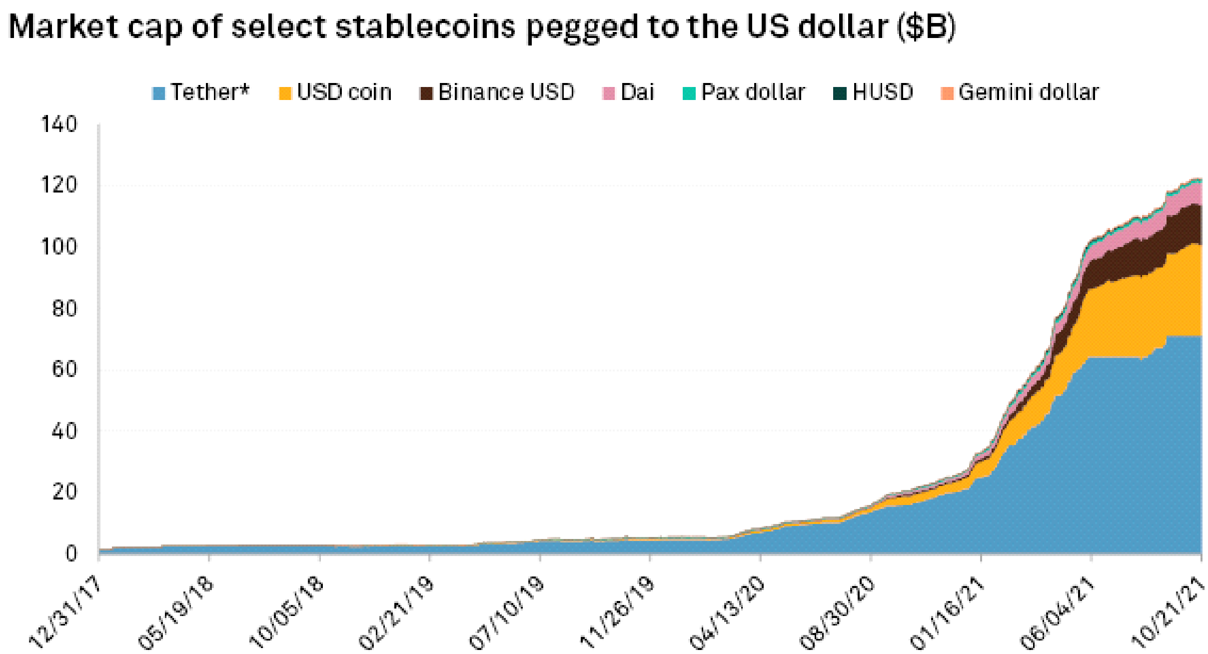
Recommendations for new cryptocurrency rules will be published within weeks, Federal Deposit Insurance Corp. Chairman Jelena McWilliams said on Oct. 25, including measures for stablecoins. The market for stablecoins, which are pegged to government-issued currencies, has ballooned to about $130 billion, according to data from Coin Metrics and The Block.

The surging growth of stablecoins has prompted calls for issuers to be regulated like banks, particularly after Tether Ltd. agreed in October to a $41 million settlement over prior misrepresentation of its reserves. Tether did not immediately respond to a request for comment; in a previous statement, the company noted the disclosure issues had been resolved since 2019 and that the company had always maintained adequate reserves.

Tighter controls could bolster the market by easing concerns about issuers' ability to redeem coins, or alternatively, choke off growth by adding burdensome regulation in a sector that advocates see as revolutionizing payments and financial services more broadly.

"Regulators are still learning a lot about this rapidly evolving and fast-moving space," said John Popeo, partner at bank consultancy The Gallatin Group. They will have to take a "thoughtful and creative approach in regulating this area, rather than trying to fit stablecoins and other crypto assets into existing pockets under current laws or regulators," he said.

As regulators express concern about systemic risk, stablecoin proponents argue that too heavy a regulatory hand could stifle innovation. Stablecoins have the potential to provide lower-cost, real-time payments for consumers, lower payment costs for businesses and connect unbanked or underbanked consumers to the financial system, wrote the chief economist for Diem Association, formerly known as Facebook Inc.'s Libra project, in a recent *Harvard Business Review* article.



Data compiled at 10:05 a.m. ET on Oct. 22, 2021.
Analysis includes the market cap of select stablecoins pegged to the U.S. dollar between Dec. 31, 2017, and Oct. 21, 2021.
Market cap is calculated based on the total coin supply, including illiquid supply held in escrow or foundation accounts, multiplied by the day close price of the coin taken at midnight UTC.
* Tether's market cap is composed of coins circulating in the Omni, Ethereum and Tron platforms, which account for over 97.5% of the outstanding Tether supply.
Source: Coin Metrics

Coming soon

In July, U.S. Treasury Secretary Janet Yellen convened a meeting to discuss the possible uses of stablecoins in payments and the potential risks, together with the President's Working Group on Financial Markets, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp.

The fact that it is largely private companies who issue and maintain the U.S. dollar-pegged digital assets concerns regulators and banks since those private nonbank entities may not be capable of managing systemic risks without proper oversight. By contrast, banks are bound by an antiquated regulatory framework and lack of clarity to race at full speed. "The uneven playing field" leaning toward the private companies is a result of regulation being outpaced by innovation, as it is easier and cheaper for the private companies to offer similar products and services compared to banks, wrote by Yale professor Gary Gorton and White House economist Jeffery Zhang in a research paper published in July.

Wyoming has granted bank charters to two crypto-related companies, crypto exchange Kraken Bitcoin Exchange and blockchain bank Avanti Bank & Trust. In 2018, the New York Department of Finance approved Paxos and Gemini, both state-licensed trust charter holders, to issue stablecoins. They are required to hold at least as much fiat currency as their stablecoins in circulation.

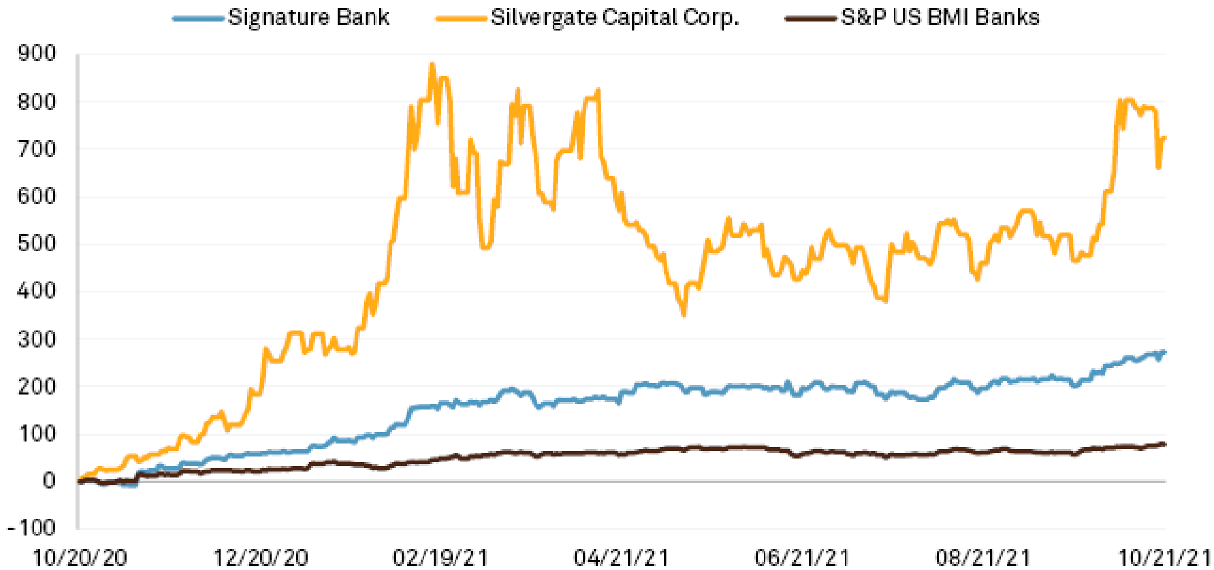
"Where I get nervous is the state of Wyoming issuing a charter to Kraken, because they want to get into bank-like services. To me, this is the same issue as with fintechs. We can't have negative regulatory arbitrage between our industry and these emerging — whether fintech players or crypto companies," Jim Reuter, president and CEO of FirstBank Holding Company, said at the annual conference of the American Bankers Association on Oct. 18.

A handful of banks have started to service crypto markets, and a couple of top players have seen both significant asset growth and skyrocketing share prices as a result. Signature Bank reported that it held $5.2 billion in stablecoin reserve in the third quarter. The bank holds reserve deposits for Circle, the issuer of USDC, and has seen digital assets driving deposit growth. Similarly, Silvergate Capital Corp. has nearly quintupled its assets over the last year. Both banks have seen strong share performance, with Signature's stock up over 270% over the last year, and Silvergate's stock up more than 720%. Those gains compare to a 78% total return in the S&P U.S. BMI Banks index.

"Our banking charter, we don't view it as a detriment, but just the opposite," said Silvergate CEO Alan Lane during the bank's earnings call. "All the news we're seeing so far would seem to indicate that the regulators are looking to bring the U.S. dollar-backed stablecoins under the regulatory tent, if you will, or under the federal banking guidelines."

The bank announced in May that it will be the exclusive issuer of the U.S.-dollar stablecoin developed by Diem.

Total return of select banks with cryptocurrency holdings (%)



Data compiled at 10:05 a.m. ET on Oct. 22, 2021.
Analysis includes one-year total returns for Signature Bank, Silvergate Capital Corp. and S&P U.S. B.M.I. Banks Index from Oct. 20, 2020, to Oct. 21, 2021.
Source: S&P Global Market Intelligence

Systemic risk concerns

Stablecoin issuers mirror banks in holding reserves in a variety of assets. The big difference is that issuers can decide for themselves how to divide holdings in terms of liquidity and quality because they are not obligated to follow Fed-defined bank capital standards. Indeed, issuers do not even face disclosure requirements.

The risk is that an issuer will overly invest in high-return illiquid assets, and then not have enough cash in hand to meet its promise of exchanging each individual token for a dollar. That would leave investors out of pocket, particularly if a market panic triggered a flood of redemption requests. The damage could spread further into the financial system as the market cap grows and more players are involved.

On Oct. 18, Fitch cautioned that stablecoins could bring new risks to short-term securities markets, as stablecoin issuers could become a significant investor group in the U.S. commercial paper market by holding those securities in their reserve.

While currently the main stablecoin issuers are private entities, the Fed is also examining the benefits and costs of a digital U.S. dollar issued or operated by the central bank itself.

Although Fed Chair Jerome Powell has been cautious about stablecoins, he testified on Sept. 30 that the central bank "has no intention to ban" stablecoins or other cryptocurrencies. But the top regulator also said, "it's appropriate that they be regulated."

Nathaniel Melican contributed to this article.

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