IX. The Risks of Stablecoin and the Call for Regulation

A. Introduction

This article discusses the concept of Stablecoins and the role they play in the economy, as well as the risks that surround this newly emerging technology. Looking at digital currencies, and more specifically Stablecoin, several federal agencies such as the Federal Reserve and the Treasury Department have begun a discourse and a push to formulate regulations on Stablecoin to address a number of perceived risks.[1] These federal agencies voiced their concerns in the form of a report calling for a number of regulations to be imposed on issuers of Stablecoin, citing the need for supervision over these issuers as well as a number of other regulatory systems.[2]

Stablecoin is clearly something that matters, as it has caught the eye of federal agencies and has spurred an important dialogue. But what exactly is a Stablecoin? Stablecoin is a digital currency, which is also often referred to as a cryptocurrency.[3] Cryptocurrencies, as their name suggests, are digital exchange currencies that are both decentralized and encrypted, and they operate without a governing body or overseer monitoring the state of the currency.[4] Another important feature of digital currencies is that they operate on a "blockchain," which is an "open, distributed ledger" used for creating and maintaining a record of all the transactions involving that cryptocurrency.[5] So, what makes Stablecoin different from all other digital currencies? For one, Stablecoin has a very attractive and key quality for traders: itis designed to emulate the stability of a fiat currency.[6] In a market where there is extensive and seemingly never-ending discussion around uncertainty

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[1] Jesse Hamilton, Stablecoin Risk Spurs U.S. Agencies to Seek Power to Crack Down BLOOMBERG, Nov. 1, 2021), https://www.bloomberg.com/news/articles/2021-11-01/stablecoin-risk-spurs-u-s-agencies-to-seek-power-for-crackdown (The Federal Reserve and Treasury Department among others have called for congressional action regarding the ability to regulate and supervise Stablecoin issuers.)
[2] *Id.*
[3] *What is a stablecoin?* COINBASE, https://www.coinbase.com/learn/crypto-basics/what-is-a-stablecoin [https://perma.cc/VT98-KCLS]
[4] Kate Ashford & John Schmidt, What is Cryptocurrency? FORBES (Jan 25, 2022), https://www.forbes.com/advisor/investing/what-is-cryptocurrency/ (Cryptocurrencies are decentralized exchanges lacking a central authority.)
[5] *Id.*
[6] *See* Coinbase, *supra* note 3.

and price fluctuations, the idea that a digital currency like Stablecoin could be as stable as a fiat currency is obviously an attractive quality for players in the market.

Stablecoin ispurported to function as a "reserve" asset, as it is backed by dollar-denominated reserve assets in order to ensure its stability.[7] Moreover, Stablecoins are backed by assets that are dollar-denominated, meaning that they have an equal value to the Stablecoin in separate amounts that are independently verified by an accounting firm.[8] At this point in time, a large number of stablecoins are currently operating on the Ethereum blockchain.[9] As previously discussed, blockchains are the ledger used for cryptocurrencies where all of the transactions are recorded in discrete blocks that together form the blockchain for a given cryptocurrency.[10] Stablecoins allow for easy and cheap transactions; they can also be programmed, and are global and internet-accessible at any moment.[11] All of these qualities shed light on why Stablecoins have garnered so much attention when compared to many other digital currencies. These features of Stablecoin make it an attractive option as a digital currency, becauseit can help tradersreduce the volatility in their trading, make cheap transfers for large amounts of Stablecoin, and transfer digital currency globally.[12]

The appeal of Stablecoin is seen in the massive market capitalization of the largest Stablecoin issuers in 2021, which was greater than $127 billion, marking an increase of about 500 percent in just one year.[13] One important note from the President's Working Group's report is that Stablecoin is currently used primarily in the trading, borrowing, and lending of other digital currencies and assets; it has replaced some of the uses of fiat currencies in speculative trading in a number of digital currencies.[14] The use of Stablecoin has also begun to replace the use of traditional fiat currencies in the space of value

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[7] *Id.* ("The USDC stablecoin, for example, is backed by dollar-denominated assets of at least equal fair value to the USDC in circulation in segregated accounts with US regulated financial institutions.").

[8] *Id.*

[9] *Id.*

[10] Ashford & Schmidt, *supra* note 4 at 2.

[11] Coinbase, *supra* note 3 at 3.

[12] *See generally Id.*, at 4.

[13] President's Working Group on Financial Markets, et. al., Report on Stablecoin 7 (Nov. 2021), https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf [https://perma.cc/8TR9-FPHM]

[14] *Id.* at 7-8.

storage and transfer for digital currency trading.[15] Moreover, the report also makes note of the potential for widespread use of Stablecoin in the retail space, as well as in supply chain payment systems and international remittances, which is a significant part of the call to attention over the emergence of Stablecoin.[16]

Stablecoin comes with a variety of risks and uncertainties thatfederal agencies propose to address through regulation This article will now explore the various risks associated with Stablecoin (perceived or actual), as well as the regulations that have been proposed and lobbied by various organizations. Part B of this paper will discuss the ability of Stablecoin to maintain its value in the absence of legislative oversight or a central authority to regulate it. Part C of this paper will discuss some of the large, overarching risks of Stablecoin, includingoperational risks and potential payment systems risks.

B. Stablecoin's Ability to Maintain Its Value without a Central Authority or Legislative Oversight

Ultimately, despite the perceived stability of Stablecoin's value, there is still substantial risk of changes in value as noted by the President's Working Group, which discusses the differences in Stablecoin value based on its reserve assets and the risks stemming from a lack ofregulation .[17] The Financial Stability Oversight Council ("FSOC") has recently released a report stating that "[t]he reserves of these stablecoins . . . may not be subject to rigorous audits and the quality and quantity of collateral may not, in some cases, correspond to the issuer's claims."[18] This concern is echoed by many other players and organizations in the market, and it indicates that the confidence in Stablecoin's ability to maintain its value and be as stable as it purports to be is really feasible in the long term. This statement also indicates a concern over the lack of a central authority to regulate Stablecoin, as it mentions a lack of "rigorous audits.".[19] The report from the FSOC also stated that "[S]tablecoins that maintain their value through algorithmic mechanisms are potentially subject to failure due to market pressures,

[15] *Id.* at 8.
[16] *Id.*
[17] *Id.*, at 4.
[18] Nikhilesh De & Danny Nelson, Financial Stability Group Warns of Stablecoin, DeFi Risks in Annual Report COINDESK (Dec 17, 2021), https://www.coindesk.com/policy/2021/12/17/financial-stability-group-warns-of-stablecoin-defi-risks-in-annual-report/ [https://perma.cc/AHS8-AA3P].
[19] *See Id.*

operational failures and other risks."[20] This statement further expands on the concern over a lack of oversight, and it pokes holes in that idea that Stablecoin is really as stable as fiat currency.

The President's Working Group's report on Stablecoin fleshes out many of the more pressing risks and concerns surrounding Stablecoin, as it discusses the systemic risk created bythis digital currency.[21] The report mentions that the transfer mechanisms used in Stablecoin transactions give rise to traditional risks involving liquidity, operations, settlement risk, and system governance.[22] The report also discusses the risk of Stablecoin runs, which involve a "self-reinforcing cycle of redemptions and fire sales of reserve assets;"if a Stablecoin run occurred, it could cause failure in funding markets that pose significant risks to the financial system as a whole, presenting the opportunity for a "shock to the economy and the financial system."[23]

Without a central governing body to regulate and oversee Stablecoin and its value, these concerns are likely to continue and potentially grow further. The FSOC also referenced the report released by the President's Working Group addressing the risks of Stablecoin and proposed regulations, and discussed preparation for a scenario where Stablecoin remains unregulated.[24] The report by the President's Working Group will be discussed in depth later in this article, but it is important to note that its central theme is that Stablecoin plainly lacks a central authority and the proper oversight that federal agencies believe is necessary for Stablecoin's. Agencies will continue to push for legislation that would put this kind of oversight in place. Ultimately, the fact that Stablecoin is unfamiliar, decentralized, and not overseen is a great concern surroundingStablecoin's future.

C. Potential Risks Surrounding Stablecoin: Operation and Payments Systems Risks

Shortly after the emergence of Stablecoin as a new digital currency in the market, the G7 Summit started a discourse on the risks surrounding the cryptocurrency and outlined the economic problems

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[20] *Id.*

[21] President's Working Group, *supra* note 13 at 12. ("Failure of a stablecoin to perform according to expectations would harm users of that stablecoin and could pose systemic risk.").

[22] *Id.* at 13.

[23] *Id.*

[24] De & Nelson, *supra* note 18.

and security threats that it poses..[25] The President's Working Group's report includes a discussion on payment risks and operational risks.[26] The report described an operational risk as "the risk that deficiencies in information systems or internal processes, human errors, management failures, or disruptions from external events will result in the reduction, deterioration, or breakdown of services;" operational risk could thus pose broad threats to the economy in the form of payment errors or fraudulent payments.[27] Subsequently, the report describes a "settlement risk" as the risk that a settlement payment will not function the way it is supposed to, which could decrease Stablecoin users' confidence in the asset and their ability to finalize transactions in time.[28] Much of the discussion at the G7 Summit surrounded the use of Stablecoin as a currency in international settlement transactions, as well as the risks it posed relating to taxation issues, money laundering and terrorism.[29] Stablecoin could present these kinds of dangers because of its potential utility in criminal transactions where transactions can be executed using a stable cryptocurrency;this is a significant part of the discussion around the absence of regulation of Stablecoin.[30]

The President's Working Group's report mentions that criminals could use Stablecoin to facilitate money laundering and terrorist financing, and that such criminal activity will occur more frequently without Stablecoin oversight; the other side of this debate argues that increased adoption of Stablecoin will make these activities more transparent.[31] Operationally, the report discusses how Stablecoin could create problems in the validation of payments, where heavy delays and failures could occur without the authority of a central body to oversee and facilitate transactions of Stablecoin, many of which the

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[25] The Real Risks of Moving all your Assets into Stablecoins MEDIUM: STABLY (Mar. 12, 2021), https://medium.com/stably-blog/the-real-risks-of-moving-all-your-assets-into-stablecoins-dee42cda25de [https://perma.cc/P3WF-CG2L].
[26] President's Working Group, *supra* note 13, at 12..
[27] *Id.* at 13.
[28] *Id.*
[29] *Id.* at 1.
[30] *See Id.* at 2. ("To address the prudential risks of payment stablecoins, the President's Working Group on Financial Markets (PWG), along with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) (together, the agencies) recommend that Congress act promptly to enact legislation to ensure that payment stablecoins and payment stablecoin arrangements are subject to a federal prudential framework on a consistent and comprehensive basis.").
[31] President's Working Group, *supra* note 13 at 11.

report mentions are unique given the blockchain ledger system.[32] The report also drew attention to risks that Stablecoin could present regarding settlement payments, discussing how Stablecoin does not have defined procedures for how settlement payments are completed and raising questions about the ability of Stablecoin payments to be finalized.[33] The report also discussed Stablecoin liquidity risks, risks of scale where problems with a single Stablecoin issuer could have a snowball effect, and the anticompetitive effects that could result if there are large commercial interactions between Stablecoin wallet providers and Stablecoin issuers.[34]

D. Regulatory Proposals for the Use of Stablecoin

The President's Working Group also proposed a number of legislative actions to address the risks it discussed.[35] The report mentioned that Stablecoin wallet providers should be subject to risk management standards by a federal body, and that commercial restrictions should be placed on issuers of Stablecoin.[36] Moreover, there has been a call for interim measures to be put in place to regulate Stablecoin operations in the absence of legislation.[37] The report also

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[32] *Id.* at 13.
[33] *Id.*
[34] *Id.* at 14.
[35] Norbert Michel, The Biden Administration Stablecoin Report Misses The Mark FORBES (Nov. 5, 2021), https://www.forbes.com/sites/norbertmichel/2021/11/05/the-biden-administration-stablecoin-report-misses-the-mark/?sh=58e267b22998 ("Specifically, the administration wants new legislation to "limit stable issuance, and related activities of redemption and maintenance of reserve assets, to entities that are insured depository institutions."").
[36] Jay G. Baris et al., *U.S. President's Working Group on Financial Markets Releases Its Stablecoin Report,* SIDLEY AUSTIN LLP (Nov. 5, 2021), https://www.sidley.com/en/insights/newsupdates/2021/11/us-presidents-working-group-on-financial-markets-releases-its-stablecoin-report [https://perma.cc/F6VE-K8ZP].
[37] Jamie L. Boucher et. Al., *Federal Regulators Move to Regulate Stablecoins Through Banking Laws Plus New Legislation* SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (Nov. 16, 2021), https://www.skadden.com/insights/publications/2021/11/recent-developments-in-the-regulation-of-virtual-assets/federal-regulators-move-to-regulate-stablecoins [https://perma.cc/E7GW-MZH3].

called for regulation of commercial transactions between issuers of stablecoin and the wallet issuers.[38]

The report in particular proposed that issuers of Stablecoins obtain insurance from the United States Federal Deposit Insurance Corporation.[39] It also proposed legislation regarding federal oversight over providers of Stablecoin wallets, as well as oversight and regulation over "any entity that performs activities critical to functioning of stablecoin."[40] The report mentions that in the absence of legislative oversight the FSOC should be involved in the regulation of Stablecoin.[41] It further provides that the designation of activities as critical or systemically important to the functioning of Stablecoin transactions may be needed to adequately oversee the currency's use.[42] Clearly, there is no shortage of potential risks that Stablecoin poses to the market, and the question now is whether legislative efforts will be quick enough to address the risks, and whether interim measures will be put in place in their absence.

E. Conclusion

Ultimately, it is clear that the risks posed by Stablecoin must be addressed by regulators. There have been calls for both legislative and administrative efforts to put some kind of oversight in place over Stablecoin as it amasses a large market share. Despite all of the uncertainties and concerns surrounding Stablecoin, its market capitalization has increased by over 500% over the past year.[43] The publication of proposals like the report by the President's Working Group indicates that Stablecoin is viewed as a risky currency and warrants scrutiny from financial regulators andmajor financial institutions.

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[38] Sidley Austin LLP, *supra* note 36.

[39] Bruce Mizrach, Stablecoin risks spur case for central bank digital currency FIN. TIMES (Dec. 6, 2021), https://www.ft.com/content/ff9bcc3d-3583-4f99-8fec-ccfdf8dd3f72

[40] Sidley Austin LLP, *supra* note 36.

[41] President's Working Group, *supra* note 13 at 3.

[42] *Id.*

[43] Pete Schroeder, U.S. regulators flag climate change, stablecoins as potential systemic risks REUTERS (Dec. 17, 2021), https://www.reuters.com/markets/us/us-regulators-flag-climate-change-stablecoins-potential-systemic-risks-2021-12-17/ [https://perma.cc/A9YA-V2NJ].

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