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CRYPTO INSIGHTS

Stablecoins

An Overview of Stablecoins in the Marketplace

WHY ARE STABLECOINS NECESSARY?

Stablecoins enable funds to be transferred 24/7, in real-time, globally, and with traceability. Existing banking solutions are unable to offer the same capabilities.

They have the power to enhance banking for the unbanked by enabling users to leverage the security and transparency of stablecoins as a means of payment and store of value.

RECOMMENDATIONS FOR STABLECOINS GOING FORWARD

Our recommendations focus on fiat-backed stablecoins, as we believe they have the clearest path to regulatory oversight and are an important underpinning of the current crypto ecosystem. We made five specific recommendations as part of the 2021 President's Working Group discussions on Stablecoins[1]:

01 Define "Stablecoins" as fully reserved coins backed by a single fiat currency in the form of cash and short-dated government securities.

02 Require that Stablecoin reserves be deposited at insured depository institutions and held in segregated accounts.

03 Establish disclosure and audit rules for Stablecoins, including a requirement that issuers regularly publish "proof of reserves" to support their ability to facilitate redemptions.

04 Require that Stablecoin issuers honor redemption requests above a minimum value within a reasonable period of time at nominal cost, provided the request adheres to established banking rules.

05 Give oversight authority to established banking regulators.

We would welcome the opportunity to participate in conversations around other types of stablecoins, as they present interesting innovations that require their own unique considerations.

1. In June 2022, The New York Department of Financial Services issued new compliance requirements for issuers of US dollar-backed stablecoins, which we broadly support as they track with many of the recommendations above.

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WHAT HAPPENED TO UST?

UST, an algorithmic stablecoin, made headlines when it lost its peg, which was completely correlated with its underlying token, LUNA. In retrospect, it's clear the incentives paid by UST overwhelmed the utility that existed for the LUNA token by itself. This was unique to UST and is not representative of the structure of most algorithmic stablecoins, but there are some important lessons to be learned.

ARE ALL STABLECOINS THE SAME?

The industry generally divides stablecoins into two major categories, however, there are many important subcategories within the broader classifications.

FIAT-BACKED

For stablecoins like Tether and USDC, for every token in circulation, there should be one dollar in reserve — either in cash or cash equivalents. This type of stablecoin will maintain its peg so long as the market believes its reserves are sufficient and redemption requests will be honored by a centralized entity in a timely manner. In a unique feature, the market self-corrects to the peg because redemptions strictly reduce supply and reserves are in liquid, low-risk assets.

ALGORITHMIC

Introduced as a means to govern a decentralized stablecoin, there is significant variability in their structure, each with its own peg-maintaining mechanism. Generally they are not backed 1:1 by cash equivalents; rather, their value is maintained by a programmatically defined mint and redemption relationship between it and associated assets.

COLLATERALIZED

One type of decentralized stablecoin is collateralized stablecoins. They share characteristics of both fiat-backed and algorithmic stablecoins. These stablecoins, such as DAI, are backed by uncorrelated cryptoassets (and are often overcollateralized to further ensure value stability) but have an algorithmic component as their peg is governed via a decentralized smart contract.

WHAT ABOUT EARNING INTEREST?

Stablecoins generally don't pay interest collected from the reserves to coin holders – the issuers keep it for themselves. Interest payments could raise a question as to whether a stablecoin is a security, significantly reducing its utility for payments and banking. However, the lack of interest payments is a major disadvantage for the unbanked population and worth considering as an opportunity to improve financial equity and inclusion. One way of solving this would be for the SEC to specify that stablecoins that meet the five criteria above – whether they pay interest or not – are not securities.

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