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Stablecoin Regulation in an Unstable Time: The Fed and Treasury Address a Stablecoin Regulatory Framework

by Stephen M. Anstey

Last week, the Federal Reserve (Fed) and the U.S. Department of the Treasury (Treasury) noted potential risks associated with certain aspects of stablecoins. While the Fed affirmed that "the aggregate value of stablecoins[…]grew rapidly over the past year to more than $180 billion in March 2022," and Treasury acknowledged that stablecoin and other digital assets, "present opportunities to promote innovation and increase efficiencies," both warned of potential systemic risks, including liquidity and valuation issues during times of market stress and a vulnerability to runs. Both agencies addressed regulatory gaps in the digital assets sphere, with Treasury Secretary Yellen calling for the development of a "consistent federal framework" to address the "issues and opportunities posed by digital assets," including stablecoins.

On May 9th, the Fed published its Financial Stability Report (Report). The purpose of the Report, which the Fed releases in May and November of each year, is to provide the Feds' "current assessment of the resilience of the U.S. financial system[,]" and to "[…] promote public understanding and increase transparency and accountability for the Federal Reserve's views on this topic." In the Report, the Fed assessed "financial system vulnerability" in four key areas: asset valuations, borrowing by businesses and households, leverage in the financial sector, and funding risks. One funding risk the Report noted was that "structural vulnerabilities persist at some money market funds, bond funds, and stablecoins," and it specifically noted that the "stablecoin sector continued to grow rapidly and remains exposed to liquidity risks."

A stablecoin is a digital asset "designed to maintain a stable value relative to a national currency or other reference assets." In common parlance, stablecoins are often referred to as being "pegged" to these other assets or groups of assets. As the Fed explained in its Report, "stablecoins typically aim to be convertible, at par, to dollars, but they are backed by assets that may lose value or become illiquid during stress; hence, they face redemption risks similar to those of prime and tax-exempt [Money Market Funds (MMFs)]." The Fed warned that "[t]hese vulnerabilities may be exacerbated by a lack of transparency regarding the riskiness and liquidity of assets backing stablecoins. Additionally, the increasing use of stablecoins to meet margin requirements for levered trading in other cryptocurrencies may amplify volatility in demand for stablecoins and heighten redemption risks." The Fed went on to note that "[t]he President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency have made recommendations to address prudential risks posed by stablecoins[,]" and that the President's Executive Order on Ensuring Responsible Development of Digital Assets has also tasked various agencies with considering digital assets regulatory development.

A day later, on May 10th, during the Financial Stability Oversight Council Annual Report to Congress, Secretary Yellen also addressed stablecoin and the need for increased regulatory oversight in the digital assets sphere. Secretary Yellen noted that "[w]ith respect to digital assets, new products and technologies may present opportunities to promote innovation and increase efficiencies. However, digital assets may pose risks to the financial system, and increased and coordinated regulatory attention is necessary." Specific to stablecoin, Secretary Yellen stated that Treasury is eager to work with Congress to "ensure that payment stablecoins and their arrangements are subject to a federal prudential framework on a consistent and comprehensive basis."

While there is agreement among certain federal entities and legislators that establishing a stablecoin regulatory framework is necessary, there is not yet consensus on what form it should take. For example, in November of 2021, the President's Working Group on Financial Markets (PWG), joined by the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC), released a Report on Stablecoins. The report called for "Congress [to] act promptly to ensure that payment stablecoins are subject to appropriate federal prudential oversight on a consistent and comprehensive basis[,]" and said that "[t]o accomplish these objectives, legislation should limit stablecoin issuance, and related activities of redemption and maintenance of reserve assets, to entities that are insured depository institutions." Alternatively, Senator Toomey, the Ranking Member on the Senate Banking Committee, who issued draft legislation in April that would establish a new regulatory framework for stablecoins, has expressed the view that while increased regulation is necessary, stablecoin issuance should be allowed by "(1) a money transmitting business or any other person that is authorized by a State banking or similar authority to issue stablecoins; (2) a national limited payment stablecoin issuer; or (3) an insured depository institution."

Regulation will play a key role in shaping the stablecoin sphere. As the use of, and uses for, stablecoin continue to develop and grow it will be important to monitor how various federal agencies and legislators determine how best to develop stablecoin regulation.

If you have any questions concerning federal agency or Congressional action regarding the development of digital assets regulation and policy, please do not hesitate to reach out to Stephen Anstey at sanstey@kilpatricktownsend.com.

If of interest, please find our previous alerts on the development of digital assets regulation:

- Crypto Enforcement Is Here, and Always Has Been – May 9, 2022
- Treasury Secretary Delivers Key Remarks on Digital Assets Regulation - Three Takeaways – April 11, 2022
- Forthcoming Bipartisan Legislation Regulating Digital Assets – March 28, 2022
- Congressional and Federal Agency Action Following Executive Order on Digital Assets Policy and Regulation – March 14, 2022

- Announced Cryptocurrency Executive Order Will Shape Federal Regulations for the $3 Trillion Digital Assets Market – March 9, 2022

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