ALERTS

President's Working Group Issues Interagency Risk Assessment of Stablecoins

November 8, 2021

On Nov. 1, 2021, The President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) (collectively, the "Agencies") released an interagency report ("Report")[1] concerning "payment stablecoins," which the Report defined as "stablecoins that are designed to maintain a stable value relative to a fiat currency and, therefore, have the potential to be used as a widespread means of payment."[2]

The Report focused on the risks stablecoins pose to the safety and efficiency of the financial market, along with recommended actions that Congress, as well as the Agencies, could take to address those risks.[3] The Report appears motivated, in part, by the rapid growth of stablecoins in the financial system, noting a market capitalization increase of nearly 500% over the preceding twelve months.[4]

Stablecoin Risks and Regulatory Gaps

The Report identified three primary "prudential concerns" stablecoins pose to financial markets[5]:

- *Loss of Value: Risk to Stablecoin Users and Stablecoin Runs*

  The Agencies found that confidence in a stablecoin may be undermined by several factors, such as: (1) reserve assets could depreciate or become illiquid; (2) failure to adequately safeguard reserve assets; (3)

lack of clarity regarding redemption rights of stablecoin holders; and (4) operational risks relating to cybersecurity and data security.[6] In the event a stablecoin did not perform according to expectations, the Report notes the threat of systemic risk and a "run" on the stablecoin, which may have the potential to "amplify a shock to the economy and the financial system."[7]

- *Payment System Risks*

  The Report indicates that payment stablecoins present many of the same risks that traditional payment systems face, including credit risk, liquidity risk, operational risk, settlement risk and risks from ineffective system governance.[8] These risks could cause payment systems to be less available or reliable to users, or create channels in which financial shocks or disruptions spread.[9]

- *Risks of Scale: Systemic Risk and Concentration of Economic Power*

  The Agencies note that the potential for an individual stablecoin to scale rapidly raises different policy issues. First, the failure of a key participant in a stablecoin arrangement, such as a custodial wallet provider or a stablecoin issuer, could pose systemic risk.[10] Second, the combination or merger of a stablecoin issuer or a wallet provider with a commercial firm could lead to an inappropriate share of economic power.[11] Third, the wide adoption of a stablecoin could create anti-competition concerns. For example, it could be difficult for a user of a widely adopted stablecoin to switch to a different payment product or service.[12]

The Report identified regulatory gaps in stablecoin arrangements that could exacerbate the risks identified above.

- There is no consistent set of regulatory standards to address such prudential risks.[13] Certain entities, like digital wallet providers, may be subject to varied levels of state regulation and supervision depending on the services they offer and the specific states in which an arrangement or transaction occurs.[14]

- The Report noted that, given the multiple parties in a single stablecoin arrangement, transparency into the nature of the services and transactions is required in order for proper supervisory oversight to exist.[15]

Given these perceived regulatory gaps, the Agencies believe a comprehensive regulatory framework is needed to ensure consistent regulation, increase transparency into key aspects of stablecoin arrangements, and to ensure that stablecoins function properly under both normal and distressed market conditions.

Recommended Congressional Actions

To address these risks, the Report made the following three recommendations to Congress.

Require Stablecoin Issuers Be Insured Depository Institutions

The Report recommended that Congress pass legislation that would require stablecoin issuers to be insured depository institutions, which requires being subject to capital and liquidity standards that aim to ensure the safety of the financial system. Requiring stablecoin issuers to be insured depository institutions would help avoid risks to stablecoin users (e.g., customers not being able to liquidate the value of their deposits) and prevent "runs" on stablecoins that could cause negative systemic impacts.[16] The Report stated that stablecoin issuers should be subject to the appropriate regulations and supervision at both the depository institution and holding company levels.[17]

Subject Digital Wallet Providers to Appropriate Federal Oversight

The Report recommended that for further payment system risk mitigation, digital wallet providers should be subject to appropriate federal oversight.[18] Potential oversight would include restricting digital wallet providers from lending customer stablecoins, and ensuring digital wallet providers are compliant with risk-management, liquidity, and capital requirements.[19] In addition, the supervisor of a stablecoin issuer should have the authority to require any entity that performs critical functions of the stablecoin arrangement to comply with certain risk-management standards.[20]

Require Affiliation and User Data Restrictions

The Report recommended that stablecoin issuers be required to comply with activity restrictions that limit their ability to affiliate with commercial entities.[21] Moreover, the Report recommended that Congress consider similar requirements for digital wallet providers, including limiting affiliation with commercial entities or limiting use of user's transaction data.[22] These recommendations are meant to address concerns about "systemic risks and concentration of economic power."[23]

The Report's Interim Recommendations

The Report noted that the U.S. Department of the Treasury is continuing to lead efforts at the Financial Action Task Force (FATF)[24] to ensure stablecoins are not facilitating money laundering and terrorism financing, and that such efforts are especially important due to the potential rapid increase in cross-border stablecoin payments that could amplify risks of money laundering and terrorism financing (as governments unevenly implement suggested FATF standards).[25] The Report also suggested that, in the absence of congressional action as recommended above, federal agencies should take interim measures to address the risks stablecoins pose.

First, the Report recommended that existing federal agencies, including the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and the Financial Crimes Enforcement Network (FinCEN), use their oversight power where appropriate, such as FinCEN mandating anti-money laundering obligations on stablecoin arrangements to the extent a stablecoin arrangement is offering "money transmission services."[26] It should be noted that the report specifically referenced the SEC and CFTC as being able to exercise regulatory authority over stablecoins to the extent stablecoins function as securities, commodities, or derivatives.[27]

Second, the Report recommended that, in the absence of congressional action, the Financial Stability Oversight Council (FSOC) designate certain activities conducted within stablecoin arrangements as, or as likely to become, systemically important payment, clearing, and settlement (PCS) activities.[28] Such designations would allow appropriate agencies to establish risk-management standards for institutions engaging in PCS activities.[29]

The Report also specifically mentioned the CFPB using its authority to mitigate the financial risks associated with stablecoins.[30] In a statement responding to the report, CFPB Director Rohit Chopra asserted that, although the CFPB was not a member of the President's Working Group that issued the report, the agency would still be "taking several steps related to this market."[31]

Conclusion

The issuing of this collaborative report, in conjunction with the statement by CFPB Director Chopra, demonstrates that federal agencies are focused on the perceived risks and regulatory gaps associated with stablecoins. We will continue to monitor regulatory developments regarding the stablecoin ecosystem.

Schulte Roth & Zabel lawyers are available to assist you in addressing any questions you may have regarding these developments. Please contact your attorney at Schulte Roth & Zabel or any of the following:

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[1] A copy of the Report is available here.

[2] *See* Report at 2. For reference, stablecoins are digital assets whose value is tied to a national currency or other reference asset, and stablecoins are used often on digital asset trading platforms to facilitate trading, lending, and borrowing of other digital assets. *Id.* at 1.

[3] *See Id.* at 2.

[4] *See Id.* at 7 ("Stablecoin supply grew from $21.5 billion on October 19, 2020 to $127.9 billion as of October 18, 2021, representing an increase of

approximately 495 percent.”).

[5] *See Id.*

[6] *See Id.* at 12.

[7] *See Id.*

[8] *See Id.* at 12, 13.

[9] *See Id.* at 12.

[10] *See Id.* at 14.

[11] *See Id.*

[12] *See Id.*

[13] *See Id.*

[14] *See Id.* at 13.

[15] *See Id.* at 14, 15.

[16] *See Id.* at 2. For example, if stablecoin issuers were required to be insured depository institutions, then they would be “subject to a special resolution regime that enables the orderly resolution of failed insured depository institutions by, among other mechanisms, protecting customers’ insured deposits, and according priority to deposit claims over those of general creditors[.]” *See Id.* at 16.

[17] *See Id.* at 17.

[18] *See Id.*

[19] *See Id.*

[20] *See Id.*

[21] *See Id.*

[22] *See Id.*

[23] *See Id.*

[24] Schulte Roth & Zabel LLP will soon publish a Client Alert discussing FATF’s “*Updated Guidance for a Risk-Based Approach to Virtual Assets*

and Virtual Asset Service Providers."

[25] *See* Report at 19.

[26] *See Id.* at 18.

[27] *See Id.* at 11.

[28] *See Id.* at 18.

[29] *See Id.*

[30] *See Id.*

[31] A copy of CFPB Director Chopra's statement can be found here.

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