Congressional Research Service
Informing the legislative debate since 1914

INSIGHT

How Stable Are Stablecoins?

July 28, 2021

Stablecoins are a type of digital asset generally designed to maintain a stable value by linking its value to another asset or a basket of assets. The term stablecoin does not affirm that a particular coin actually achieves a stable value. Some consider terms such as "private asset-linked tokens" as better descriptors of the nature of the instruments. Collateral backing stablecoins could include fiat currencies, traditional financial assets, or other digital assets. The top three stablecoins by value (Tether, USD Coin, and Binance USD) reached around $100 billion in market capitalization as of July 2021. Stablecoin-related policy concerns include issues related to market integrity, investor protection, financial stability, monetary policy, payments, and illicit activity prevention. This Insight focuses on stablecoins' design structure, selected investor protection issues, and financial stability concerns.

Stablecoins' Investment-Fund-Like Structure

Stablecoins often have reserve asset portfolios that hold collateral assets backing the coins' value. Many industry observers view this structure to be similar to pooled investment vehicles, such as exchange-traded funds (ETFs) or money market mutual funds (MMFs), which are overseen by the Securities and Exchange Commission (SEC).

Some stablecoins' perceived investment fund structure has captured congressional attention in recent years. For example, the Facebook-backed stablecoin Libra, which was later renamed Diem, has attracted congressional inquiries since its announcement in 2019. At related congressional hearings, Facebook received multiple questions regarding whether Libra was an ETF and how it should be regulated. Facebook argued that Libra was a payment tool instead of an investment vehicle because "you cannot use an ETF for payments" and it did not meet the Howey Test criteria used to determine if a financial instrument is a security.

If a stablecoin were to be deemed an ETF or MMF (either through interpretation of the existing legal frameworks and SEC authorities or the creation of new frameworks and authorities), it would be required to comply with the SEC's regulatory regime governing securities, investment advisers, and investment companies. In this case, SEC approval would be required to launch stablecoin projects.

Congressional Research Service

https://crsreports.congress.gov

IN11713

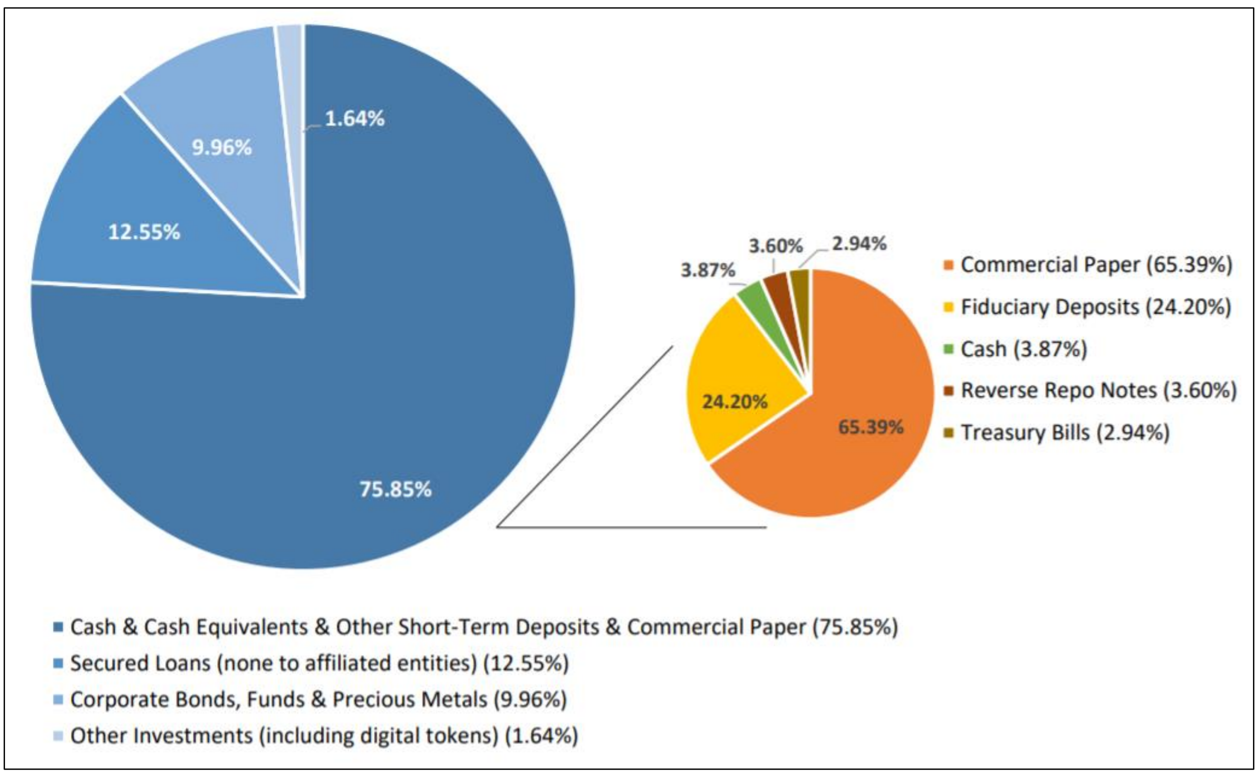
CRS INSIGHT
Prepared for Members and
Committees of Congress

Investor Protection: Disclosure and Transparency

The largest stablecoin, Tether, was created in 2014 with a prospectus that states, "each tether issued into circulation will be backed in a one-to-one ratio with the equivalent amount of corresponding fiat currency." Subsequently, the New York attorney general's office investigations revealed that it was not fully backed in this way at all times, raising investor-protection concerns. The office charged Tether and its affiliated trading platform Bitfinex $18.5 million to settle a case in 2021, claiming that the stablecoin overstated its reserves and covered up losses. Tether and Bitfinex denied any wrongdoing but paid the fine and agreed to provide quarterly disclosures of reserve assets. With Tether's first disclosure of its reserves breakdown (**Figure 1**) for March 2021, investors learned for the first time that a large portion of Tether's reserves was in unspecified commercial paper, a type of short-term debt instrument that could expose the holder to losses in the event of issuer default or substantive collateral downgrade, although such events are rare given the short-term nature of the instrument.

Tether's market valuation achieved around $60 billion as of July 2021, and some observers worry that any potentially deceptive activities may create widespread harm to investors. Tether's disclosure of reserve asset breakdowns, which allowed investors to identify Tether's potentially deceptive claim that it would be backed by fiat currency one-to-one, drew discussions about whether such disclosure should be more broadly mandated for other stablecoins. Opponents of such a mandate worry that additional disclosures may increase compliance costs and hinder innovation.

Figure 1. Tether's Reserve Asset Breakdown on March 31, 2021



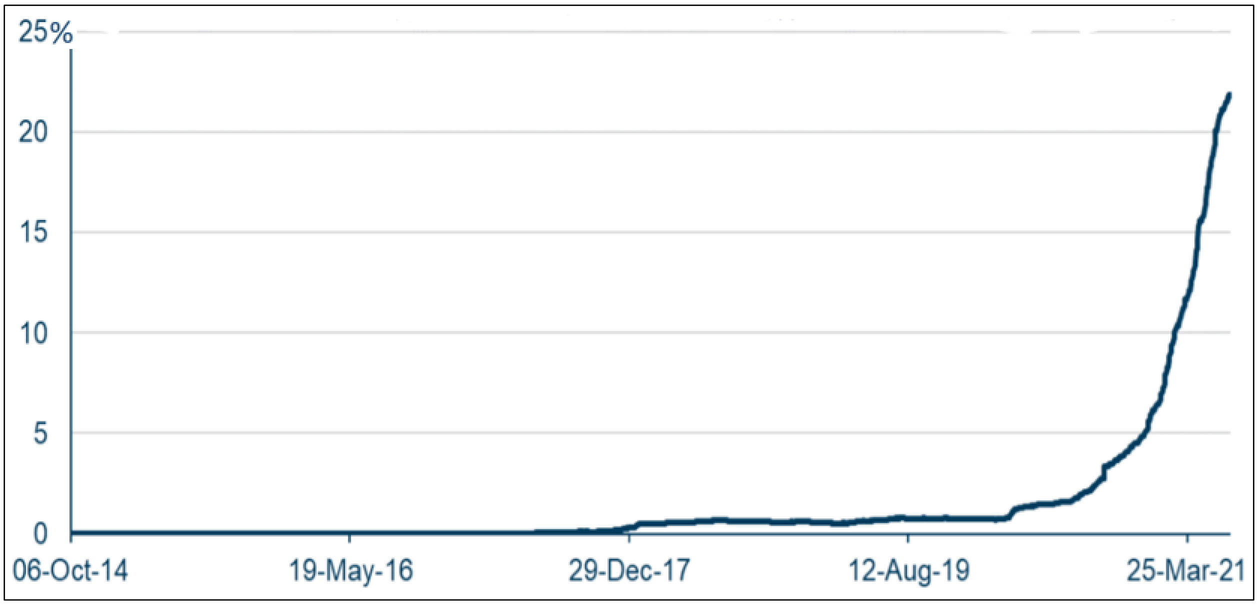
Source: Tether; see also a summary table by Federal Reserve Bank of Boston.

Financial Stability: Will Stablecoins Face "Run" Risk?

Industry observers and regulators have voiced concerns about stablecoins' potential to trigger capital markets contagion—that is, that losses or instability of stablecoins could generate distress in other markets. For example, credit rating agency Fitch Ratings issued a release saying that Tether's commercial paper holdings may be larger than those of most prime MMFs—instruments that played a role in financial instability during the 2007-2009 financial crisis and the Coronavirus-induced market selloffs in 2020, and are currently at the center of a regulatory reform debate—and that a sudden mass redemption could affect financial stability of short-term credit markets. In addition, Federal Reserve Bank of Boston President Eric Rosengren reportedly said stablecoins are like MMFs, asserting that their size and opacity mean they could pose financial stability concerns and that stablecoins' market capitalization has reached more than 20% of the size of prime MMF assets (**Figure 2**).

Figure 2. Stablecoins' Market Capitalization Relative to Prime Money Market Mutual Fund Assets Under Management (%)

October 6, 2014-June 23, 2021



Source: Federal Reserve Bank of Boston based on data from Coin Metrics and iMoneyNet.

Some observers argue that stablecoins in general are subject to runs, if coin holders have suspicions about their backing. Even without the influence of adverse market conditions, certain stablecoins have already displayed run-like behavior (e.g., a large number of investors withdrawing their investments simultaneously, which could potentially trigger negative feedback loops and contagion effects). For example, the Iron Titanium token faced a run-like scenario in June 2021 and saw its price crash to near zero from around $60 within one day.

Calls for Regulatory Changes

Federal Reserve Chair Jerome Powell said at a Senate Banking hearing that stablecoins are not yet adequately regulated, stating, "They're like money funds, they're like bank deposits and they're growing incredibly fast but without appropriate regulation."

At a President's Working Group on Financial Markets (PWG) meeting in July 2021, Treasury Secretary Janet Yellen "underscored the need to act quickly to ensure there is an appropriate U.S. regulatory framework in place." The PWG plans to issue stablecoin-related recommendations soon.

Bills in the 116th Congress would have subjected stablecoins to increased regulation. For example, H.R. 5197 (116th) and H.R. 8827 (116th) would have subjected certain stablecoins to securities and banking regulation, respectively.

Author Information

Eva Su
Analyst in Financial Economics

Disclaimer