

Stablecoin Regulation Roundtable
November 30, 2022
hosted by the
Digital Assets Policy Project
Mossavar-Rahmani Center for Business and Government
Harvard Kennedy School

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On November 30, 2022, the Digital Assets Policy Project of the Mossavar-Rahmani Center for Business and Government at the Harvard Kennedy School hosted an all-day roundtable on stablecoin regulation. It was attended by approximately two dozen people, consisting of senior officials of the Biden Administration, leaders of stablecoin issuers and traditional financial institutions that have a significant presence in payments, lawyers with expertise in payments and digital assets, and leading academics. The focus was to discuss what a regulatory framework should look like if we were to create one in order to bring stablecoins within the regulatory perimeter. Comparisons of legislative and other proposals to create such a framework, as well as a comparison of terms of existing stablecoins, were provided to participants as background. These comparisons are attached to this summary.

The event was conducted under Chatham House rules. Consistent with those rules, this summary refrains from referring to any individual, by name or position. Although many participants agreed on a number of issues, there was no formal process for reaching consensus and so this summary also refrains from characterizing any issue as being a point of agreement.

Session One: The first session focused on what should be the key elements of the regulatory framework. What types of institutions should be allowed to issue stablecoins? Should issuers be limited to only insured depository institutions, as proposed by the President’s Working Group report of November 2021, or should issuers include or be limited to nonbank institutions, narrow banks or special purpose entities not engaged in other activities? What regulatory requirements are needed to meet prudential, financial stability, and consumer protection goals?

The key points discussed by participants included:

Legal structure/type of entity. Many participants said that issuers [should not/need not] be full-service, insured depository institutions, and that it would be preferable to house the activity in a separate legal entity, so that assets could be segregated and distinct regulatory requirements could apply. Some felt that issuers could be nonbanks, narrow banks or special purpose entities, and that the full scope of banking regulation is not necessary or appropriate if the entity is only engaged in issuing a stablecoin and is not leveraging deposits or engaged in credit creation. Segregation of assets and specifying the nature of claims were also seen as helpful to addressing insolvency issues.

Key elements of issuer regulation. Many participants said that stablecoins should be fully reserved with cash or high-quality liquid assets, and that there should be no use of stablecoin reserves to create credit. Capital and liquidity requirements (see below), as well as know-your-customer, anti-money laundering, and combating financial terrorism requirements should be applied also. The hard issues with respect to KYC, AML and CFT pertain to what to do about transfers of stablecoins to and from unhosted wallets (see discussion in session 3). Many thought there should also be standards pertaining to operational resilience. Settlement and redemption issues should also be dealt with, although there was only limited discussion of these issues. See also summary of session 3 regarding standards pertaining to choice by an issuer of the blockchains on which stablecoins are transferred or traded.

Capital and liquidity requirements. There should be capital requirements even if stablecoins are fully backed by cash and HQLA because there can be operational and other risks. There should also be liquidity requirements, because there could be issues liquidating even Treasury securities intraday or during periods of financial stress. A requirement to hold all reserves in Fed master accounts, or some accommodation of mechanical application of leverage requirements, could be considered. Other possibilities include off-balance sheet, segregated models not subject to the full bank leverage ratio, though separate capital requirements would still be needed for operational and other risks. A range of perspectives were expressed whether liquidity risks and short-term duration mismatches of even short-term high-quality assets (e.g., 90 day Treasuries) warranted a modified leverage requirement or some form of public backstop, such as access to the discount window.

Broad scope for regulation. Many agreed that a comprehensive, federal approach to payments regulation would be better than just focusing on stablecoins. That would be the best way to avoid inadvertent consequences and regulatory arbitrage problems. Many issues, such as AML regulations, would be best served by a broader perspective, aiming for consistency across payment platforms and many of the regulatory issues associated with stablecoins (consumer protection and prudential requirements) are also applicable to other non-bank payment services. But it was acknowledged that achieving such a comprehensive approach may be difficult.

Differences in stablecoin/e-money models should be taken into account. Stablecoins should be distinguished from tokenized deposits: the former should be regulated as payment instruments –meaning fully backed by highly liquid reserves, and not permitted to be leveraged, and issuable by regulated nonbanks or narrow banks. The latter would be issued only by IDIs and regulated as a form of deposit. One could also imagine an intermediate model in which stablecoins are backed by FDIC-insured deposits issued by other banks. These differences suggest a legislative approach that broadly defines stablecoins so as to include tokenized deposits would be problematic. That is, the two types of instruments should be distinguished to avoid a requirement that a tokenized deposit issued by an IDI must be subject to a full reserve requirement.

Alignment of Regulatory Standards Applicable to Legacy Firms and New Standards Devised for Stablecoin Issuers. A recurring issue raised throughout the day was the need to be attentive to differences between legal standards applicable to legacy financial firms and new standards being considered for application to stablecoin issuers. A case in point was due diligence obligations that legacy firms are required to undertake with respect to third-party vendors, including technology providers and other third-party vendors. A number of participants commented on the importance of aligning these standards so as not to create an artificial regulatory incentive to move payment services away from legacy firms. Rather, it was suggested regulatory requirements should be agnostic with respect to the medium whereby payments services are offered.

Balance between regulation and competition. There's no one-size-fits-all solution, but regulation should strive to create a level playing field for banks and nonbank payment service providers, while allowing for innovation in existing structures. It should seek to increase competition, but hinder *unfair* competition.

Federal versus state regulation. Although the topic was not discussed at length, the discussion presumed some degree of regulation at the federal level and the value of having a unified system of payments regulation, including (among other things) the capacity of such a unified system to coordinate with payments regulation in other countries.

Session two: The second session focused on aligning stablecoin regulation with other regulatory frameworks. In particular, what should be the resolution framework for a stablecoin issuer? Should stablecoin issuers be limited in the activities they can undertake or in their affiliations with other entities, as are banks? Should there be application of the requirements under the Bank Holding Company Act, or similar standards, to prevent affiliation of a stablecoin issuer with commercial entities? Should stablecoin issuers have access to the Federal Reserve payments infrastructure, including master accounts?

Application to Other Payment Providers. There was a lot of support for the idea that the perimeter of any regulatory framework for stablecoins should be technologically neutral, such that it could encompass payment service providers regardless of whether they use legacy systems, DLT or other technologies, including technologies that may be developed in the future. However, once an institution was inside the framework, the relevant regulatory requirements would need to be flexible enough to accommodate some degree of variance in technological approach and risk profile: e.g. governance models, open versus closed networks, permission versus permissionless networks, validation protocols, etc.

Defining Insolvency Rules. There were many who said that uncertainty around the application of corporate bankruptcy law amplifies potential risk related to an insolvency both to users and the broader system. Participants identified a number of possible models: including chapter 11, chapter 7, FDIC resolution, and a new bespoke resolution framework, possibly under the oversight of the Federal Reserve as stablecoin regulator. This framework should be capable of

ensuring rapid payments to stablecoin holders in the event of the issuer's bankruptcy. Clarity as to what framework would apply was seen as extremely important.

Restrictions on Affiliations and Inter-Affiliate Transactions. There was also a lot of support for the idea that the stablecoin issuer and its assets should be legally and economically ring-fenced from other entities within a corporate group, including tight restrictions – and, possibly, an outright prohibition – on intragroup borrowing and lending. But many participants noted that the existing activity restrictions for banks under the BHCA – if applied wholesale to non-bank payment institutions – risked unnecessarily constraining their financing sources and tech-related activities. Conversely, there was sensitivity around the possibility that expanding the activities these institutions were permitted to undertake could potentially facilitate the direct entry of Big Tech into the payments industry, with potential negative consequences for competition and privacy. Many thought it would be best to develop a set of restrictions that seeks to balance these concerns rather than apply existing standards under the BHCA.

Privacy and Data Sharing. The session also touched upon the appropriate degree of sharing of consumer data and other information with affiliated entities as well as the selling of such information to third parties. While it was recognized that data from payments service can be a valuable asset and a means of lower credit costs for many borrowers, several participants also noted the need to define the terms of permissible data sharing and the need to impose a more robust regulatory framework than currently existed under the Gramm-Rudman-Holling Act. Others note the need to align requirements in this area with the ongoing work of the CFPB on consumer data sharing.

Relationship with Federal Reserve. While there was only limited discussion of the issue, participants were generally open to the prospect that a well-regulated non-bank payment institution might be eligible to open a master account with the Federal Reserve and hold reserve balances as permitted assets. There was limited discussion of whether the Fed should perform a LOLR function and several voiced views that it is difficult to address that issue without determining what the rest of the regulatory framework would look like, although others noted the potential need for LOLR support even if stablecoin reserves were allowed to be held in short-term Treasuries, given potential liquidity issues and even modest duration mismatches with immediately redeemable liabilities.

Lunchtime Discussion: Representatives of stablecoin issuers and traditional financial institutions shared their thoughts on the potential future use cases of stablecoins. Although stablecoins are mostly used for crypto trading today, this focus was not seen as the important use case for the future. Rather, stablecoins were seen as one means of lowering the cost of payments generally – according to one estimate, possibly an order of magnitude cheaper than current payment services. Others noted the value of stablecoins for facilitating the movement of dollars instantaneously around the world, at costs already lower than traditional mechanisms for remittances. There were a variety of specific use cases mentioned, including remittances and other cross border transfers, treasury management, payroll management and micropayments. Stablecoins could also be a means for foreign households to obtain dollar

exposure when there is local currency weakness, government instability or similar conditions. Some said that as a general matter, demand for stablecoins might not be driven by consumers, who generally do not perceive the cost of payments. Instead, usage outside of crypto might be driven first by niche areas where merchants see an advantage, such as gaming or the creator community. B2B payments might also be a significant source of increased usage. Some felt stablecoins would become commoditized and that would be desirable: if they are subject to a regulatory framework that requires 1 to 1 backing and other measures to ensure safety and stability, as well as interoperability, then identity of the issuer will not be important. Stablecoins should not be a credit product but rather only a means of payment. They might represent a significant alternative but would not dominate the market. There might be more competition in payments, with banks offering tokenized deposits or other instant payment options. There could be greater concentration in blockchains however, as a smaller number of stablecoin providers consolidated their operations and limited themselves to a smaller number of blockchains.

Session Three: The last session focused on regulation of the distribution and transfer of stablecoins as opposed to the regulation of stablecoin issuers, including, among other things, risks related to transfer on decentralized blockchains (including operational risks, cybersecurity risks and risks related to illicit activity and AML/CTF compliance), privacy, custody arrangements (including self-custody issues), and relationships between stablecoin issuers and platforms for trading or borrowing and lending.

Decentralized Finance and Trading Markets. There was recognition that it may be more difficult to regulate risks related to decentralized blockchains than the issuer-centric risks. Prudential and other requirements developed over the years for traditional financial institutions may be suitable to address issuer-related risks. But the risks related to transfers on decentralized blockchains are new, and may be more challenging because of the lack of a centralized operating entity, although it was noted that there are often groups that exercise some control through governance tokens, administrative keys or otherwise. In the course of this discussion, it was acknowledged that a number of the issues related to decentralized trading platforms and other trading matters might better be addressed in reforms focused on the larger issues of decentralized finance and digital assets regulation, rather than as a by-product of stablecoin regulation.

KYC and Illicit Finance Issues. A critical question is how to apply KYC/AML/CFT requirements when stablecoins can be transferred to holders that may not be screened by the issuer or any other financial institution. One option is to restrict transfers to hosted wallets, but that may be impractical given the wide usage of self-custody. Another is to rely on the screening that takes place by the issuer as well as any on-ramps or off-ramps—i.e., crypto exchanges, banks and other financial institutions subject to FINCEN requirements-- at the point of redemption or cashing out into fiat currency. The sufficiency of this approach depends on the quality of that screening, but also the options for use of a stablecoin without conversion into fiat currency—that is, what goods or services can be acquired or sold, or other financial transactions consummated, with a stablecoin or other crypto currency. The “holy grail” solution that is yet

to be developed may be some type of on-chain digital identity verification, possibly incorporated into a smart contract, which would automatically block a transfer unless a recipient's identity has been cleared.

Blockchain Resilience and Cybersecurity. Many participants said stablecoin issuers should have some responsibility for ensuring that blockchains they support meet certain requirements pertaining to resilience, cybersecurity and perhaps AML/CFT compliance. Regulators should impose a set of standards on stablecoin issuers pertaining to their selection of blockchains they support, though there was not extensive discussion on exactly what those standards should be or exactly what the level of issuer responsibility should be (e.g., reasonable due diligence or greater?) It was noted that NYDFS approves blockchains used by issuers subject to its oversight but that its criteria are not clear. An issue that could be relevant when developing standards might be the need to identify the blockchain's validators or whether gas fees are being paid to unwanted individuals in sanctioned jurisdictions. There was also discussion about the extent to which smart contracts might be used to limit the ability of stablecoin holders from making transfers to wallets that have not been screened for AML/CFT compliance in some way. Several participants noted that a number of firms are seeking to develop commercially viable systems of this sort. There was also a discussion of whether and when a stablecoin issuer should have the obligation to freeze its stablecoins on a particular blockchain, if it fails to meet certain standards. (An issuer might also have an obligation to freeze its stablecoins if the stablecoin is wrapped and made available for transfer on a blockchain the issuer does not support.)

Regulation of exchanges' conflicts of interest. There was discussion of the relationships between trading venues and stablecoins. Many trading venues offer customers a yield on deposits of stablecoins and other crypto assets. Some stablecoin issuers share their revenue from investment of reserves with such platforms to promote use of the stablecoin. There could be situations, depending on the terms, where such arrangements constitute an indirect payment of interest by the stablecoin issuer. Generally, participants thought these activities and relationships should be addressed separately from the framework of stablecoin regulation, although others noted the importance of understanding the extent of indirect interest payments. There should at least be clear disclosure of relationships that might create conflicts of interest, possibly by both the stablecoin issuer and by the recipient of any such compensation. Regulation of the particular activity should depend on its terms.