BETTER MARKETS

STABLECOIN

FACT SHEET

Fact Sheet: "Un" Stablecoins and Risks to Investors, Consumers, and Economic Productivity

"History doesn't repeat itself, but it often rhymes"

The short history of stablecoins has been characterized by instability, bank-like runs, and the evaporation of tens of billions of dollars in investor losses. The use of the moniker "stablecoin" has become a misnomer in that these financial products are anything but stable. A more appropriate name would be "unstablecoins" considering how susceptible they are to bank-like runs and how often they depeg from their "stable" value.

Stablecoins are remarkably similar to money market funds – an industry that had to be bailed out by the federal government in 2008 and 2020 after experiencing bank-like runs. And despite industry fantasies and talking points touting stablecoins as an innovative and inclusive form of payment, stablecoins have not lived up to the hype as a payment mechanism outside the unregulated crypto ecosystem. In fact, more than 80 percent of the trade volume on major centralized exchanges involves stablecoins – demonstrating that their primary use case is simply trading activity for no purpose other than the pursuit of speculative profit.[1]

However, despite their instability and lack of prowess as a form of payment, policymakers have debated codifying these money market fund-like products as a payment mechanism. For the reasons stated below, regulators and policymakers should stop and consider the risks to investors, consumers, and the economy before legislating stablecoins into a form of payments.

The Myth of "Stable"coins and Inherent Run Risk

Stablecoins are defined in President Biden's Executive Order as "a category of cryptocurrencies with mechanisms that are aimed at maintaining a stable value, such as by pegging the value of the coin to a specific currency, asset, or pool of assets or by algorithmically controlling supply in response to changes in demand in order to stabilize value."[2] The term "stablecoin" can refer to a number of different types of digital asset products, which all claim to maintain a stable value relative to a reference asset, often the U.S. dollar, but not exclusively. There are principally three different types of stablecoins:

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[1] *Share of Trade Volume by Paid Denomination*, THE BLOCK (last visited May 16, 2023), https://www.theblock.co/data/crypto-markets/spot/share-of-trade-volume-by-pair-denomination.

[2] Exec. Order No. 14,067, Ensuring Responsible Development of Digital Assets, 87 Fed. Reg. 14,143, 14,152 (Mar. 14, 2022).

- off-chain collateralized (fiat-based or commodity-based)
- on-chain collateralized (crypto-based)
- non-collateralized (algorithmic)

Despite stablecoins only having existed for a few years, all three types of stablecoins have exhibited bank-like run risk that is inherent in any financial product that is not guaranteed by a sovereign government. While each type of stablecoin presents differing degrees of run risk, they all present run risk, nonetheless. The President's Working Group on Financial Markets *Report on Stablecoins* identifies four specific ways confidence in stablecoins could be undermined and trigger bank-like runs:

1. use of reserve assets that could fall in price or become illiquid;
2. a failure to appropriately safeguard reserve assets;
3. a lack of clarity regarding the redemption rights of stablecoin holders; and
4. operational risks related to cybersecurity and the collecting, storing, and safeguarding of data.[3]

We have already witnessed that many of these risk factors have triggered runs on stablecoins within the past year alone. If stablecoins have proved anything over their short history, it is that they will experience bank-like runs and depeg. The questions regarding stablecoins have quickly become *when* will they depeg from their exchange rate, not *if* they will depeg, and what happens to token-holders in the aftermath.

Off-chain collateralized stablecoins.

Off-chain collateralized stablecoins are the most popular stablecoins. These stablecoins are designed to maintain a stable value in reference to a specific asset, often the U.S. dollar, with a fixed one-to-one exchange rate by holding in reserves various forms of traditional financial products (e.g., cash, U.S. treasury securities, commercial bonds, etc.). But there is often little transparency into the reserves held by stablecoin issuers. And stablecoin issuers are vulnerable to runs if customers lose faith in their reserves. What is more, most stablecoin issuers are not subject to federal regulations and protections designed to instill faith in an issuer's reserves, such as deposit insurance and portfolio restrictions.[4] Issuers are also free to change the composition of their reserves or modify their disclosures without prior notice.[5]

Specifically, the two most prominent off-chain collateralized stablecoins, Tether ($82.8 billion) and USDC ($29.9 billion), make up about 80% of the market cap of all stablecoins.[6] Tether

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[3] President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, Report on Stablecoins 12 (November 2021).

[4] Stablecoins: Legal Issues and Regulatory Options (Part I), Congressional Research Service, June 9, 2022, https://crsreports.congress.gov/product/pdf/LSB/LSB10753.

[5] Wilmarth, Arthur E. Jr., Comment Letter to the U.S. Treasury Department regarding the Risks of Stablecoins (2022), https://scholarship.law.gwu.edu/faculty_publications/1623.

[6] David Canellis, *Tether Nears 50% of Stablecoin Markets, Highest in 14 Months*, BLOCKWORKS (Feb. 13, 2023), https://blockworks.co/news/tether-stablecoin-market-half.

reportedly[7] holds a combination of cash and cash equivalents, corporate bonds, commodities, and other cryptocurrencies in reserves to maintain its peg to the U.S. Dollar. For its part, USDC reportedly holds a more conservative mix of assets in reserves that includes cash and cash equivalents. However, it is important to remember that cash equivalents can include short-term investment securities with maturity periods up to 90 days.

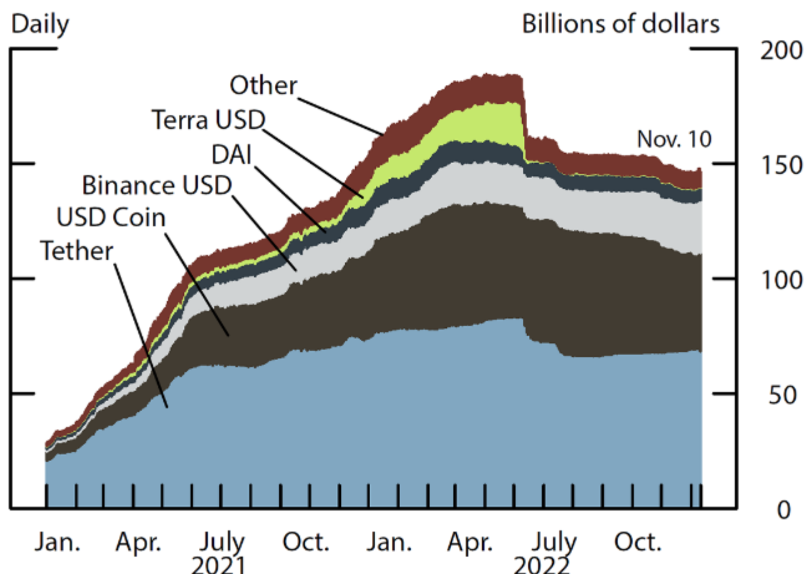

Figure 1. Market cap by stablecoin

Source: Federal Reserve [The Fed - The stable in stablecoins (federalreserve.gov)]

Despite their market dominance, both stablecoins have experienced bank-like runs and depegged from their fixed exchange rate within the past 6 months. Tether, a stablecoin notorious for secrecy and misstatements about the status of their reserves, depegged in November 2022 after the failure of FTX. In the days after the collapse of FTX, Tether traded as low as 96 cents on the dollar.[8] As a point of reference, in 2008, the Federal Reserve felt compelled to intervene and rescue the money market fund industry as it confronted funds facing less dramatic deviations from the dollar. Similarly, USDC depegged in March 2023 after the failure of Silicon Valley Bank,

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[7] Tether has been fined by the NYAG and CFTC for lying about its reserves in the past. *See* Press Release, Attorney General James Ends Virtual Currency Trading Platform Bitfinex's Illegal Activities in New York, NYAG (Feb. 23, 2021) ("Tether's claims that its virtual currency was fully backed by U.S. dollars at all times was a lie"), https://ag.ny.gov/press-release/2021/attorney-general-james-ends-virtual-currency-trading-platform-bitfinexs-illegal; *See also* Press Release, CFTC Orders Tether and Bitfinex to Pay Fines Totaling $42.5 Million, CFTC (Oct. 15, 2021) ("Tether has represented that the tether token is a stablecoin with its value pegged to fiat currency and 100% backed by corresponding fiat assets…However…Tether misrepresented to customers and the market that Tether maintained sufficient U.S. dollar reserves to back every USDT in circulation with the 'equivalent amount of corresponding fiat currency' held by Tether and 'safely deposited' in Tether's bank accounts. In fact Tether reserves were not 'fully-backed' the majority of the time").

[8] Crystal Kim, *Tether's USDT stablecoin depegs from dollar for a brief window*, AXIOS (Nov. 10, 2022), https://www.axios.com/2022/11/10/tethers-usdt-stablecoin-depegs-from-dollar-for-a-brief-window.

which held $3 billion of USDC's reserves, dropping to as low as 85 cents on the dollar and experiencing $6 billion in redemptions.[9]

On-chain collateralized stablecoins.

On-chain collateralized stablecoins represent a much smaller subset of stablecoins in the market. Similar to off-chain collateralized stablecoins, on-chain collateralized stablecoins are designed to maintain a stable value in reference to a specific asset, often the U.S. dollar, with a fixed one-to-one exchange rate. However, instead of holding traditional financial products such as cash and bonds in reserves, they instead hold other cryptocurrencies in their reserves. So on-chain collateralized stablecoins introduce an additional weakness, as the collateral is another cryptocurrency whose value can fluctuate significantly relative to the U.S. Dollar.[10] The largest on-chain collateralized stablecoin is MakerDAO's DAI ($4.8 billion), which uses a system of smart contracts and user deposits of Ethereum in exchange for DAI stablecoin tokens. Despite the decentralized nature of DAI and the use of Ethereum as collateral for its stablecoins, the DAI stablecoin depegged in March 2023 after the collapse of Silicon Valley Bank to 88 cents on the dollar.[11]

Non-collateralized stablecoins.

The most volatile and most dangerous of the three types of stablecoins are the non-collateralized stablecoins. Similar to off-chain and on-chain collateralized stablecoins, these stablecoins are designed to maintain a stable value in reference to a specific asset, often the U.S. dollar, with a fixed one-to-one exchange rate. However, instead of holding assets in reserves, non-collateralized stablecoins utilize complicated algorithms and smart contracts to maintain their peg to their reference assets.

While these stablecoins witnessed the most growth in the first half of 2022, they also witnessed the most dramatic collapses of all stablecoins. The most prominent collapse, which triggered the crypto carnage of 2022, was that of TerraUSD. At its height, TerraUSD was a $18 billion non-collateralized stablecoin that used a companion token, LUNA, to help it maintain a one-to-one peg with the U.S. dollar. However, this financial alchemy project blew up in a matter of days in May 2022. The crash in crypto markets that followed Terra's collapse inflicted painful losses on millions of retail investors.[12] The $40 billion overnight collapse of both TerraUSD and LUNA

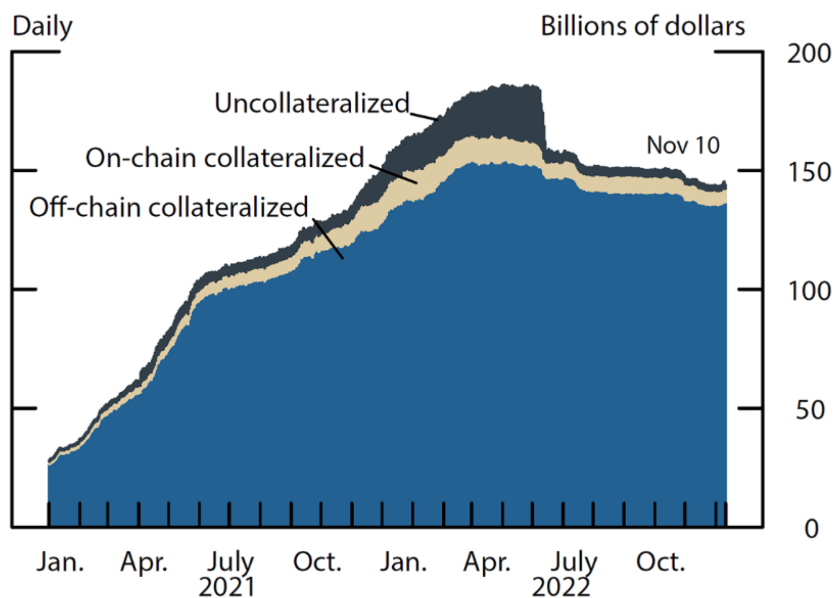
[9] Olga Kharif, *Circle USDC Stablecoin Redemptions Rise to About $6 billion*, BLOOMBERG (Mar. 21, 2023), https://www.bloomberg.com/news/articles/2023-03-21/redemptions-rise-to-about-6-billion-from-circle-usdc-stablecoin?sref=mQvUqJZj.

[10] Garth Baughman, Francesca Carapella, Jacob Gerszten, and David Mills, The stable in stablecoins, FEDS Notes, Board of Governors of the Federal Reserve System (Dec. 16, 2022), https://www.federalreserve.gov/econres/notes/feds-notes/the-stable-in-stablecoins-20221216.html.

[11] Sam Reynolds, *DAI Depegs to Lifetime Lows as Stablecoin Rout Plagues Crypto*, COINDESK (Mar. 11, 2023), https://www.coindesk.com/markets/2023/03/11/dai-depegs-as-stablecoin-rout-plagues-crypto/.

[12] Wilmarth, Arthur E. Jr., Comment Letter to the U.S. Treasury Department regarding the Risks of Stablecoins (2022), https://scholarship.law.gwu.edu/faculty_publications/1623.

caused widespread financial panic in the crypto ecosystem, spurring more than $300 billion in losses in the aftermath, including notably FTX.[13]



Source: Federal Reserve [The Fed - The stable in stablecoins (federalreserve.gov)](#)

Redeemability Risks

In addition to the risk of stablecoins due to their stabilization mechanism, stablecoins contain other features that add to their riskiness. For instance, investors should be able to redeem their stablecoins at any moment and at par value to the referenced, fixed exchange rate. However, stablecoin issuers often constrain investors' right of redemption and offer insufficient public disclosure about their redemption terms. Currently, the two most prominent stablecoins issuers do not provide a direct right of redemption to investors because many of those investors purchase the stablecoin through unregulated cryptocurrency exchanges.[14] In other cases, holders of stablecoins also face limits or high minimum thresholds for redemptions.[15] This makes them unredeemable for the majority of ordinary retail users.[16] Investors must pay particularly close

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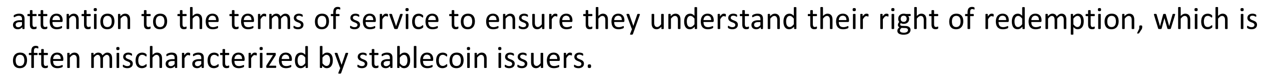
[13] Elizabeth Napolitano, *The Fall of Celsius Network: A Timeline of the Crypto Lender's Descent Into Insolvency*, COINDESK (Jul 15, 2022), https://www.coindesk.com/markets/2022/07/15/the-fall-of-celsius-network-a-timeline-of-the-crypto-lenders-descent-into-insolvency/.

[14] *See* Gary Gensler, Chairman, Sec. and Exch. Comm'n, Prepared Remarks of Gary Gensler on Crypto Markets at Penn Law Capital Markets Association Annual Conference (Apr. 4, 2022); *See, e.g.,* Circle Legal & Privacy (Last updated December 20, 2022) ("You may not redeem USDC with Circle unless and until you open a Circle Account. Eligibility for and requirements related to opening a Circle Account are set forth in the Circle Account User Agreement."), https://www.circle.com/en/legal/usdc-terms; *See, e.g.,* Tether Legal (Last updated September 2, 2022) ("In order to cause Tether Tokens to be issued or redeemed directly by Tether, you must be a verified customer of Tether. No exceptions will be made to this provision"), https://tether.to/en/legal/.

[15] *See* Tether Legal (Last updated September 2, 2022) ("Tether reserves the right to delay the redemption or withdrawal of Tether Tokens if such delay is necessitated by the illiquidity or unavailability or loss of any Reserves held by Tether to back the Tether Tokens"), https://tether.to/en/legal/.

[16] Mitsu Adachi et al., Stablecoins' role in crypto and beyond: functions, risks, and policy, European Central Bank, https://www.ecb.europa.eu/pub/financial-stability/macroprudential-



attention to the terms of service to ensure they understand their right of redemption, which is often mischaracterized by stablecoin issuers.

Money Market Funds by Another Name

Much like an off-chain collateralized stablecoin, a money market fund is a financial services product that invests in short-term corporate and government debt securities while offering investors a stable value of exchange. Created in the 1970s, money market funds purported to offer investors higher returns than bank deposit accounts, while at the same time offering the same security as a bank account. Because of their stable value and higher rate of return, investors came to expect they could benefit from the same on-demand liquidity and protection from losses that they already received through bank deposit accounts. However, money market funds are unlike bank deposit accounts, which are facilitated and supported by extensive regulations that ensure the safety and soundness of banks and explicitly protect depositors from losses—from capital requirements that ensure the financial health of banks to federally-backed, bank-funded deposit insurance that protects depositors from losses should their banks fail. Money market funds do not have mandatory capital cushions, deposit insurance, or the other protections surrounding bank accounts. Thus, despite the purported stable value offered to investors by money market funds, in times of stress they have experienced bank-like runs requiring government bailouts.

During the Financial Crisis of 2008 and the COVID-19 panic in the markets in March 2020, money market funds "broke the buck" from their fixed exchange rates. During the week of September 15, 2008, investors withdrew approximately $310 billion (or 15 percent) of prime money market fund assets. This caused havoc in the short-term funding markets, triggering a vicious cycle of asset fire sales, depressed prices, redemption requests, more asset fire sales, and rapidly evaporating liquidity. Controlling the run required drastic government (and taxpayer) intervention: the Treasury, on September 19, 2008, established the Temporary Guarantee Program for Money Market Funds, and the Federal Reserve established a variety of facilities to support the credit markets frozen by the money market fund crisis.

Once again, in March 2020, the money market fund industry experienced financial stress and the corresponding contagion imperiled the markets broadly and forced government intervention. For the second time in just a dozen years, taxpayer money had to be put at risk to support a backstop of money market funds. The assets of prime money market funds dropped dramatically. For example, ICI data showed that prime money market fund assets overall dropped by $85.38 billion, or over 10%, just between March 4 and March 18, 2020. Some funds were faring much worse, with their assets falling by half as investors withdrew.[17] And many money market fund sponsors were being forced to backstop their money market funds with cash infusions to prevent

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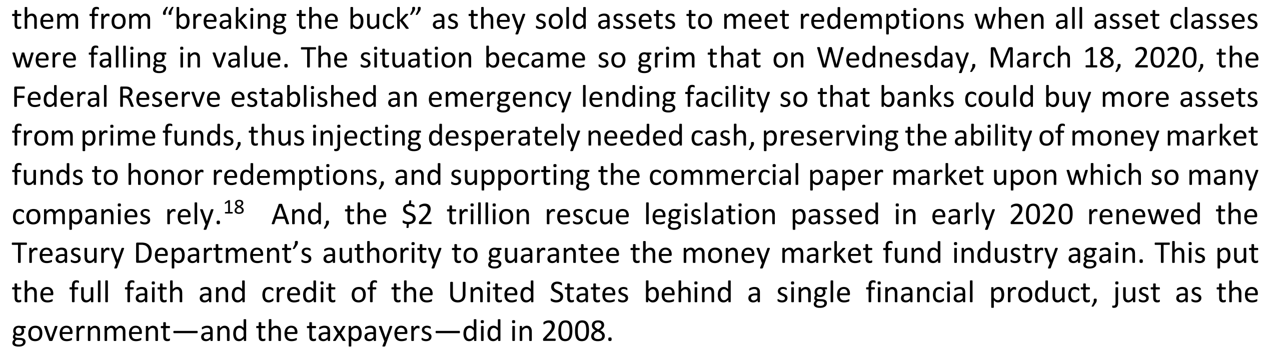
[17] Paul Kiernan, Andrew Ackerman & Dave Michaels, *Why the Fed Had to Backstop Money Market Funds, Again*, WALL ST. J. (Mar. 21, 2020), https://www.wsj.com/articles/why-the-fedhad-to-backstop-money-market-funds-again-11584788401?mod=article_inline.



them from "breaking the buck" as they sold assets to meet redemptions when all asset classes were falling in value. The situation became so grim that on Wednesday, March 18, 2020, the Federal Reserve established an emergency lending facility so that banks could buy more assets from prime funds, thus injecting desperately needed cash, preserving the ability of money market funds to honor redemptions, and supporting the commercial paper market upon which so many companies rely.[18] And, the $2 trillion rescue legislation passed in early 2020 renewed the Treasury Department's authority to guarantee the money market fund industry again. This put the full faith and credit of the United States behind a single financial product, just as the government—and the taxpayers—did in 2008.

One of the purported benefits of money market funds to investors is the higher rate of return than bank deposit accounts. A big distinction between money market funds and some of the most prominent stablecoins is that money market funds actually return interest to its investors. Investors in Tether and USDC receive none of the interest that the pooled assets collect. Instead, those assets go right to Tether and USDC's bottom line. Even a conservative investment portfolio of short-term U.S. Treasury bills can yield between 2-4%, which for an $80 billion investment portfolio can mean billions of dollars in profits that investors of stablecoins are forgoing. For example, Tether claimed to make $1.4 billion in net profit last quarter alone, all forgone interest income from its investors.[19] Compared to the $2.36 billion in net income Mastercard made last quarter, stablecoins are quickly catching up to major credit card companies in gouging their consumers.

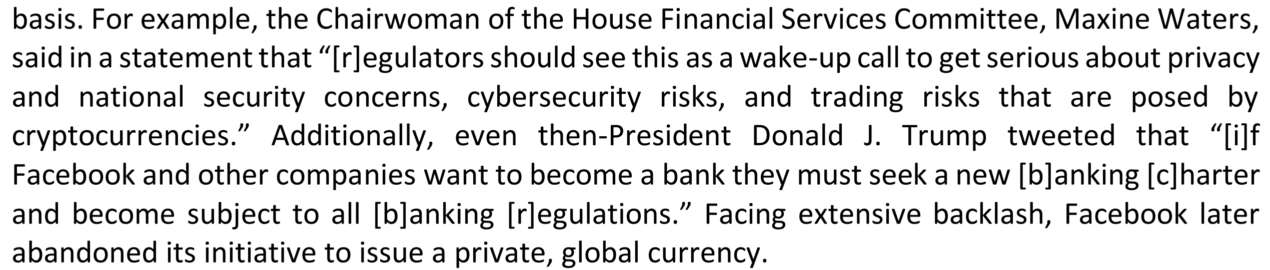
The short history of stablecoins and the much longer history of money market funds have confirmed that these similarly designed products—offering instant liquidity to investors despite holding much longer duration assets—are susceptible to bank-like runs, especially during periods of financial stress. However, unlike bank deposit accounts, investor assets are not insured by the FDIC. Further, the recent volatility in the regional banking sector, specifically the runs on banks with high percentages of uninsured deposits, is further proof that any financial product will be subject to bank-like runs absent a federal guarantee. Stablecoins have already faced significant bank-like runs in their short history and have proven that during times of financial stress they are anything but "stable."

The Misguided Lure of Private Money

Since the announcement of Facebook's Project Libra in June 2019, which sought to create a blockchain-based stablecoin payment system, regulators and policymakers have grappled with the idea of a blockchain-based stablecoin. In the midst of the announcement, governments around the world and policymakers in the U.S. expressed concern with the project on a bipartisan

[18] James Politi, Federal Reserve sets up facility to make loans to banks, FIN. TIMES (Mar. 19, 2020), https://www.ft.com/content/0e6029be-6995-11ea-800d-da70cff6e4d3.

[19] Tether, Tether's Latest Q1 2023 Assurance Report Shows Reserves Surplus At All-Time high of $2.44B, up $1.48B in Net Profit; New Categories for Additional Transparency Reveals Bitcoin and Gold Allocations, (May 10, 2023), https://tether.to/en/tethers-latest-q1-2023-assurance-report-shows-reserves-surplus-at-all-time-high-of-244b-up-148b-in-net-profit-new-categories-for-additional-transparency-reveals-bitcoin-and-gold-allocations/.



basis. For example, the Chairwoman of the House Financial Services Committee, Maxine Waters, said in a statement that "[r]egulators should see this as a wake-up call to get serious about privacy and national security concerns, cybersecurity risks, and trading risks that are posed by cryptocurrencies." Additionally, even then-President Donald J. Trump tweeted that "[i]f Facebook and other companies want to become a bank they must seek a new [b]anking [c]harter and become subject to all [b]anking [r]egulations." Facing extensive backlash, Facebook later abandoned its initiative to issue a private, global currency.

However, despite that announcement by Facebook and the severe backlash by governments around the world, the use of stablecoins have risen in prominence, although only as a means of facilitating trading in cryptocurrencies. Nevertheless, stablecoin advocates have advanced the theory that stablecoins could be an effective form of payment for a broader spectrum of assets. Now, regulators and policymakers are debating how to regulate stablecoins as "payment stablecoins" even though they are not currently used as a form of payment outside the incestuous world of crypto. Moreover, both regulators and policymakers have skipped the more important threshold question of whether or not it is desirable to have a form of currency controlled by a private company coexisting with the U.S. dollar, a sovereign currency controlled and issued by the U.S. government. For instance, banks use customer deposit funds to make loans to individuals in their community, spurring economic activity. Additionally, tying up safe and liquid assets in a stablecoin arrangement means they are not available for other uses, such as helping banks satisfy their regulatory requirements to maintain sufficient capital and liquidity. This could lead to disruptive shortages of safe and liquid assets.[20] Have regulators or policymakers explored the primary and secondary economic effects of a migration of customer funds out of banks and into digital wallets? What are the effects on bank lending to prospective homeowners to purchase their first house or the effects on small business lending for innovative entrepreneurs seeking to start their own business? These are important economic considerations being glossed over in this debate over how to regulate payment stablecoins.

There is a reason why privately issued currencies are not prominent in the U.S. economy and it isn't because they have never been attempted. Prior to enactment of the National Banking Act of 1863, private banks issued their own bank notes on a one-for-one basis with state bonds in a period known as the Free Banking Era.[21] However, these hyper-localized currencies required merchants to be wary when accepting bank notes for fear of counterfeiting.[22] The inefficient Free Banking Era was replaced when the National Bank Act required all notes to be backed by U.S. Treasury bonds and the taxation of all forms of private bank notes. Another example of private currencies in the U.S. was the use of company scrip in remote towns across the country. Scrip was a credit for wages and it was often used in remote towns where money supply was scarce and a single private enterprise such as a mining company was the central employer. Private

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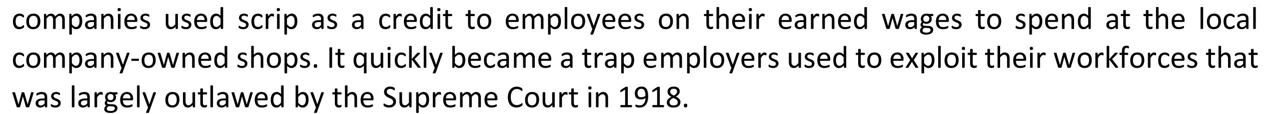
[20] Rod Garratt, Michael Lee, Antoine Martin, and Joseph Torregrossa, *The Future of Payments is Not Stablecoins*, Liberty Street Economics, Federal Reserve Bank of New York (Feb. 7, 2022), https://libertystreeteconomics.newyorkfed.org/2022/02/the-future-of-payments-is-not-stablecoins/.

[21] Gary B. Gorton and Jeffrey Y. Zhang, *Taming Wildcat Stablecoins*, 90 UNIV. OF CHICAGO L. REV. at 25 (Forthcoming 2023).

[22] Gorton and Zhang at 29.



companies used scrip as a credit to employees on their earned wages to spend at the local company-owned shops. It quickly became a trap employers used to exploit their workforces that was largely outlawed by the Supreme Court in 1918.

Regulators and policymakers should first debate whether or not private currencies as a form of payments, such as stablecoins, are in the best interest of the American people prior to codifying stablecoins as a form of payments. Private currencies have been tried in the U.S. before and abandoned because they were either too inefficient or because they were used by private enterprise to exploit their workers. Payment stablecoins appear to be repeating the mistakes of the past.

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