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Regulatory Alert

Regulatory Insights

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Interagency Report on Regulation of Stablecoins

This highly anticipated report from the President's Working Group on Financial Markets recommends that only insured depository institutions should be permitted to issue stablecoins. Congressional action would be required to implement the recommendation but in the absence of such action, the agencies further recommend the FSOC designate certain stablecoin activities as systemically important payment, clearing, or settlement activities. Together these recommendations reinforce the agencies' concerns and expectations that the risks associated with stablecoins should be subject to more comprehensive supervision and enforcement. In the near term, financial services companies, including nonbank financial entities and third parties, should anticipate heightened attention to activities related to payments and digital assets.

The President's Working Group on Financial Markets (PWG), consisting of representatives from Treasury, the Federal Reserve, SEC, and CFTC, in collaboration with the FDIC and OCC, has released a report on stablecoins—digital assets whose value is linked to an underlying asset such as a national currency or other reference asset. The report, however, is limited to "payment stablecoins," defined as those stablecoins that are designed to maintain a stable value relative to a fiat currency, due to the potential for these assets to be used as a widespread means of payment. The report suggests the use of stablecoins as a means of payment raises a range of prudential concerns (discussed below) and puts forth recommendations to address these concerns through both Congressional action and interim risk mitigation measures.

The report states that stablecoins are not currently subject to a consistent set of regulatory standards or a supervisory framework. Furthermore, due to varying stablecoin arrangements and participants, they primarily occupy the jurisdictions of the SEC and/or the CFTC, but can also fall within the oversight of other regulatory authorities, such as the federal banking regulators, DOJ, CFPB, and FinCEN, depending on facts and circumstances. The SEC and CFTC have primary enforcement, rulemaking, and oversight authorities over transactions and participants within their jurisdictions, but due to the wide distribution of responsibilities based on various arrangements, the report states there is risk of incomplete or fragmented oversight.

Recommendations

Based on the prudential risks posed by payment stablecoins, and the gaps in the current regulatory framework, the PWG recommends:

— Congress "act promptly" to enact legislation to ensure that payment stablecoins and associated arrangements are subject to a consistent and comprehensive federal regulatory framework, which would include:
  - **Establishing an appropriate federal prudential framework** for payment stablecoin arrangements by providing for consolidated supervision, prudential standards, and access to appropriate components of the federal safety net.
  - **Limiting stablecoin issuance, redemption, and reserve asset maintenance to insured depository institutions** (state- and federally-chartered banks and savings associations) that are subject to federal

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supervision and regulation, and safety and soundness standards such as liquidity and capital requirements and orderly resolution. Supervisory authority would extend to third parties performing activities critical to stablecoin arrangements.

- **Requiring federal oversight of custodial wallet providers**, including authority to restrict certain activities and require compliance with risk management, liquidity, and capital requirements.
- **Providing regulators flexibility to address future developments and risks** across a variety of organizational structures including the ability to adopt standards to promote interoperability between stablecoins.

— In the interim, the PWG recommends that the agencies use their existing authorities to address the prudential risks to the extent possible. This includes:

- Continued **coordination and collaboration between agencies and regulators** to address risks of overlapping jurisdictions related to payment stablecoins. Relevant authorities could include the federal banking regulators, DOJ, SEC, CFTC, CFPB, and FinCEN.
- Consideration by the **FSOC to designate certain stablecoin arrangements as "Systemically Important Payments, Clearing, or Settlement (PCS) Activities"**, and establish risk management standards for financial institutions engaging in those arrangements, including examination and enforcement.

Risks

These recommendations are intended to address the prudential risks posed by payment stablecoins that the PWG identified in the report, outlined below.

— **Loss of value: Risks to stablecoin users and stablecoin runs,** where:

- Confidence in the value of stablecoins could be undermined by:
  - Use of reserve assets that could fall in price or become illiquid
  - A failure to appropriately safeguard reserve assets
  - A lack of clarity regarding the redemption rights of stablecoin holders, or
  - Operational risks related to cybersecurity and the collecting, storing, and safeguarding of data.
- Failure of a stablecoin to perform as expected could pose systemic risk by resulting in a "run" on that stablecoin, which could disrupt funding markets, financial institutions, or the broader financial system.

— **Payment system risks**

- Payment stablecoins face many of the same basic risks as traditional payment systems, including credit risk, liquidity risk, operational risk, governance risk, and settlement risk.
- Key challenges in addressing these risks adequately are the lack of consistent risk management standards across various stablecoins, the varying participants in stablecoins payment arrangements, and operational complexities unique to each arrangement.

— **Risks of scale: Systemic risk and concentration of economic power**

- Stablecoins have grown rapidly in the past year and may continue to grow rapidly at both individual and aggregate levels. The potential for individual stablecoins to scale rapidly poses three risks:
  1. A single stablecoin issuer (or transaction participant, such as a custodial wallet provider) could pose systemic risk,
  2. The combination of a stablecoin issuer or wallet provider and a commercial firm could lead to an excessive concentration of economic power, such as accessing credit or using customer data with detrimental effects to competition, and
  3. A stablecoin that becomes widely adopted as a means of payment could present concerns about anti-competitive effects, such as costly transitions to other payment methods or services.
- Likewise, the aggregate growth of stablecoins may have important risk implications for the overall financial system. If insured depository institutions lose retail deposits to stablecoins, and the reserve assets that back stablecoins do not support credit creation, the aggregate growth of stablecoins could increase borrowing costs and impair credit availability in the real economy.

FATF. Treasury notes that stablecoins can pose illicit finance concerns and risks to financial integrity, particularly with rules governing Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT) and proliferation. The Financial Action Task Force (FATF) recently published updated guidance on implementation of FATF standards for virtual assets and virtual asset providers, including new information on how the FATF standards apply to stablecoins.

CFPB Response. Though not a member of the PWG or a participant in preparation of the report, the CFPB released a statement outlining steps it is taking in relation to crypto and digital assets that may translate to the stablecoin market. These include soliciting input on digital payments networks operated by Big Tech companies and monitoring consumer adoption of crypto currencies for other than trading purposes, which may trigger consumer protection regulations.

Relevant links:

— The Interagency Report on Stablecoins is available here.

— We encourage you to also read the KPMG Regulatory and Compliance Risk brief, *Stablecoin regulation and adherence*, available here.

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