



# Predicting Stablecoin Regulation: 5 Key Takeaways from Gorton and Zhang’s “Taming Wildcat Stablecoins”

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The recent [paper](#) by Yale economist Gary Gorton and Fed attorney and economist Jeffery Zhang — currently serving as a senior economist for the Council of Economic Advisors — seeks to demystify stablecoins by providing a thoughtful and thorough analysis of key legal issues and policy concerns raised by stablecoins. It is also timely: it was published nearly simultaneously to Fed Chair Powell telling Congress for the first time that stablecoins should be regulated and a highly publicized meeting of the President's Working Group on Financial Markets, which has promised to recommend a stablecoin regulatory framework by early fall.

At 40 pages, the paper is not an insurmountable read, but we figured we’d offer a quick synopsis of some of the key points.

**1. *Stablecoins are not new -- they are merely a new form of private money, “a subpar medium of exchange . . . subject to runs.”***

While stablecoins are garnering a lot of attention as cutting-edge means of payment, in reality, the authors argue, stablecoins merely represent the latest iteration in a long line of various forms of money that have evolved over time in the United States. Like private money instruments of the past – private banknotes of the 19<sup>th</sup> century, uninsured demand deposits, and money market mutual funds (MMMFs) – stablecoins present risks that, if left unchecked, can subject them to destabilizing runs.

This is because in order to be immune to these runs, money must meet what the authors call the “no questions asked (NQA)” principle, which “requires the money be accepted in a transaction without due diligence on its value.” In the absence of NQA, holders of the instrument tend to run if they suspect a decline in the value of the assets backing the instrument. This property of money has been difficult to achieve. Indeed, demand deposits “were unable to achieve NQA without deposit insurance,” which substantially mitigates run risk. But this problem has not been adequately solved for MMMFs, which are vulnerable to runs when they “break the buck.” “When the share price of a money market fund deviates more than 0.5 percent from its stable \$1.00 share price, investors will no longer be able to redeem one share for one dollar akin to bank depositors not being able to withdraw the full value of their deposits. Breaking the buck can unleash a market-wide panic as investors rush to sell their shares.” MMMFs are still subject to runs, as seen in 2020, even after more stringent controls were placed on these funds after the runs they experienced during the 2008 financial crisis.

The authors note that some stablecoin issuers have sought to mitigate this run risk by providing transparency into the holdings backing their promises that customers can redeem the par value of their coins. (As the authors show, even what transparency is provided is limited.) However, if past is prologue, mere transparency is not enough to stop runs. If customers suspect that the assets backing the coins are insufficient to cover the par value, then they will run. Usually, it’s the sophisticated customers who will figure it out first, and they quickly seek to get out at par before other less sophisticated holders realize what’s going on. As the institution rapidly seeks to sell more and

more assets to meet redemptions, fire sales can ensue, causing asset prices to fall, risking the spread of contagion throughout the system. The strong incentive to get out the door first is what makes runs so dangerous, destabilizing and costly.

So, the authors argue, government regulation *ex ante* to prevent an inevitable and potentially destabilizing run on stablecoins is preferable to avoid a future stablecoin bailout – like those which the government provided for the MMMFs twice in the last 13 years – in the future.

How should stablecoins be regulated? The authors present several options for the federal government to address the NQA problem and run risk presented by stablecoins.

**2. To mitigate risks posed by stablecoins, the government could explore ways to bring them within the regulatory perimeter. One way would be to treat stablecoins like bank deposits.**

The authors argue that many stablecoins are akin to deposits, and thus stablecoin issuers could be regulated like banks. The authors point to Section 21 of the Glass-Steagall Act which makes it a crime for a person to accept deposits without being properly licensed and regulated as a bank.<sup>1</sup>

To determine whether stablecoins are deposits, the authors look to a December 18, 1979, DOJ interpretation of section 21 of the Glass-Steagall Act distinguishing between deposits and shares in MMMFs.<sup>2</sup> In that interpretation, the DOJ distinguished deposits from MMMF shares based on the fact that depositors are creditors of banks, yet holders of MMMF shares are owners. As the DOJ put it:

“It is patent . . . that a depositor is only a creditor of his depository (a debtor in the case of an authorized overdraft, which indebtedness he must liquidate by a “deposit”). It is equally patent that one who invests in a money market fund is an owner pro tanto of the fund. Availability of particular mechanisms for an investor to transfer his ownership is a mere formality and serves in no way to alter the substance of his status as an owner . . . he is not, by his selection of the mechanism of a combined order to sell and pay over (check) to realize his investment, converted into a mere creditor of the fund with no expectation of capital gain or loss from the fund upon realization.”<sup>3</sup>

Gorton and Zhang note that under this analysis, most stablecoins look more like deposits than MMMF shares “because holders of those stablecoins are not owners of the stablecoin issuer. [Rather, t]hey are essentially a creditor of their depository—e.g., 1,000 stablecoins for 1,000 U.S. dollars.”

Therefore, one way to protect investors in stablecoins is for “the Department of Justice to update and publicize its interpretation of section 21 of the Glass-Steagall Act,” declaring that stablecoins are deposits and thereby forcing those stablecoin issuers to conduct their business within a licensed bank. The stablecoin issuer could, presumably, itself become a licensed bank, or it could choose to conduct its stablecoin activities through a partnership with a licensed bank (as Facebook is reportedly planning to do with its stablecoin, Diem). If the stablecoins are sold to

<sup>1</sup> Section 21 of the Glass-Steagall Act basically requires deposit-taking to be conducted only by organizations that are licensed, regulated and examined as or like banks. See Section 21(a) of the Glass Steagall Act, codified at 12 U.S. C. 378(a) (“it shall be unlawful...for any person... to engage... in the business of receiving deposits ... unless such person [is] authorized to engage in such business ...and subjected to examination and regulation . . . or [otherwise subject to] examination by the [relevant state or federal] banking authority... [just like any other] banking institution...”). Willful or knowing violations of Section 21(a) are punishable by up to five years in prison.

<sup>2</sup> The authors do not identify the date of the letter, but state that the letter was from Philip B. Heymann, the Assistant Attorney General of the Criminal Division, to Martin Lybecker, Associate Director, Division of Marketing Management, Securities and Exchange Commission, in response to an inquiry dated October 18, 1979. Based on our own research, we believe the letter to have been dated Dec. 18, 1979.

<sup>3</sup> Letter from Philip B. Heymann, Assistant Attorney General of the Criminal Division, to Martin Lybecker, Associate Director, Division of Marketing Management, Securities and Exchange Commission, December 18, 1979.

retail customers, that would be the equivalent of accepting retail deposits, and the bank then also would be required by law to carry FDIC insurance.<sup>4</sup>

The authors observe that this approach could bring other bank-like entities such as PayPal, Venmo, WeChat Pay, and AliPay into the regulatory perimeter, as these payments platforms effectively allow customers to accumulate “positive balances” that look and feel a lot like deposits subject to Section 21(a) restrictions.<sup>5</sup>

The argument that stablecoins are deposits and therefore the activity must be conducted within a licensed bank does not extend to those stablecoins that are, like MMMFs, based on equity contracts rather than debt contracts. The authors cite Tether as an example of this kind of arrangement.

As a side note, the authors consider, but ultimately dispense with, the idea of whether existing stablecoin issuers might fall within the scope of the BHC Act. This would happen if the issuers met the BHC Act’s definition of “bank,” which in relevant part includes an institution that both accepts demand deposits and makes commercial loans. On the one hand, stablecoin “deposits” look a lot like *demand* deposits, based on the test articulated in the Supreme Court case, *Board of Governors of the Federal Reserve System v. Dimension Financial Corporation*. Demand deposits are those that the depositor has a legal right to withdraw on demand – without any prior notice requirement. Based on the current terms of agreement, many stablecoin issuers could be considered to be accepting demand deposits. On the other hand, the authors conclude that stablecoin issuers are unlikely to be deemed to make commercial loans, citing a narrow test articulated for such lending transactions by the Supreme Court in *Dimension Financial*.

### **3. Another way would be for FSOC to designate stablecoins as systemically important payment instruments.**

As the authors note, Title VIII of the Dodd-Frank Act authorizes the FSOC to designate “**payment, clearing, or settlement activities** that [FSOC] determines are, or are likely to become, systemically important” conducted by financial institutions.<sup>6</sup> “Payment, clearing, or settlement activity” means “an activity carried out by 1 or more financial institutions to facilitate the completion of financial transactions,” subject to an exclusion for sales of securities and related activities.<sup>7</sup>

Once such an activity is designated, the Fed has the authority to “prescribe risk management standards . . . governing the conduct of designated activities by financial institutions” and, on delegation from the appropriate financial regulator, may examine the financial institution conducting such activities and has backup examination authority over these activities as well.<sup>8</sup> The authors posit that the “Federal Reserve could then require stablecoins

<sup>4</sup> Federal deposit insurance is mandatory for all federally-chartered banks. All states also require federal deposit insurance for newly-chartered banks that accept retail deposits. A few states permit banks to accept wholesale deposits without a requirement that they be FDIC-insured (e.g., Connecticut and Wyoming).

<sup>5</sup> For example, PayPal’s current account agreement states, “Any balance in your Cash Account represents an unsecured claim against PayPal. Your cash funds held in a PayPal Cash account are eligible for Federal Deposit Insurance Corporation (“FDIC”) pass-through insurance, but only if you have bought cryptocurrency. Your cash funds held in a PayPal Cash Plus account are eligible for FDIC pass-through insurance, but only if you have a PayPal Cash Card debit card, or have enrolled in Direct Deposit, or have bought cryptocurrency. If your Cash Account is not eligible for FDIC pass-through insurance, PayPal combines your Cash Account balance with the balances of other Cash Account holders and invests those funds in liquid investments in accordance with state money transmitter laws. PayPal owns the interest or other earnings on these investments. However, the claim against PayPal represented by your Cash Account balance is not secured by these investments and you do not have any ownership interest (either legal or beneficial) in these investments. <https://www.paypal.com/us/webapps/mpp/ua/cashagreement-full> (emphasis added).

<sup>6</sup> 12 U.S.C. § 5463(a)(1).

<sup>7</sup> 12 U.S.C. § 5462(7). A “financial institution” includes a company engaged in activities that are financial or incidental to a financial activity under section 4 of the BHC Act. 12 U.S.C. § 5463(5).

<sup>8</sup> 12 U.S.C. § 5464(a)(1); 12 U.S.C. § 5467(d)-(e).

to be issued from FDIC-insured banks or require stablecoin issuers to hold cash reserves at the Federal Reserve one-for-one (i.e., transform stablecoins into public money).”

The authors identify a few drawbacks with this approach. First, they believe that some may argue that “stablecoins are currently not systemically important.” However, the FSOC can designate a payment activity that is “likely to become” systemically important, so this may not be a significant roadblock. Second, the authors note that FSOC designation can be reversed, as happened with MetLife, which was “undesignated” when a district court judge determined that the designation was arbitrary and capricious.

**4. Yet another way would be for Congress to act, ideally creating a uniform national framework, reducing fragmentation and opportunities for regulatory arbitrage.**

The authors describe several legislative options that could address the risks presented by stablecoins. For example, if Congress required stablecoins – and all other entities presenting the same fundamental economics as banks, regardless of legal distinctions – to become FDIC-insured banks or to run their businesses out of FDIC-insured banks. This would eliminate, or at least reduce, the current fragmented regulation of economically identical entities that have taken advantage of loopholes or special chartering opportunities to avoid full bank regulation and supervision, such as the state-chartered cryptobanks, the OCC’s national trust charters to cryptofirms and industrial loan companies.

**5. Finally, private digital money, like stablecoins, could be replaced with public digital money in the form of a central bank digital currency issued by the Federal Reserve.**

Finally, the authors opine that the sovereign should have a monopoly on money issuance, because “the provision of NQA money is a public good, which only the government can supply. In addition, preserving the monetary sovereignty of the government is crucial for monetary policy.” The authors suggest that Congress could retain this monopoly by requiring the Federal Reserve to issue a central bank digital currency (CBDC) as a substitute for privately-issued stablecoins. The authors state without substantial analysis that “The benefits of implementing a central bank digital currency are to increase the convenience yield, reduce the costs of payment systems and maintain monetary sovereignty.”

The authors do note some of the drawbacks of a CBDC, primarily highlighting the market distortions that would occur in the capital markets if the central bank, all of a sudden flush with deposits, had to invest that money. These distortions, the authors assert, would arise from the private sector’s overproduction of “the highest risk securities that the Federal Reserve purchases . . . ‘if central bank money is available only against igloos, or igloo-backed securities, igloos will be built.’”<sup>9</sup>

In a series of [research notes](#), we at BPI have analyzed the complex costs and benefits of a CBDC. For example, Gorton and Zhang do not discuss the massive reduction in lending and economic growth that would occur if deposits that currently fund loans moved to the “digital mattress” that a CBDC represents, either in a steady state or in crisis (e.g., March 2020). As Federal Reserve Vice Chairman Quarles recently observed, “a Federal Reserve CBDC could create considerable challenges for the structure of our banking system, which currently relies on deposits to support the credit needs of households and businesses. An arrangement where the Federal Reserve replaces commercial banks as the dominant provider of money to the general public could constrict the availability of credit, fundamentally alter the economy, and expose the public to a host of unanticipated, and undesirable,

<sup>9</sup> Citing Kjell G. Nyborg, COLLATERAL FRAMEWORKS: THE OPEN SECRET OF CENTRAL BANKS (2016). See also Stefano Pegoraro & Mattia Montagna, Issuance and Valuation of Corporate Bonds with Quantitative Easing, ECB WORKING PAPER SERIES NO. 2520 (Jan. 2021), available at <https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2520~9bb4771fac.en.pdf>.

consequences.”<sup>10</sup> Nor do the authors explain how the type of CBDC they envision can be consistent with existing laws to restrict money laundering and counter the financing of terrorism, or to impose economic sanctions. Nor do they discuss the [implications for U.S. monetary policy](#) that a CBDC would have.

If policymakers consider a U.S. CBDC as a possible antidote to the systemic threats that stablecoins may pose, they should undertake a more robust and balanced analysis about the possible implications of a CBDC.

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<sup>10</sup> Speech by Federal Reserve Board Vice Chair for Supervision Randal K. Quarles, At the 113th Annual Utah Bankers Association Convention, Sun Valley, Idaho, “Parachute Pants and Central Bank Money,” (June 28, 2021), available at: <https://www.federalreserve.gov/newsevents/speech/quarles20210628a.htm>.