

Making Stablecoins Stable: Is the Cure Worse than the Disease?

Greg Baer | Sept. 27, 2021

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I'll begin with something of a disclaimer. As an aside, I should note that when I hear people from government agencies or major organizations begin their remarks by saying that they don't represent the views of their organization, I always think either, "Then why the hell am I listening to you?" or "You're clearly lying; of course you speak for your organization!" So, I generally resist the urge to issue disclaimers. But in this case, not only have I not consulted my members yet but also I'm not even sure if I'm right. So, if it turns out I am right, and even prescient, then these were in fact the views of BPI; if I turn out to be wrong, these are the views of my administrative assistant, Emily Harris, who clearly corrupted the file.

So, off we go.

We are currently coming to the end of an era that I'll call the "unstable stablecoin." Stablecoins have been issued with backing from assets that include commercial paper and in some cases receivables, including loans to crypto affiliates. Four problems have arisen with unstable stablecoins.

First, as a matter of consumer protection, many stablecoin issuers have failed, with consumers losing all their money – whether because the underlying declined in value, or in some cases when the money was simply stolen through hacking or defalcation.

Second, such stablecoins have been marketed as being backed by "reserves," an undefined term but one that consumers could be forgiven for not equating with uncollateralized receivables. So, consumers have been *deceived*.

Third, because stablecoins are regulated at the state level as money service businesses, there is generally no requirement that they even disclose what is backing the stablecoins. For those who wish to know more, I heartily recommend a law review article – something I say infrequently – titled "Bad Money" by Dan Awrey.¹

Fourth, while it has yet to materialize, financial stability risk could arise if the failure of a major stablecoin issuer prompted a run on other stablecoins, with those stablecoins forced to liquidate the assets backing those coins and – well, we've seen this movie before.

All that said, this era will end soon. Enforcement action may await those who misled the public, but more significantly, securities regulation appears certain to await the stablecoins they offer. At the very least, it seems, issuers will be required to register as money market funds, and become subject to the disclosure requirements that come with securities regulation.

¹ https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3532681#

Even if regulation were not going to force a change, the market would. Currently, the predominant users of stablecoins are those engaged in crypto trading and decentralized finance. This cohort is by definition highly tolerant of risk. After all, they are using stablecoins as a currency to trade 24/7 in crypto assets that have no underlying value, often with considerable leverage. So, the risk of a stablecoin losing its value may be the least of their worries from a risk perspective. Thus, if stablecoins were to migrate to become prime money market funds, this cohort would probably be satisfied with taking that risk.

(Of course, this assumes as a matter of *technology* that an interest in a prime money market mutual fund could be tokenized and therefore fit for the use that stablecoins currently serve as means of exchange in crypto trading. And this means that they would need to exist in a form that is consistent with compliance with anti-money laundering/countering the financing of terrorism laws, tax compliance and sanctions enforcement. I don't see why they could not – though I readily acknowledge that I could be wrong.)

In any event, if stablecoins are to migrate for use from a crypto trading sidecar to serve as a consumer or commercial payments instrument, their *new* holders will be utterly intolerant of the risks stablecoins currently present. So, the *use case* -- the *market* -- as much as regulation, will dictate their holdings. That means that if they are to take the form of a money market mutual fund, it will perform be a Treasury fund or a government fund – that is, invested in cash, government securities, or repo backed by government securities. These, then, would be *stable* stablecoins.

The question, then, is: are *stable* stablecoins a greater threat to financial stability than *unstable* stablecoins? Is the cure worse than the disease?

So, suppose we have a Diem that ends up being effectively a tokenized version of a government money market fund. And let's assume that it would be constructed to comply with all the relevant law enforcement and foreign policy imperatives – so not a vehicle for money laundering or tax or sanctions avoidance. What would be the use case for customers? Put more specifically, why would *consumers* choose to move money out of their FDIC-insured accounts and into a money fund in the form of a stablecoin, and why would *businesses* choose to move their uninsured deposits out of a deposit and into such a thing? The latter question is complicated by the fact that a deposit is only part of a suite of products offered by a bank providing treasury services or serving as a prime broker, which makes such a transfer more costly to the business.

The first incentive would be interest paid on the investment. Of course, this is how government funds make their money now – by paying investors an interest rate and earning the margin between that rate and the rates earned on the underlying assets. Another answer of course is marketing. This is a powerful force. And marketing could include benefits offered by Facebook or another issuer – access to special discounts. Assuming, though this is debatable, that interchange fees are not charged on transfers of the stablecoin, merchants might reward it as a payments mechanism. Another incentive could be ease of use in payments, particularly cross-border payments or remittances. Currently, no one would think to use a government money market fund as a payments mechanism. But if it took a form that was quickly and cheaply transferred, one might.

What would be the effect on financial stability of such a project at scale, assuming that consumers move considerable money out of their bank deposits and into stablecoins in one digital wallet or another? Banks would have less funding and less stable funding with which to finance loans, and the cost of loans therefore would increase, and their availability decrease. On the other hand, demand for government securities would increase as those would be the only assets available to fund growing stablecoin issuance; presumably Treasury yields would be lower. So the Treasury and the GSEs would be able to fund themselves more cheaply, even as U.S. consumers and businesses would have to fund themselves more expensively.

(One interesting aside: government money market funds are permitted to invest in agency securities issued by Fannie, Freddie and the Federal Home Loan banks. Given financial stability concerns, their inclusion would make them even more clearly TBTF, and should preclude their ever being privatized.)

The loss of significant deposit funding for banks would be a significant development. The core business of banking in this country has been maturity transformation, resting on a system of fractional reserves. Post-1864, national banks issued liabilities payable on demand and backed those liabilities with a fractional reserve in the form of specie and notes of, or deposits at, other specie-paying banks. Since 1913, banks have taken deposits, with a percentage of those deposits in the form of reserves at the Fed or vault cash, and then were able to lend out the rest. This system allows short-term deposits to fund medium- and long-term loans to consumers and businesses. Currently, there are no reserve requirements, given a revolution in how the Fed conducts monetary policy, but instead banks are subject to capital and liquidity requirements, which serve to safeguard deposits – but still leave a large proportion of those deposits available for lending to the real economy. And because those deposits are a stable and low-cost source of funding to the bank, the economy benefits from low-cost loans that are available through the economic cycle.

It is worth noting that concerns about the impact of stablecoins on banking are magnified, not reduced, with one option that some have advocated as a substitute for privately issued stablecoins: a central bank digital currency. As I have [written before](#), a fundamental problem arises from the fact that a CBDC would be a direct obligation of the central bank. As such, it cannot support lending, any more than a banknote in your wallet can; it is a digital mattress or electronic safety deposit box. Thus, whereas in 2009 and 2020, corporates looking to move to the lowest-risk asset could not hire enough armored cars to take physical cash and did not think of government money funds as a means of exchange, they could have effortlessly moved assets from money funds and bank deposits to a riskless CBDC if one had been available.

Clearly, in crisis, that result could be catastrophic, but problems would arise even in peacetime. Bank liquidity regulation presumes that insured deposits and more importantly corporate operational deposits are stable funding. But with a CBDC waiting in the wings, deposits could no longer be considered such stable funding. Which is to say that regulators would be less willing to allow them to fund illiquid loans. So, banks, too, would be forced to become larger buyers of Treasury securities and GSE debt, and lend less to small and large businesses and consumers.

So, an easy-to-use, Treasury-backed stablecoin or a CBDC risks severely undermining the system of fractional reserve banking that has supported lending and thus our economy for over a hundred years.

Some may view the end of fractional reserve banking as a benefit. The President's nominee for Comptroller of the Currency, Professor Omarova, advocated in 2020 for the government to move *all* demand deposits from the banking system to the Federal Reserve. Thus, the individuals and businesses currently holding over \$6 trillion in deposits would be forced to become creditors of the government, not the banking system. The government then would be responsible for lending out this money, effectively replacing the banking system as a commercial, consumer and municipal lender. Of course, the government could use that \$6 trillion to fund banks or others making loans as its agent, but then it would have to determine which lenders would receive that funding, and on what terms and to whom they would make those loans, as the taxpayer would be backing them directly. In her manifesto, Professor Omarova notes that this would end the potential for bank runs, which is certainly correct, but a lot of baby would go out with that bath water.

Thus, three threats to the existing fractional reserve system are currently present: first, privately issued stablecoins; second, a central bank digital currency; third, a nationalization of deposits as the state forcibly takes control of what has heretofore been the business of banking. Without fractional reserve banking, there seem to be two possible results: first, lending being increasingly

funded by market-financed companies, which will inevitably be higher-cost and more likely to dry up under stress, leading to more frequent government interventions; second, a state-run economy, which to put it mildly has an extremely poor history.

There is actually a fourth threat, albeit moribund, which is worth noting. Little noticed, but four years ago, a former Federal Reserve staffer applied for a bank charter to operate a bank called The Narrow Bank. Its business model, which would have seemed unimpeachable from a risk perspective, was to take uninsured corporate deposits and invest them in reserves at the Fed, where they would earn interest. The bank would pass through most of that Fed-paid interest to its depositors, and retain the rest as profit. It was a riskless business model, and in retrospect a trial run for the notion of a stable stablecoin. But the Federal Reserve denied the application because it would encourage flights to safety and would disintermediate banks and have unpredictable disruptive consequences. An interesting precedent indeed.

Notably, under all these options, there would be less reason to hold a commercial bank charter. One of the oddities of post-crisis regulation has been that nonbank affiliates of banks are regulated just as intensively as their bank affiliates. One could reason that this is justified given that while bank deposits are government-guaranteed and nonbank affiliates are market-funded, the reason that nonbanks merit regulation is exactly that absence of that deposit funding – as their reliance on market funding makes them more susceptible to runs. What this logic wholly fails to explain is why nonbank affiliates that are *not* affiliated with banks are subject to no prudential regulation by the Federal Reserve. Consider Citadel Securities — the largest market maker in options in the United States and a firm that executes over 27% of U.S. equities volume and 37% of U.S. retail equity volume.² It is not subject to regulation or examination by the Federal Reserve because it has no commercial bank affiliate. But if it were to establish a commercial bank affiliate and take even \$1 of deposits, it would be subject to the full panoply of federal bank regulation and examination.

What is puzzling is that an assault on commercial banking should come at this time. We have seen commercial banking distinguish itself in the response to COVID. It seems inarguable that one of the great lessons of the Global Financial Crisis in 2008-09 was that deposit-funded lending was the only form of finance that was stable under stress. The great lesson that regulators took from that crisis was that financial intermediation based on short-term wholesale funding was unstable, even if that funding was collateralized by high-quality assets. The liquidity regulations written post-crisis explicitly rewarded banks for funding themselves either with insured deposits or operational wholesale deposits. All three of the current initiatives would serve to bleed those deposits away.

Meanwhile, consumers now transfer money to each other in real time through apps like Zelle and Venmo. The Clearing House, a utility operated by 24 banks, has been offering a real-time payments system for a couple of years, which is currently accessible to financial institutions that hold 73% of U.S. demand deposit accounts. Growing applications include real-time payment of wages; instant transfers routed through the RTP network became available on PayPal's Venmo in August 2019, and in February 2021, Early Warning Services and The Clearing House announced that Zelle transactions can officially be cleared and settled over the RTP network. The Federal Reserve has said it plans to offer a competing system in coming years. Again, assuming stablecoins will not offer anonymity in furtherance of illegal conduct, it is difficult to understand as a business matter what is gained by consumers paying each other for their pizzas or concert tickets, or a business paying a supplier, with a stablecoin rather than an instantaneous bank transfer. Perhaps more importantly, as a policy matter, it is difficult to understand what societal benefits they offer that could possibly offset their potential costs.

The one component of the current payment system that is the slowest and most costly is cross-border payments, including remittances. Indeed, this was the stated use case for Facebook's original Libra. But one seriously doubts

² <https://www.citadelsecurities.com/products/equities-and-options/>

that OFAC and FinCEN will exempt cross-border transfers of stablecoins from the same restrictions and enforcement threats that have forced many banks to disassemble their correspondent banking networks. U.S. banks will soon be ready to make cross-border payments in real time, if regulators permit it. The Financial Stability Board currently has a project underway on this topic, and perhaps the rise of stablecoins will energize that effort, as it risks mooting it.

There does seem to be one way for stablecoins to avoid undermining the fractional reserve system while still offering convenience to customers, and that is for them to reach a state of equilibrium with bank deposits. (With a CBDC, equilibrium is impossible.) A clear way to establish that equilibrium would be for banks to issue stablecoins, with those stablecoins *pari passu* with bank deposits, and likewise available to fund bank lending. Thus, consumers and businesses would retain any convenience that comes with using a stablecoin, and consumer and commercial lending would continue apace. Again, though, with a revolution towards real-time, 24/7 payments well under way, and assuming enforcement of anti-money laundering and tax avoidance laws, one wonders how large a benefit that would be.

Many thanks for your kind attention – that is, if you were not answering emails with my image minimized on your screen.

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