Will Circle's BlackRock Money Fund Create a Back-door CBDC, Give Circle an Account at the Fed or Both?

BPI Staff | Jan. 4, 2023

As reported in [CoinDesk](#) on Nov. 6 and in a Barclays note on Dec. 7, Circle is shifting many of the assets backing its USDC stablecoin from direct holdings of Treasury securities to a government-only money market mutual fund created by BlackRock for Circle's sole use, known as the [Circle Reserve Fund](#). With the shift, 80 percent of the assets backing USDC will be investments in the money fund. The remaining 20 percent will remain bank deposits for the time being. More significantly, BlackRock in turn plans to apply for the fund to access the Fed's overnight RRP facility. If access is granted, Circle plans to shift the remaining 20 percent into the fund, with the fund investing that cash into the ON RRP facility.

The ON RRP facility provides money funds and GSEs a standing option to invest overnight with the Fed at a fixed rate, currently 4.3 percent. The Fed opened the ON RRP facility in September 2013 for experimentation and officially adopted it as a temporary tool for normalizing policy in September 2014.[1]

The ramifications here are difficult to overstate. In essence, anyone in the world wishing to hold the equivalent of reserves at the Federal Reserve will be able to do so by purchasing USDC. Especially in times of crisis, this asset would be highly desirable as a back-door CBDC or account at the Federal Reserve. As such, it is a breathtaking example of regulatory arbitrage. It takes the fact that the Fed's balance sheet is so large that it can no longer be funded with currency or bank reserves and combines it with a structure that avoids all federal oversight of Circle or limits on potential holders of the coins.

POTENTIAL OBSTACLES

AML/Sanctions

It is unclear if the money fund will get access to the ON RRP facility. As part of the application, BlackRock will need to state "[t]he percentage of shareholders operating in high-risk industries as defined in the firm's AML program."[2] It would be hard to imagine BlackRock failing to list the fintech and stablecoin industry as anything other than high-risk from an AML perspective, so the answer would seem to have to be "100 percent." That answer would presumably be grounds for rejecting the application, assuming the New York Fed asks the question for a reason.

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[1] When the FOMC announced the ON RRP facility, it stated "During normalization, the Federal Reserve intends to use an overnight reverse repurchase agreement facility and other supplementary tools as needed to help control the federal funds rate. The Committee will use an overnight reverse repurchase agreement facility only to the extent necessary and will phase it out when it is no longer needed to help control the federal funds rate." https://www.federalreserve.gov/newsevents/pressreleases/monetary20140917c.htm

[2] https://www.newyorkfed.org/medialibrary/media/markets/Expression-of-Interest-Form-for-RRP-Money-Funds.pdf

As a substantive matter, the question is how much assurance Circle could provide that its stablecoin would not be used to launder money or avoid sanctions. Circle is a privately held company headquartered in Massachusetts. It is not subject to examination by any federal banking agency. Its business model includes facilitating decentralized finance, where, in its own words, "individual users conduct transactions without intermediaries capable of performing standard AML processes."[3]

Financial Stability

More broadly, this development seems to be exactly why the ON RRP facility needs to be temporary, as the FOMC's originally intended. In extraordinarily prescient remarks at the June 2014 meeting of the FOMC, then-Governor Daniel Tarullo, when describing the risk that the ON RRP facility could cause destabilizing flights to safety, stated:

> Even financial actors that are not certified ON RRP counterparties might take advantage of this safest of havens through a restructuring of the interconnections of financial actors, whereby such actors would have what we might call a standing line of liability with qualified counterparties.[4]

If USDC were to become effectively a means by which anyone in the world could invest overnight in the Federal Reserve System, it would become a magnet for inflows in times of stress, exactly as Tarullo feared. The dash-for-cash in March and April 2020, during which bank deposits rose more than $1 trillion in five weeks, could have been a dash-for-USDC. If so, banks would not have received that inflow of deposits to fund the massive increase in bank lending that occurred at the same time as businesses drew down their lines of credit. Other nonbank lenders would have seen their funding dry up to an even greater extent.

Furthermore, even in the absence of economic crisis, nations around the world facing political or idiosyncratic economic problems could expect to see their anxious corporations and citizens choosing to fund the U.S. government rather than their local economies. There is thus the potential for disruption of emerging markets.

A stablecoin with access to the ON RRP would also introduce the potential for systemic contagion from the crypto markets into the traditional financial system. The recent financial crisis in the crypto markets was contained within the crypto markets because the offramps from crypto to the traditional markets were not sufficiently developed. However, a stablecoin effectively backed by the Fed would provide a mechanism by which a crypto financial crisis could be transmitted to the conventional markets. If crypto assets decline precipitously in a financial crisis, crypto market participants could rush into USDC, thereby withdrawing deposits from the traditional banking system.

While there are caps on the usage of the ON RRP facility that would have been tripped in such circumstances, the caps are not credible. As Tarullo reasoned in June 2014:

> Based on what we know and have discussed to this point, the cap system strikes me as an almost textbook case of a time-consistency problem. We will grow the ON RRP facility and solemnly indicate that its usage has limits, but then as stress builds and the money markets in which ON RRP will have become such a major part come under pressure for capital conservation, we could be tempted to offer this safe

[3] https://www.circle.com/blog/circle-highlights-role-of-innovative-technology-in-addressing-illicit-finance
[4] https://www.federalreserve.gov/monetarypolicy/files/FOMC20140730meeting.pdf

> haven without any limit but the size of our balance sheet, at least to those previously qualified as counterparties and maybe to others as well. And, it's important to note, that might well be the right ex post response under such circumstances, but it's precisely for this reason that the caps may lack ex ante credibility.

Because overnight reverse repurchase agreements are essentially the same as a deposit, the ON RRP facility would appear to be a transparent end-run around Congress's intention that only credit unions, thrifts and commercial banks be allowed to have interest-bearing accounts at the Federal Reserve. That restriction limits access to entities that lend to households and nonfinancial businesses. The subterfuge may have been tolerable when the facility was expected to be temporary and relatively small, but it currently exceeds $2 trillion, making up about a quarter of the liabilities of the Federal Reserve System, and shows no signs of going away soon.

The Fed should not only deny Circle's money fund access to the ON RRP facility, it should take steps to hasten the winding down of the facility as an attractive nuisance. It should do so by returning the spread between the IORB rate and the ON RRP rate to 25 basis points, where it was for a decade, versus the current spread of 10 basis points. The narrow spread results in repo rates and T-bill rates being so close to the ON RRP rate that the facility is excessively attractive to money funds as an investment rather than as a backstop as originally intended.
