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Engaging with stablecoins?

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Center for
**Regulatory
Strategy**
US

Figure 1. Timeline of recent regulatory developments specific to stablecoins

Stablecoins specific regulatory developments in 2022 – 2023						
January	June	July	September	October	December	January
<p>Agustín Carstens, General Manager of the Bank for International Settlements (BIS), delivered a speech titled “Digital currencies and the soul of money”</p>	<p>New York Department of Financial Services (NYDFS) released “Guidance on the Issuance of U.S. Dollar-Backed Stablecoins”</p>	<p>The Committee on Payments and Market Infrastructures (CPMI) along with the Board of the International Organization of Securities Commissions (IOSCO) published the final guidance on the “Application of the principles for financial market infrastructures to stablecoin arrangements”</p>	<p>Draft legislation to create a US federal framework around stablecoins was released</p>	<p>EU member states formally endorsed the final text of the Markets in Crypto-Assets (MiCA) regulation</p>	<p>The Basel Committee on Banking Supervision released the final standards on the prudential treatment of banks’ crypto-asset exposures</p>	<p>The Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) issued a statement on crypto-asset risks to banking organizations; specifically related to stablecoins, it highlighted the susceptibility of stablecoins to run risk, creating potential deposit outflows for banking organizations that hold stablecoin reserves</p>
<p>Acting Comptroller of the Currency Michael J. Hsu spoke before the British American Business Transatlantic Finance Forum’s Executive Roundtable to discuss the regulation of stablecoins and other crypto-assets</p>						

As the regulatory agencies have increased their focus on entities involved in stablecoin transactions, issuers are also making efforts to align with regulatory expectations by improving the risk profile, oversight, and disclosures around the reserve management before issuing a stablecoin.

Opportunities presented by stablecoins

Stablecoins come with significant market and regulatory risks and yet traditional financial institutions, banks, and nonbanks still see opportunity. Why?

For banks, stablecoins could be a way to retain deposits, at least until bank deposit tokenization gains traction from still-evolving payments utility. As more consumers are expecting payment products to be global, programmable, instantaneous, and always-on, stablecoin issuance could offer financial institutions a payment solution that meets these requirements. Indeed, such offerings might even help banks attract new deposits since blockchain-based payments are a differentiated product. It’s also possible that stablecoin issuance—and the associated real-time to near-real-time payment capabilities—offers banks a foundation to expand into peripheral digital asset services (e.g., collateralized lending, treasury management, tokenization). Stablecoin issuance could also increase both the efficiency and liquidity of transactions due to increased automation (via near instantaneous settlement via smart contracts), thereby reducing administrative overhead.

For nonbanks (including a broad set of money transmitters and broker-dealers), stablecoins could be a way to meet customer demands, too. Offering stablecoin payments can provide choices for customers who are expanding into the digital currency ecosystem. Stablecoin issuance can also be an opportunity to increase market share. Offering a differentiated product might help issuers acquire new customers and better position themselves within the industry. Also, stablecoin payments enable near-real-time finality, more predictability, and better transparency, thereby improving the customer experience. Importantly, stablecoins are an opportunity for nonbanks to reduce their reliance on correspondent banks since they limit the need for a bank partner to conduct foreign transactions; this also helps reduce costs for customers.

As the market offering of stablecoins matures, merchants may wish to accept stablecoins as payment for a number of reasons. For example, stablecoins offer a way to reduce credit risk by linking payment to delivery of goods. They also can enhance working capital by reducing days sales outstanding (DSO). Stablecoins could diminish processing fees by removing central intermediaries (e.g., credit card processing companies) and potentially increase sales as a flexible payment option that attracts a wider consumer base.

Stablecoin vs. real-time payments vs. CBDCs

The United States is actively studying wholesale central bank digital currency (CBDC) and tokenized deposits alternatives to address the well-known payment frictions of speed, cost, safety, and transparency. While there are good indications that our future monetary system eventually may be tokenized and “on-chain,” progress likely will be gradual, with a justifiable abundance of caution and thoughtful consideration given to various alternatives along the way.

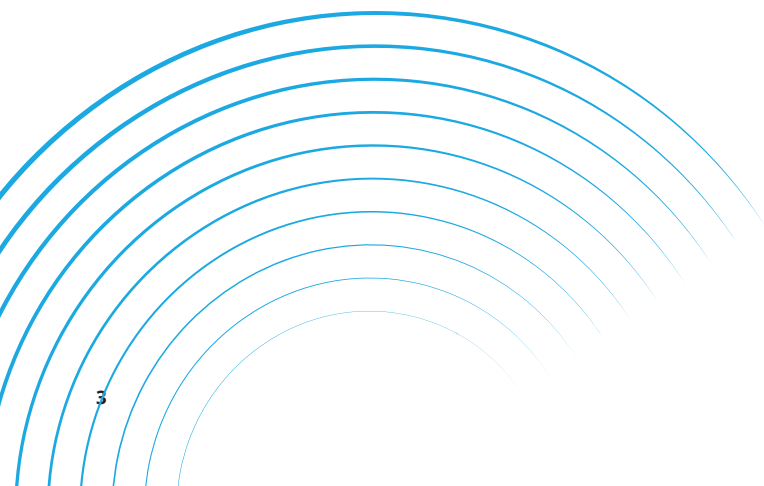
There is a reasonable expectation in the industry that stablecoins could (and should) be complementary and part of this vision for the future of the payments system. While a CBDC represents a liability of the US government and could increase the money supply if other dollars are not removed from circulation, dollar-backed stablecoins are a payments product that, if broadly used, reinforce the dollar akin to a CBDC while investing in and supporting US debt markets. Timing is another important consideration since any CBDC or tokenized deposit initiative will take time, potentially leaving room for stablecoins in the near term.

Risks posed by stablecoins

Despite some of the opportunities that stablecoins present, there are several risks that should be considered. Some of these risks are common to most financial products and others are more acute for this particular asset class. Here we'll discuss some of these risks and potential risk mitigation strategies.

Liquidity and redemption	
Risk	Potential mitigation strategy
Market risk and risk of broken peg during market stress.	Hold sufficient high-quality liquid reserves that are ideally segregated and publicly vetted. Market risk and liquidity management.
Insufficient safeguarding against technical glitches; breach of stablecoin smart contract (e.g., rogue minting/burning, stolen tokens).	Engage vendors that offer security incident and event monitoring solutions to help you safeguard against breaches, hacks, and glitches. Preventative controls in place.
Risk of ineffective incident management due to reliance on third parties for critical functions (e.g., inability of a digital assets-enabled payment processor to continue operations due to collapse of the settlement partner).	Rigorous and documented third-party oversight; identify back-up service providers; more dynamic third party risk monitoring
Risk of fraudulent activity due to an unauthorized external actor accessing and manipulating the agent to send fraudulent instructions to the key signing infrastructure due to a lack of oversight or insufficient access controls. There could be additional risk due to inadequate backup/availability of the private keys considering vulnerabilities in devices utilized to run the node software; however, the impact will be limited to the issuers acting as a custodian (e.g., 3Commas hack of API keys). ⁹	State-of-the-art cybersecurity systems and practices and IT controls; documented private key management policies and procedures across the private key management life cycle in line with cryptocurrency security standards.

Legal	
Risk	Potential mitigation strategy
Legal uncertainties and risk of non-enforceability of contractual agreements between the issuer and a market participant involved in the stablecoin value chain.	Ensure an understanding of dependencies in the stablecoin value chain; contracts associated with redemptions (timely, and 1:1 to USD) and custody (manner of segregation, non-co-mingled with issuer/exchange/custodian accounts) warrant a heightened standard of prudent disclosure and legal care.



Compliance and regulatory	
Risk	Potential mitigation strategy
Dynamic regulatory landscape with respect to stablecoin issuances might impact a bank's business strategy and increase compliance burden (e.g., new bipartisan House stablecoin bill ¹⁰).	Leverage existing banking and broker-dealer regulatory expectations (including NYDFS guidance on licensing, redemptions, reserves, custody) to address how product meets these expectations.
Risk of noncompliance in areas such as anti-money laundering (AML)/countering the financing of terrorism (CFT), as bad actors may attempt money laundering/terrorist financing activities, which may not be caught through traditional Bank Secrecy Act/AML control activities.	Robust AML program (demonstrating belts and suspenders approach, e.g., multiple transaction monitoring blockchain analytic vendors).
Risk of noncompliance with consumer protection laws due to inaccurate or misleading representations and disclosures (e.g., manipulative advertisements ¹¹).	Leverage existing regulatory and legal standards associated with advertising and disclosure for traditional financial products.

Technology and cyber	
Risk	Potential mitigation strategy
Inadequate quality assurance activities (e.g., smart contract audits) performed on smart contracts prior to upgrades and on a regular basis.	Work with trusted vendors to audit systems on regular basis; conduct two audits from two separate vendors for each contract.
Technical issues with the stabilization mechanisms, or cyber incidents related to the underlying smart contracts, may result in loss of value to consumers and other stablecoin users (e.g., hackers stole \$31 million due to bug in software used by MonoX Finance for drafting smart contracts). ¹²	Rigorous code control and testing (dynamic and static); software development change management and life cycle controls (e.g., oversight of upgrades, and code switches).

Third-party risk management	
Risk	Potential mitigation strategy
Lack of internal controls to ensure business continuity for cases where key financial institution partners cease operations or have a severe disruption to provide critical services.	Leverage leading risk and internal control practices; business continuity planning; preemptively address concentration risks for critical processes, develop bypasses/alternatives to meet recovery standards aligned with risk appetite and client service expectations.



Getting started:

To help market participants understand the capabilities required for stablecoin issuance or engagement

Stablecoin arrangements are not equal, and the opportunities and risks that they present depend on the structure and design underlying each stablecoin. There are commonalities, however. Some of the risks—for example, regarding the safety and efficiency of payment systems, money laundering and terrorist financing, consumer/investor protection, and data protection—are familiar and could be addressed, at least partially, within existing regulatory, supervisory, and oversight frameworks. The specific characteristics of a given stablecoin (e.g., reserve management mechanism, purpose of the stablecoin, entity type of the issuer) will drive the relative complexity involved in the application of the regulatory frameworks.

Stablecoin issuers and partners likely will be expected to meet the same criteria and abide by the same regulatory requirements as traditional payment systems, payment schemes, or providers of payment services.

Deciding whether and how to engage with stablecoins can be challenging. Some activities that firms may want to consider when developing their strategy include the following:

- Conduct a review and risk-based assessment of your stablecoin (for issuers) or assess the stablecoins that you are considering as initial candidates for your solution (for others)
- Evaluate considerations of the risks to you, your customers, and the ecosystem associated with stablecoin usage, taking into account the blockchain technology, financial stability of the coins, future regulation, tax treatment, etc.
- Conduct due diligence of the third parties and partners (e.g., issuers, exchanges, custody providers, proprietary trading firms) you plan to leverage for providing your solution
- Identify the required capabilities and deliverables for the proposed solution, based on the regulatory requirements and industry leading practices (e.g., obtaining a BitLicense for virtual currency activities from NYDFS)
- Identify end-to-end cross-functional critical processes/technology to deliver the client stablecoin experience; identify and address internal/external process chokepoints; concentrations; dependencies with credible, tested backups and alternatives

- Assess different stablecoin-specific risks that should be assessed and considered while conducting risk assessment
- Draft pro forma controls that each impacted function should have to mitigate the net new stablecoin-specific risk

As other jurisdictions press forward with stablecoin regimes and the US regulatory framework remains fluid, firms should be thoughtful and highly strategic in their approach. We have developed a detailed assessment framework leveraging existing bank and broker-dealer



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Center for Regulatory Strategy US

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