GLOBAL DIGITAL ASSET &
CRYPTOCURRENCY ASSOCIATION

Down Range from Terra Luna

Stablecoin Strength Remains Unabated

Responsible Innovation in Action

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INTRODUCTION

Following the TerraUSD (UST) collapse and related events, the Global Digital Asset and Cryptocurrency Association (Global DCA) in collaboration with Lisa Weingarten Richards and Maggie Sklar from Davis Wright Tremaine (DWT) published the report "Beyond Terra: An Assessment of Stablecoin Benefits and Policy" ("Beyond Terra").

The report received positive support from many companies, thought leaders, and policymakers. It was also selected as a featured paper for this year's DC Fintech Week, which showcases cutting-edge thought leadership and research from fintech academics, innovators, and others. On the other hand, the report was also subject to criticism from stablecoin skeptics, and may make points that are not in line with the stablecoin sections in the Financial Stability Oversight Council's (FSOC) recent report: "Digital Asset Financial Stability Risks and Regulation." This paper is a response to the critiques of the original publication, addresses some of the stablecoin rhetoric we find problematic in the FSOC report, and brings our information about true stablecoins up to date.

STABLECOIN TAXONOMY

The opposition to "Beyond Terra" appears to be based on an overly broad definition of "stablecoin." The opposition also tends to conflate the risks of algorithmic tokens and other tokens that are not 1:1 backed by liquid assets, unlike true stablecoins. For example, a Wall Street Journal op-ed noted: "A stablecoin is the crypto-world's preferred medium of exchange: a token pegged to a fiat currency like the U.S. dollar. Maintaining the advertised fixed exchange rate, however, has been difficult for stablecoin issuers. The failure of TerraUSD this month was followed by Tether 'breaking the buck'." The problem with this statement is that it fails to note that Tether was not backed 1:1 by high quality liquid assets and also that Tether regained and has since maintained its peg (despite the overall downturn in digital assets and the broader equities market).

Tether to USD Chart

As a note, “Beyond Terra” clearly delineates the differences among so-called “stablecoins.” It also highlights that other digital assets, including UST, should not be classified as “stablecoins.” “Beyond Terra” asserts that a token backed by high quality liquid assets is no less stable than the assets that back it. A true fiat-backed stablecoin will retain a consistent peg as long as the underlying fiat currency is stable. UST never had any reason to be considered stable with respect to the US dollar (which it claimed to be pegged to through an algorithm) as it had no fiat backing.

Therefore, UST should not be lumped together with true fiat-backed “stablecoins,” which we believe should be defined only as tokens with reserves that are backed 1:1 by the fiat currency they are pegged to. As such, we continue to support the need for the industry and policymakers to develop and adopt a clear taxonomy that distinguishes among fiat and other asset-backed tokens and that establishes clear parameters for what constitutes a stablecoin.

Characteristics of “Stablecoins”

Source: Unagii Docs

	Fiat-Backed	Commodity-Backed	Crypto-Backed (Over-Collateralized)	Algorithmic Stablecoins
Pro	Reserved 1:1 by traditional financial assets; More Resilient to Runs; Can be regulatory compliant.	Backed by commodities with real-world uses (diamonds, gold, oil); More Resilient to Runs; Can be regulatory compliant.	Decentralized; Backed by on-chain assets; Assets resilient to protocol failure; Transparent.	Do not require underlying collateral; Can be built natively into the network.
Con	Requires real-world assets; Vulnerable to censorship; Requires collateral attestation.	Requires real-world assets; Vulnerable to censorship; Assets may fluctuate; Not redeemable 1:1 for other currencies; Requires collateral attestation.	Smart-Contract Risk; Debt Position Liquidation Risk; Loans must be “Over Collateralized.”	Highly unstable Peg; Not collateralized; Risk of hyper-inflation of underlying collateral.

Source: “Beyond Terra” report

AUDITS AND TRANSPARENCY

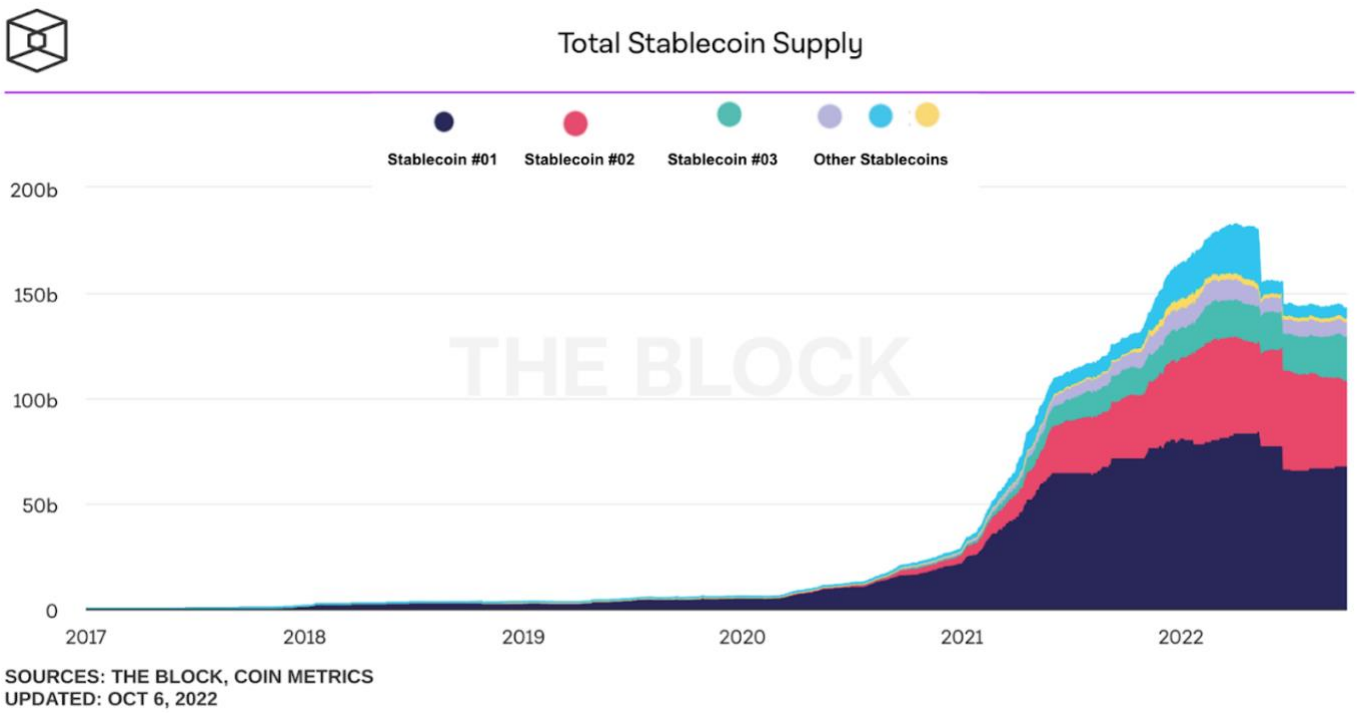
The WSJ op-ed notes that Senator Toomey's proposed draft law, Stablecoin Transparency of Reserves and Uniform Safe Transactions Act, outlined a verification process, but that process would have been less rigorous than a formal audit. As of the time of writing, the U.S. House has not moved forward on this or any other stablecoin related bill. We agree that third-party assurance is needed and recommend that audits by an accounting firm be required. On page 13 of "Beyond Terra" we noted, "Independent auditing could be provided by third-party auditing firms, or in some cases, the banks holding the underlying assets themselves."

The FSOC report also supports audits and faults entities for failing to be audited. The report states: "Many stablecoin issuers are opaque about the exact nature of their asset holdings, if any. That opacity could be due to non-compliance with applicable rules and regulations. Opacity is also partly related to the lack of standards for disclosing stablecoin asset composition, auditing or review requirements, or guidelines around acceptable asset management strategies." However, we believe that legitimate stablecoin issuers would be willing to comply with audit rules. The problem is just that no applicable rule(s) or clear guidance yet exist. Moreover, the use and exchange of stablecoins is global, and it would need to be clearer which jurisdiction's rules would apply and when.

TRANSPARENCY, TRUST, AND STABLECOIN TRENDS

Furthermore, policymakers and critics should acknowledge that companies across the cryptocurrency industry have long voiced their support for more government regulatory clarity for stablecoins and their issuers - particularly regarding audits and disclosures. In the absence of such clarity, market competition and consumer preferences, as well as the maturing of the market, have naturally continued to steward the industry towards becoming more transparent about asset reserve management. For example, every USDC stablecoin that Circle issues is fully-reserved and 100% backed by cash and short-dated U.S. treasuries, which are redeemable 1:1 for U.S. dollars.

Each month, Grant Thornton, one of America's largest audit, tax, and advisory firms, provides third-party assurance on the size of the USDC reserve. This is in addition to the annual SEC audits of their financial statements. Circle also publishes weekly data on the size and composition of the USDC reserves, and the volume that is minted and redeemed. A competing issuer of stablecoin USDT, Tether, has stated it intends to provide more fulsome audits and further transparency into their own reserves.



SOURCES: THE BLOCK, COIN METRICS
UPDATED: OCT 6, 2022

Market preferences and trust in fully-reserved stablecoins is also reflected in the data. Today, the total outstanding stablecoin supply remains above $140 million. While this is down about 22% from an April peak of $182 million, on a relative basis, the percentage decrease in supply amount is less dramatic than the precipitous drops in value across other markets and asset classes. But most importantly, despite this, stablecoins have maintained their pegs, performing exactly as intended. This occurred even though for the first nine months of the year, the S&P 500 index was down 23.9%. Nasdaq's Global X FinTech ETF, which represents a basket of high-growth fintech companies, has seen a year-to-date decline of 48.1%. Today, fiat-backed stablecoins account for more than 90% of the total stablecoin supply. The two-largest stablecoins, USDT and USDC, alone account for 76% of the total stablecoin supply.

SETTLEMENT RISKS

Some have said that stablecoins face a Herstatt risk (a cross-currency settlement risk) because of the difficulties of syncing the on- and off-chain settlement time of large transactions. In other words, there could be a lag between large flows of capital "on-chain" and when the stablecoin issuer's collateral is posted "off-chain." This theoretical time difference, as the argument goes, introduces the possibility of a stablecoin issuer failing to deliver the collateral due to their own attempts to mitigate counterparty risk. The WSJ op-ed, for example, voices concerns over hypothetical $100 million stablecoin transaction(s). It is unclear whether this number is arbitrary, is based on a real stablecoin's liquidity, or derives from a dollar value associated with a specific event in financial history as a point of comparison.

Furthermore, the op-ed proposes that such a risk can be addressed by synchronizing on- and off-chain transactions. However, doing so requires eliminating stablecoin's speed advantage. As such, what they posit would make transacting with regulated bank deposits or money market mutual fund balances no worse, if not better, than using stablecoins, and ultimately renders a purpose of stablecoins obsolete. This assertion conflates two potential sources of settlement risks with one another: one source being the potential time gap from issues related to the operations of the underlying blockchain technology and its associated payments infrastructure; the second source being the potential time gap from issues related to the lack of underlying asset reserves, which is not applicable to fully-reserved stablecoins.

As a note, this framing also implies that stablecoin's speed is the only added value that derives from using fiat-backed tokenized cash to conduct large value transactions, which is not true. There are significant parts of the world population that are unbanked, and/or have no access to financial products like mutual funds, but do have smartphones and could therefore use stablecoins for making transactions, payments, and/or remittances.

Concerns over financial settlement risks that arise from the time gap in collateral settlement and issuance is a moot point. Serious technologists in this space have been considering these concerns and technological responses to time-delays for years. The criticism also ignores the other uses for stablecoins. These concerns may reflect a lack of appreciation for the value of stablecoins in the digital economy, instead preferring a concentrated legacy financial system which may not use the latest technology, and some financial regulators are concerned more with preventing anything that has any risk rather than quantifying systemic risk.

If a hypothetical settlement risk were to ever exist due to issues in collatorizing the underlying reserves, the collapse of UST presumably serves as the single largest historical event that would trigger it. However, there was little connectedness with other stablecoins or digital assets from which risk might spread or from which risks would derive. If this was the case, market fears over such risks would be reflected in the price action across different stablecoins. The year-to-date price performance data of other stablecoins, however, paints a different picture. Overall, the price performance between tokenized cash and its U.S. dollar parity value have remained stable.

In addition, if there are concerns about the ability to instantly clear a $100 million stablecoin redemption, we should ask no less of the incumbents. Can a US national bank guarantee a depositor who walks into the bank an immediate redemption(s) of $100 million in physical cash? Does that deposit have FDIC insurance? (Both are rhetorical questions. FDIC insurance caps coverage at $250,000 per account.) A large transaction event that would disable stablecoin redemptions would do the same to bank deposits and money markets. Though, the opposite remains likely untrue.

That is because US national banks have a significantly lower-collateral backing than do true fiat-backed stablecoins. A well-capitalized national bank holds approximately 8% of its deposits in reserves. During the height of the Covid-19 pandemic, the Federal Reserve lowered the deposit-reserve requirement ratios to 0%. As a reminder, it was increased fictitious (float) reserve deposits, and the inability to mobilize reserves that led to the bank runs that catapulted the US

into the Great Depression. On the other hand, a true fully-reserved stablecoin is 100% backed by cash and short-dated U.S. treasuries, and is redeemable 1:1 for U.S. dollars at all times.

Since the advent of fully-backed stablecoins, there remains to be any large-scale settlement concerns that stem from collateral, counterparty or other financial risks. The Herstatt risks that played out in the mid-1970's also took place during a time in which settlement systems and times were extremely manual and lengthy and which did not have the supporting ecosystem for more rapid and accurate settlements that exists today. This is not to say that non-financial technical risks do not exist or potentially exist in connection with fully-reserved stablecoins. A tail-end risk event, otherwise known as a black swan or catastrophic (CAT) event, could result from a disaster of monumental proportions and may have a significant impact both within and across industries, stablecoins, cryptocurrencies, treasuries, equities, and derivatives alike.

However, such an event is not an intrinsic risk of stablecoins themselves or unique to the broader cryptocurrency industry. CAT events are complex and increasingly cyber in nature. Often these risks derive from concentrated reliance on specific companies and specific technology infrastructure that serve as single points of failure (SPoFs). This type of risk exists across all industries, including in the legacy financial world and the broader technology industry. For example, the SWIFT system and leading cloud service providers, such as AWS and Google Cloud, function as SPoFs. In an event that one or more cloud service providers is *severely* compromised, there would be a negative downstream impact within and across industries and companies that rely on these services. However, the value that these platforms provide to society far outweigh the risks. As a result, this has not deterred reliance on these platforms.

Instead of using hypotheticals to dismiss the merits of stablecoins, we recommend that the crypto industry and policymakers work together to identify sound cybersecurity practices leading to safe system architectures that minimize the effect of a possible future CAT event. We also would tell stablecoin and cryptocurrency skeptics to keep in mind that risks do not exist in a vacuum. History has shown that global welfare improves when innovative financial technology is adopted. Today, fully-backed stablecoins provide consumers and businesses with a lower-cost, safer, and more efficient means of transferring value than the incumbent alternatives.

Stablecoin Price Performance

Stablecoin #02

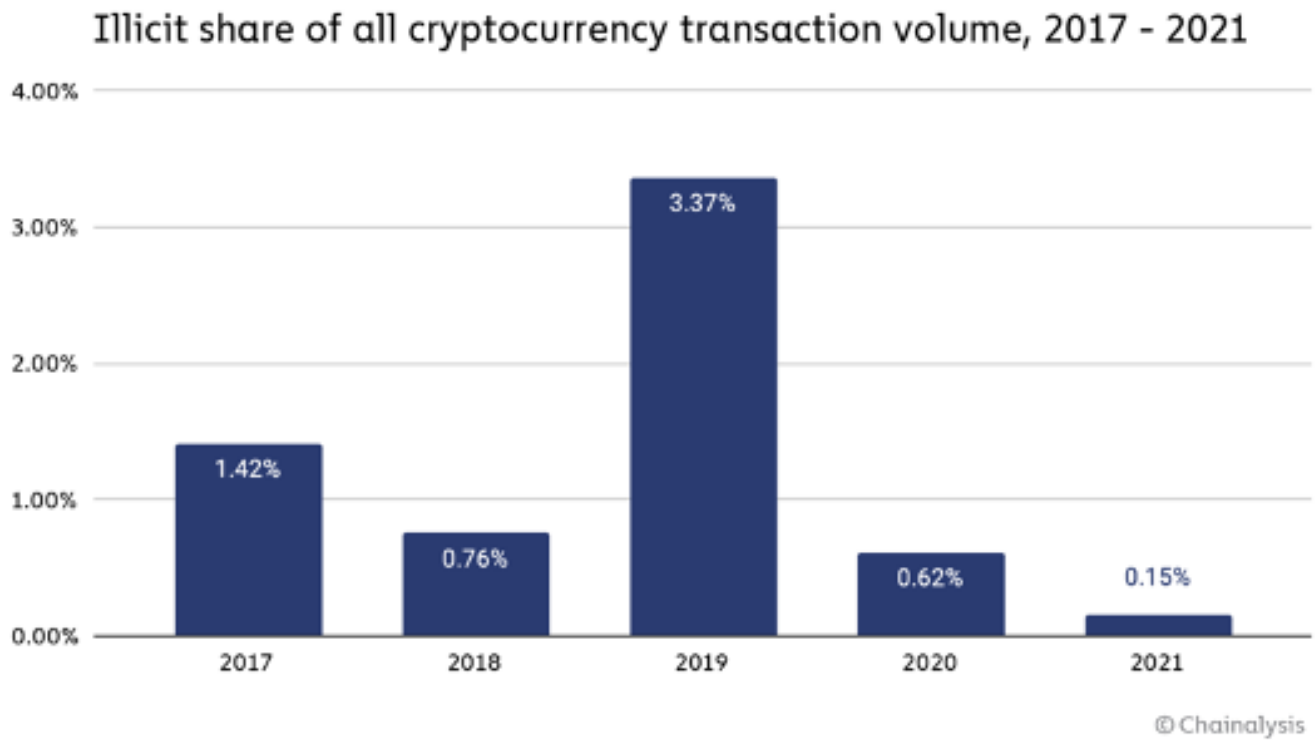
Stablecoin #03

Stablecoin #04

Stablecoin #05

KYC AND AML

Arguments against stablecoins also restate problems with Know-Your-Customer (KYC) and Anti-Money Laundering (AML) practices. But these arguments are also rooted in a misunderstanding of stablecoins. In fact, one of the main features of blockchain technology is the tracking and recovery of tokens used in illicit transactions. Fraudsters engaging in cryptocurrency theft have been repeatedly apprehended. Earlier this year, the U.S. Justice Department managed to seize over $3.6 billion in cryptocurrency stolen during the 2016 hack of Bitfinex, a virtual currency exchange. This was the Department's largest seizure ever (cash in a suitcase might have worked better for these bad actors). Recovery efforts have been conducted in partnership with cryptocurrency and blockchain forensic companies, such as Chainalysis and Elliptic. These companies provide services that the majority, if not all, of the leading crypto companies rely on to conduct their KYC/AML operations. It goes without saying that Global DCA and the authors do not support illicit activities but criminal actors are fortunate that such technology does not exist to track illegal usage of fiat currency and gold.



We believe that minimal KYC and AML risks are also backed by objective and unbiased data. This is the same data that law enforcement units around the world rely on. In 2021, only 0.15% of all cryptocurrency transactions were connected to illicit activity. It is important to emphasize that this rate reflects the illicit activity amongst *all* cryptocurrency transactions. However, this figure also serves as a strong indicator for the lack of illicit activity that is conducted using stablecoins, which only make up a fraction of all cryptocurrency and digital asset transactions.

It is also important to recognize that many in the cryptocurrency industry, including stablecoin issuers, continue to implement and uphold sound KYC/AML practices. This ongoing trend has been industry-led and, in some cases, conducted without formal regulatory requirements or requests. For example, many companies and decentralized layer-2 applications recently froze transactions with smart contract addresses associated with OFAC sanctioned Tornado Cash, a decentralized protocol. While this action was not void of criticism, it further reflects the industry's willingness to engage in self-regulation to protect the interest and safety of the broader public. Use of stablecoins is not the "Wild West" after all.

Moving forward, further industry-driven KYC/AML developments are always welcomed. We also recommend that policymakers continue to rely on real-world data when evaluating stablecoins as well as other digital assets. We also encourage policymakers to reference the KYC manual that was developed for Special Purpose Depository Institutions charters in Wyoming. Wyoming's policy leadership as it pertains to digital assets can also serve as a guide for policymakers that are concerned about the KYC/AML compliance in connection with stablecoins.