

# Testimony of Under Secretary for Domestic Finance Nellie Liang before Committee on Banking, Housing, and Urban Affairs, U.S. Senate

February 15, 2022

*As prepared for delivery*

Chairman Brown, Ranking Member Toomey, and other members of the Committee, thank you for the opportunity to testify this morning on stablecoins.

Stablecoins are part of an emerging set of digital assets, activities, and services that could have profound implications for the U.S. financial system and economy. Treasury supports responsible innovation that helps meet the evolving needs of users and the financial system. But stablecoins also raise policy concerns, including those related to illicit finance, user protection, and systemic risk. To mitigate these risks while supporting the potential benefits from innovation, Treasury believes that regulation of stablecoins should be clear and consistent.

In November, the President's Working Group on Financial Markets, along with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, took an important step in this direction with the publication of a stablecoin report (PWG Report). The PWG was formed by Executive Order in response to the 1987 stock market crash. The group is chaired by the Secretary of the Treasury and composed of federal financial regulators. The PWG regularly produces reports on financial markets issues for the President, which may include recommended legislative changes.

As described in the PWG Report, stablecoins are a type of digital asset designed to maintain a stable value relative to the U.S. dollar or other reference asset. Today, stablecoins are used primarily to facilitate trading in digital assets. But, because stablecoins are designed to maintain a stable value, they could potentially be used more widely as a means of payment by households, businesses, and financial firms. There are no standards regarding the composition of assets used to support the value of stablecoins (reserve assets), and information made publicly available regarding stablecoin reserve assets is not consistent across stablecoin arrangements in either its content or the frequency of its release.

Stablecoins are growing and developing rapidly and are not subject to a statutory or regulatory framework that mitigates the risks they present in a consistent and comprehensive manner.

Currently, regulators have authorities that can be used to address illicit finance and investor protection concerns in the context of stablecoins. However, as described in the PWG Report, regulatory gaps exist regarding certain prudential risks. The PWG Report recommends legislation to ensure that stablecoins are subject to appropriate federal prudential oversight.

Such legislation would complement existing authorities with respect to market integrity, investor and consumer protection, and illicit finance. The PWG's specific recommendations included: limiting issuance of stablecoins to insured depository institutions (IDI); giving supervisors of stablecoin issuers authority to set risk management standards for critical activities related to use of stablecoin as a means of payment; and certain measures to reduce concerns related to concentration of economic power.

As mentioned, stablecoins are part of the much larger and quickly evolving market for digital assets. The Biden Administration continues to work across the agencies to develop a comprehensive strategy for all digital assets, with the goals of ensuring that cryptocurrency is not used for illicit finance; addressing risks related to financial stability and consumer and investor protection; and furthering financial inclusion and our continued leadership of the global financial system

Given their potential to be used as a means of payment, as well as the design mechanisms that they rely on to maintain a stable value, stablecoins present risks that are similar to some of the prudential risks traditionally associated with bank deposits and other forms of private money. History has shown that, without adequate safeguards, bank deposits and other forms of private money have the potential to pose risks to consumers and the financial system. These prudential risks include the risk of stablecoin runs; payment system risks related to the mechanisms that are used to store or transfer stablecoins; and broader concerns related to concentration of economic power.

“Run risk” refers to the potential for a scenario in which a loss of confidence in a stablecoin sets off a wave of stablecoin redemptions, which could then be followed by distressed sales of the stablecoin's reserve assets. Such distressed sales of assets could negatively affect critical funding markets and broader financial conditions. Runs could also spread contagiously from one stablecoin to another, or to other types of financial institutions that are viewed as having a similar risk profile. The dynamics of a run, as well as the harm that runs can inflict on

the broader system, are amply demonstrated by the history of runs on banks and shadow banks – including those that occurred in 2007-2008 and, more recently, at the start of the Covid-19 pandemic in March 2020. The first stablecoin run is believed to have occurred in June 2021, when a sharp drop in the price of the assets used to back the stablecoin set off a negative feedback loop of stablecoin redemptions and further price declines.

“Payment system risks” refer to a disruption in the mechanisms used to store or transfer value, which could interfere with the ability of users to make or settle payments. Payment system risks distinguish stablecoins from certain investment products that are not designed to serve as a means of payment. Custodial wallet providers – meaning wallet providers that hold stablecoins on behalf of users – are one locus of payment system risk, as the failure or disruption of such a wallet provider could deprive users of access to their stablecoins. More generally, use of stablecoins depends on a range of activities that are often distributed across multiple entities within a stablecoin arrangement. Depending on the particular design of a stablecoin, these activities include: governance of the stablecoin arrangement; stablecoin issuance and redemption; management and custody of stablecoin reserve assets; distributed ledger operation, validation, and settlement; and interfacing with stablecoin holders. Even if a stablecoin itself is adequately protected against run risk, problems related to the activities or entities that support the stablecoin could still interfere with its use as a means of payment, harming stablecoin users and resulting in a loss of payments efficiency.

Finally, I would highlight two concerns related to concentration of economic power. First, connections between a stablecoin (or stablecoin wallet provider), on one hand, and a commercial company, on the other, could be used to give the commercial company an unfair competitive advantage. These policy concerns are analogous to those traditionally associated with the mixing of banking and commerce, such as advantages in accessing credit or using data to market or restrict access to products. Second, the issuer of a stablecoin that becomes sufficiently widely adopted as a means of payment could become a dominant provider of payment services. Market power with respect to payments could reduce incentives for further investment in payments innovations or lead to higher prices for payment services.

Current statutory and regulatory frameworks do not provide consistent and comprehensive standards for the risks of stablecoins as a new type of payment product. Certain regulatory schemes may have the flexibility to address some issues presented by stablecoins, such as illicit finance. However, stablecoins are not subject to standards to address concerns about run risk, payment system risk, or concentration of economic power. Some of the largest

stablecoin issuers operate with limited regulatory oversight, raising significant questions about whether these stablecoins are adequately backed and other aspects of their operations. The regulatory frameworks that apply to stablecoin issuers and service providers are inconsistent, creating opportunities for regulatory arbitrage and uncertainty among stablecoin users. Even where the issuer of a given stablecoin is subject to oversight, the number of different key parties that may be involved in an arrangement, and the operational complexity of these arrangements, may pose substantial challenges for supervisors. The exponential growth of stablecoins – from a market capitalization of roughly \$5 billion at the start of 2020 to approximately \$175 billion today – increases the urgency of ensuring that an appropriate regulatory framework is in place.

Having described the regulatory gaps at a high level, I would like to discuss in more detail several frameworks that have featured prominently in discussions of stablecoins: state money transmitter laws, securities laws, and commodities laws. While Treasury and the PWG fully support efforts by state and federal agencies to use existing authorities in support of their statutory mandates, we do not believe existing authorities provide a sufficient basis for comprehensive and consistent oversight of stablecoins.

In many states, stablecoin operators are licensed or registered as money transmitters and money services businesses, and are subject to standards that include minimum net worth requirements, surety bond and other security requirements, and restrictions on permissible investments. These standards are generally designed to address consumer protection concerns. They are not meant to address the financial stability and payment system concerns that would arise if stablecoins become widely adopted by households, corporations, and financial institutions as a means of payment.

Some have suggested that stablecoins could be regulated either as securities or as money market mutual funds (MMFs). Certain legal academics have raised a threshold question as to whether stablecoins qualify as securities or MMFs under existing laws. Assuming that stablecoins satisfy the definition of securities or MMFs, there is a further question as to whether these regimes would effectively address the prudential risks of stablecoins. Requirements that apply generally to issuers of public securities are not designed to address concerns about run risk, payment system risk, or concentration of economic power. MMF regulations do not focus on payment system risks or concerns about concentration of economic power.

Under the Commodity Exchange Act, the CFTC has the authority to police fraud and manipulation in commodities spot markets, which the CFTC has indicated include digital assets. In addition, derivatives products on commodities and leveraged retail transactions are subject to jurisdiction of the CFTC. These are important tools for ensuring the integrity of these markets and protecting investors, but they are not intended to address prudential risks.

The PWG Report recommends requiring stablecoin issuers to be IDIs because IDIs are subject to a regulatory and supervisory framework that would help to mitigate the prudential risks the report identifies. Run risk would be reduced by features including capital, liquidity, and other prudential standards, as well as access to the Federal Reserve as lender-of-last resort. Payment system risk would be mitigated through the establishment of risk-management standards for entities that conduct critical activities within stablecoin arrangements. Concerns about concentration of economic power would be addressed by prohibiting stablecoin issuers from conducting commercial activities, or affiliating with commercial companies, and by allowing supervisors to establish interoperability standards. In short, IDI regulation provides a tested regulatory model that would protect against the prudential risks of stablecoins and help to support confidence of stablecoin users.

In developing this recommendation, the PWG relied upon the flexibility that the banking agencies would have to calibrate supervision and regulation of stablecoins based on risk. Banking agencies currently use existing authorities to adjust supervision and regulation in the context of overseeing IDIs with a diverse range of business models (e.g., commercial banks, trading banks, custody banks) and systemic risk footprints (e.g., community banks, mid-size banks, regional banks, large banks). The fact that some prominent stablecoin issuers are already seeking IDI charters provides additional reason to think that IDI regulation is a feasible regulatory model for stablecoin issuance.

Since the publication of the PWG Report, some have asked whether stablecoins issued by an IDI would be covered by FDIC insurance, or its equivalent. The PWG Report does not take a position on this issue. While insuring stablecoins would protect users against the risk of loss, it would also introduce certain policy and technical challenges. For this reason, Congress (or the banking agencies) might want to consider alternative measures to protect stablecoin users.

Finally, the Financial Stability Oversight Council (FSOC) continues to evaluate potential systemic risks related to stablecoins and other digital assets, and the steps that may be available to the FSOC to mitigate such risks. These may include designation of certain

activities conducted within a stablecoin arrangement as, or as likely to become, systemically important payment activities.

As I stated at the beginning of my testimony, Treasury supports responsible innovations that meet the needs of users, the financial system, and the economy. The Administration continues to evaluate the broader set of issues and opportunities posed by digital assets and distributed ledger technology, and welcomes the opportunity to continue to work with Congress.

To date, much of the public policy discussion of digital assets has focused on regulatory questions about digital assets themselves. I would identify two additional sets of issues that merit focus as policy is developed in this area:

The first relates to the regulation of intermediaries that participate in digital asset markets. Some of these intermediaries are banks, investment companies, and other traditional financial actors that are increasingly expanding into digital assets. Other intermediaries -- such as stablecoin issuers, custodial wallet providers, and digital asset exchanges -- are native to the digital asset ecosystem, but provide financial services similar (and sometimes identical) to those provided by traditional financial services providers. For both traditional and digital native intermediaries, it is critical to ensure that regulatory frameworks are in place that appropriately address risks to businesses, consumers, and investors, as well as the broader financial system. The banking agencies' recent "crypto sprint," the Securities and Exchange Commission and Commodity Futures Trading Commission's assessment of authorities over digital exchanges, and the PWG's work on stablecoins are important steps in this direction. But clearly, much work remains to be done.

The second set of issues relates to potential for systemic risk that could result from the build-up of leverage against digital assets. As we saw in the 2007-2008 financial crisis (and most that preceded it), leverage can play a key role in catalyzing and accelerating financial instability. To address these risks, the Administration is building its knowledge and understanding of the role that leverage plays in digital asset markets and of the implications of that leverage for the rest of the financial system. We would be pleased to discuss this set of issues further with the Committee as our understanding deepens.

I want to thank the Committee for its leadership on these important issues and for inviting me here to testify today. I am happy to answer any questions from the Committee. I also look forward to additional conversations regarding broader issues raised by digital assets and distributed ledger technology.

