

TECHNOLOGY TRENDS

In March of this year, the Financial Policy Committee (FPC) at the Bank of England signalled their intent around the future of regulation for crypto-assets and DeFi by publishing their *Financial Stability in Focus* paper. Within it, whilst recognising the value that stable coins could bring to the wholesale financial marketplace, they outlined the need for a regulatory framework to protect coin holders against systemic failure or redemption risk (is the coin backed by sufficient assets to maintain convertibility at par?). Recent market events surrounding Luna/Terra created further anxiety around the relative 'stability' of stablecoins, the confidence in them as a legitimate store of value and ultimately their ability to play a role within the future of capital

markets. And whilst some industry commentators push for broader recognition of stablecoins as effectively a less politically complex alternative to CBDC's (a discussion which has some merit in wholesale markets), broader adoption continues to be effectively stymied by the absence of regulatory certainty.

Within this debate I see some parallels with the emergence of ETFs post-2008, where the attraction of this new asset and the role it played within capital markets was undermined by concern around the risks surrounding it. Was it 'physically' backed and able to evidence the assets underpinning it or was this created 'synthetically' where derivatives or illiquid collateral were held to underpin performance? In the event of

issuer failure, could assets be ring fenced to prevent them being used to settle the issuers liabilities? Or if a derivative counterparty fails, how could this counterparty risk impact the end investor? The answer to many of these questions in Europe came in the form of UCITS regulation, which effectively gave a mark of quality assurance around the ETF and laid out certain standards. As an example, the underlying assets had to be segregated from those of the ETF provider, ensuring they were effectively ring fenced away in a third-party custodian. Limits were also put in place around asset quality or counterparty concentrations. It was this regulatory certainty around the conduct of the providers and protection for investors that played a major role in ETFs becoming mainstream assets, utilised widely by both retail and institutional investors alike. An example of regulation enhancing innovation and bringing value in the form of a new asset class to the market.

OK, but what has this got to do with stablecoins you may ask?

The relevance of this comparison comes with the announcement on June the 8th by the New York Department of Financial Services (DFS), who announced formal criteria around the issuance of US dollar stablecoins in New York. This made important moves around addressing some of the risks in adopting stablecoins within wholesale financial markets and gave clarity around standards that issuers have to adopt.

In summary, these standards cover:
Backing & Redeemability
Issuers must give clarity and have approved by the DFS in writing the

mechanism 'that confer on any lawful holder of the stablecoin a right to redeem units of the stablecoin from the Issuer in a timely fashion at par for the U.S. dollar'. In addition, issuers must ensure that the stablecoin is backed by a reserve of assets that is at least equal to the value of the outstanding stablecoins every day. So basically, providing assurance to coin holders around being able to redeem their coins, at par, in a timely fashion.

Reserve Requirements

Firstly, all reserves must be segregated away from the assets of the issuer and these assets must be held by state or federal chartered deposits or custodians. Basically, providing robust ring fencing of the underlying assets that back the coin - which is not the case now, even though some seem to believe that their digital assets somehow get the same level of bankruptcy protection that traditional assets do! Secondly, the asset range that can be used to back these coins is narrow and conservative - cash, UST's - that's it. No derivatives or 'synthetic' replication is on the table, making it clean and simple to monitor the underlying asset quality and coin valuation.

Independent Audits

These must be completed at least monthly by an independent, certified accountant who is registered in the US. This will check attestations and validate what the issuer has said they will do, they are doing every month. Emphasis will still be on the internal controls or oversight functions to ensure they are compliant, but a monthly independent audit will also help focus the mind as well as ensure standards are adhered to. And if they are not, this will give clear

justification for sanction by the authorities.

Alongside these specific points, it should also be noted that there are other considerations that the DFS will also look at as part of the approval process. These cover areas such as AML/KYC that you would expect but also consider technology and operational considerations as well in terms of the ability of the stablecoin to mitigate any operational or resilience risk. Another example of recent regulation focussing on 'banking' as opposed to 'banks', which is an important step in legitimising this new asset class and the service providers that support it. So, whilst the issuers may not be banks or traditional financial institutions, they will be held to the same standards as incumbents. Which is important to create 'trust' in the asset.

OK, but why does this matter?

It matters because a functioning 'trusted' stablecoin I see as being a fundamental building block for the future of financial services. One where DeFi enables a much more efficient, faster and safer environment for collateral management. Post the 2008 crisis, collateralisation was a key tool for regulators to mitigate risk and it has been widely adopted across the globe. But the market infrastructure and the processes that support it remain woefully archaic, struggling to keep pace with wider adoption making quick and efficient settlement of collateral challenging. Intraday settlement is expensive and resource intensive for capital markets players, who are often blind to where collateral is at any given time - 'has it settled yet?' - and as a result still have to rely on T+1 settlement conventions for

much of their business. And these antiquated processes also have a knock-on effect on mobility of collateral, limiting its re-use and overall velocity within the financial system. DeFi challenges this paradigm, which is why JPMorgan and others are actively pushing solutions on this new technology to try and remove friction from the process. And as importantly, circumvent the limitations of legacy market infrastructure that makes such a time sensitive process a source of market wide frustration.

I do not know if the parallels with the ETF market will play out for stablecoins, but it provides good context to the discussion around why regulation is important and a necessary step to unlocking the value of DeFi. UK supervisors continue to assess the role of stablecoins within the existing regulatory framework, but the FPC and others should consider the moves made by the DFS and recognise the value a legitimised stablecoin can bring to supporting efficient markets. And whilst many may feel the CBDC debate solves this market structure problem in the long term, the social and political complexities around that will not be solved quickly. ETFs have shown us the value that new asset classes can bring to the capital markets arena in a relatively short timeframe - but only if the regulatory environment can respond to innovation rather than restrict it.



James Maxfield
Managing Director,
Ascendant Strategy

Why stablecoin regulation is good