Memo: Response to the FSB's consultative document on Global Stablecoins

To: Financial Stability Board

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We would like to thank the Financial Stability Board for its important contribution to the discussion on stablecoin technology, with a particular focus on the regulatory, supervisory, and oversight challenges raised by "global stablecoin" arrangements. Our comments on this consultative document can be organized into three broad categories, namely: 1) defining a GSC, 2) differentiating operational- versus policy-related risks, and 3) specific concerns around protocol design.

The importance of defining a global stablecoin

Perhaps the single most important issue regarding the challenges raised by global stablecoins (GSCs) is how one defines a GSC in the first place. Although we are sympathetic to the extremely difficult task regulators face with regards to how they would define a GSC, it is still important to provide as much clarity as possible.

Additionally, we understand the near impossibility of assigning quantifiable metrics to the definition of a GSC, but it would be helpful for the market to understand which attributes might be most important. Although the GSC definition provided in the Glossary is extremely limited, it would be advisable for the FSB to provide more thoughts on the list of potential elements, provided in Annex 5, that could be used to determine whether a stablecoin qualifies as a GSC. In fact, it would be helpful to incorporate this list much earlier in the document, instead of assigning it to the last page, where it may be overlooked entirely.

When thinking about the necessary elements for defining a GSC, we would like to highlight three important aspects related to growth, value, and ecosystems.

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Understanding the growth characteristics of a GSC

When contemplating the potential risks to financial stability associated with a GSC, there seems to be a focus on GSCs that could be fully formed at the time of launch. As such, the analysis appears to presume that all stablecoin projects have the same risk exposures as those entering the market at scale with an extremely large user base and significant reserve assets. Although we recognize that stablecoin projects entering the market at scale could impact financial stability, our concern is that if these risks are assumed to manifest for smaller stablecoin projects that enter the market with only the potential to scale, regulators could be prejudiced against allowing innovative projects from proceeding.

We believe there is a significant difference in the current risks to financial stability associated with projects that have a significant scale at launch, compared to those that are still in infancy and must face typical market pressures before they can achieve scale through organic growth. A GSC that simply "bursts onto the scene" with a large installed user base and huge network could destabilize financial markets through the purchase and sale of reserve assets or through significant changes in capital flows. However, smaller, startup projects have to prove the robustness and utility of their technology to users before they can even hope to achieve scale, and will be subject to market forces and regulations as they grow their network and reserves.

Where there is substantial competition with traditional currencies and payment methods, we can appreciate that the market is well positioned to determine whether a new project is better for its users. Designating startup projects which do not have a user base that could destabilize financial markets is likely to stifle innovation. Greater forbearance for projects that do not immediately impact financial stability would also be consistent with the approach prudential regulators have taken in designating SIFIs, or Systemically Important Financial Institutions, following the financial crisis.

As such, we feel it would be beneficial to differentiate GSCs that pose financial stability risks associated with projects that launch at a scale from projects that must grow organically to achieve scale. Projects that do not pose an immediate threat to financial stability could be monitored without being designated as GSCs, thereby enabling innovation.

Defining the "value" of a GSC

Throughout the consultative document there are references to GSCs being used as a "common store of value" -- as compared to simply a "medium of exchange" -- and the potential risks associated with this outcome. However, there is no direct discussion about what is meant, or at least perceived, to be the value that is stored in a GSC.

The first risk identified in the document states that "if a GSC were used as a common store of value, even a moderate variation in its value might cause significant fluctuations in users' wealth". From this we can infer that the implication is that the GSC's value is denominated in a currency (or currencies) other than the user's domestic currency. Indeed, Factor VIII in Annex 5 makes reference to "Redemption linked to a foreign currency or multiple currencies".

But simply knowing that the value of a GSC is denominated in something other than a user's domestic currency does not necessarily help us understand the specific risk(s) to financial stability. For example, if the GSC was pegged to a global reserve currency (e.g. USD, EUR, etc.) this would suggest the main concern to stability might be the transmission of monetary policy from one country (e.g. U.S. or Euro area) to another (e.g. host country), whereby the GSC basically serves as the transmission mechanism. Although this is certainly a valid risk, it is one, at least, that the global financial system has encountered before, given the myriad occurences of "dollarization" throughout the world.

Alternatively, a GSC's value could be dictated by a private entity -- perhaps by stabilizing the value of a new currency using a proprietarily-defined basket of existing sovereign currencies. In this scenario, monetary policy decisions would no longer belong to an existing (albeit foreign) central bank, but rather they would be at the discretion of the private entity controlling the stability reserve mechanism of the GSC. This scenario would certainly represent a significant, and unconventional, risk to the global financial system.

As such, we believe it would be helpful if the FSB could provide more details about the specific "value" it is focused on when referencing the usage of "common store of value" as it relates to GSCs.

Distinguishing the activities of a GSC's protocol from the ecosystem

When analyzing the potential vulnerabilities that may arise from various stablecoin functions and activities, the consultative document appears to conflate issues that arise from financial uses of stablecoin platforms with those that arise from the architecture and operation of the platforms themselves. For example, we agree that an analysis of vulnerabilities associated with governance arrangements, the managing of reserve assets, and the underlying operational infrastructure should all be included in the protocol's risk profile when considering whether the GSC designation is appropriate.

However, the document also includes, in its assessment of the protocol and platform level, risks factors which arise from the activities of third parties, such as wallets and exchanges that use a given stablecoin platform. Indeed, stablecoin platforms are likely to have multiple third parties such as hosted wallet providers, custodians, exchanges and others that create an infrastructure through which users interact with it and which are regulated. Some of these third parties may not be meeting their regulatory obligations, but we believe that it is important to distinguish between this set of risks and those that arise from the inherent characteristics of the platform.

Although we certainly agree that hosted wallets and exchanges should be regulated, the inclusion of risks of non-compliance by third parties who use stablecoin platforms with the regulatory, supervisory, and oversight challenges of stablecoin platforms, could suggest that regulators consider such platforms responsible for the actions of third party providers, which would hinder innovation. In a similar vein, it is important to separate the risks of open-source, decentralized stablecoin platforms from their use by non-compliant third parties, and perhaps reconsider whether language suggesting a potential prohibition of the technology is warranted.

Given the relative infancy of the stablecoin market, it is understandable that the FSB would want to highlight all potential sources of vulnerability associated with any new projects. However, it would be beneficial if the FSB could provide guidance on how regulators should think about protocol-specific vulnerabilities, compared to those associated with third-party providers.

Differentiating operational risks from policy issues

It would be extremely helpful, and insightful, if the FSB could differentiate financial stability risks stemming from a potential breakdown in GSC operations, compared to policy-related issues that could be exposed (and exacerbated) by the GSC itself.

As mentioned earlier, the document provides important analysis about the potential vulnerabilities associated with governance arrangements, the managing of reserve assets, and the underlying operational infrastructure. It could be argued that all of these vulnerabilities are associated with a potential breakdown in GSC operations. There is certainly real value in understanding the risks associated with the failure of a GSC's stability protocol or the compromising of its ledger, for example.

Indeed, the operational integrity of a GSC is an important risk exposure to understand at the protocol level, but the FSB documentation also highlights some important, and complex, policy issues arising from the normal operations of a GSC arrangement that needs to be addressed by the public and private sector alike.

Perhaps one of the most complex issues is that of cross-border transactions. Stablecoin technology was developed, in part, to address the very real-world problem that many people around the world face when trying to remit money to family and friends in different countries. For individuals, cross-border transactions can be extremely expensive and slow. But with access to global liquidity, large corporations have been able to send money quickly and efficiently around the world for quite some time. Stablecoin technology was developed, in part, to give individuals and small businesses access to similarly efficient cross-border transactions.

From an operational perspective, the risk to financial stability of moving money from one country to another using a GSC is low. Instead, the issue highlighted by the FSB relates to macrofinancial risks associated with "destabilizing capital flows" from households that choose to hold GSCs over their local fiat currency.

It would be helpful if the FSB separated operational risks to stability from the more complex, and nuanced, policy-related issues. This is especially important with respect to the high-level recommendations provided by the FSB.

As stated in the consultative document: "The objective of the recommendations is to help authorities to determine their regulatory, supervisory and oversight approaches to mitigate potential risks to financial stability and market integrity, and risks for users (consumers) that GSCs may pose, while also being supportive of responsible financial innovation."

When it comes to GSC operations, the operational risks are fairly well-known and straightforward. Additionally, the goals of regulators and users will likely be aligned. For example, both regulators and users should be intolerant of fraud and would likely work in unison to raise awareness of such issues.

However, policy-related issues, such as cross-border transactions, are complex and stakeholder incentives may not be aligned. For example, what happens if the needs of consumers (e.g. users) are in conflict with the desires of the monetary authority? If a country is experiencing hyperinflation, it would likely be in the interest of consumers to switch their savings into a more stable currency (which may be facilitated by a GSC pegged to a reserve currency). But such an outflow of capital could further destabilize the situation, prompting authorities to ban the use of the GSC.

Obviously, this is an incredibly difficult issue that will need to be carefully considered and debated over time. The point is that it would be helpful for the FSB to differentiate the more straightforward issues and their respective risks, from those that are more divisive. Otherwise, there is a danger that these divisive issues could prematurely prejudice regulators against GSCs.

Specific concerns around protocol design

The first vulnerability associated with GSC arrangements discussed in the consultative document involves the choice and management of reserve assets. The document notes the inherent risks associated with choosing reserve assets that are illiquid, which could result in large-scale GSC redemptions and fire sales that might spill over into the broader financial system. This is an important issue, and although the guidance by the FSB does not recommend GSC reserves hold any specific assets, the notion that GSCs should hold highly liquid, safe assets, does point to short-term, highly-rated sovereign debt.

However, this brings up another, perhaps equally important, issue highlighted by the ECB's recent report on regulatory and financial stability with respect to GSCs. In its report, the ECB uses the example of the Libra Reserve, to suggest that if a reserve is sufficiently large enough, and predominantly holds sovereign debt, it could "become an important investor in highly rated short-term government papers, thereby potentially contributing to the scarcity of safe assets."

In essence, the FSB suggests that GSCs (and, by proxy, SCs) should hold highly rated liquid assets, but the ECB warns of the potential adverse consequences for the broader financial system if GSCs hold such assets, in size. Both positions are understandable and valid -- but also somewhat discordant.

Another issue related to GSC reserve assets raised in the consultative document is the degree of transparency into a GSC's reserves. It was suggested that more transparency regarding the nature, sufficiency, and liquidity of these assets might improve confidence in the GSC.

While we believe transparency is preferable and advisable, to help build market confidence in any GSC initiative, there is the possibility that detailed information about a GSC reserve could lead to adverse effects, as some market participants may try and front-run trading in certain assets known to be held by GSCs, ahead of a potential crisis, thus exasperating conditions.

In light of this, it would be helpful if the FSB (and other regulators) could provide further guidance, to the extent possible, on issues related to reserves management. It is understood that the FSB may not be able, or willing, to suggest specific assets (or classes of assets) that it deems to be "liquid". But it would be constructive if regulators could offer guidance on specific attributes they associate with liquid assets, such as market size, trading volumes, daily turnover, trading hours, etc. Additionally, it would be useful if the FSB could provide more information as to the level of detail regulators expect to see with respect to GSC reserve portfolio transparency.