

Overview

Stablecoins are a type of cryptocurrency designed to maintain a stable value, typically by being pegged to a real-world asset like the US dollar. Unlike other cryptocurrencies, which can have unpredictable prices, stablecoins aim to provide a more predictable and steady value. This makes them useful for everyday transactions and a reliable store of value, bridging the gap between traditional money and the digital world of cryptocurrencies. Stablecoins represent a pioneering endeavor in the cryptocurrency world. By anchoring their value to real-world assets such as fiat (i.e., national currencies), stablecoins offer a promising compromise between the stability of traditional currency and the innovation of blockchain technology. These digital tokens, residing on secure and transparent blockchain networks, facilitate seamless transactions and reduce the risks associated with price fluctuations inherent in these other conventional cryptocurrencies. Acting as a bridge between the established financial system and the rising crypto economy, stablecoins hold the potential to revolutionize digital commerce, offering swift, efficient, and cost-effective solutions for various financial services.

Despite their relatively recent emergence, stablecoins' rapid growth calls attention to their potential to reshape the financial landscape, opening a new era of digital financial services characterized by stability, security, and accessibility. In this Basic, we will define the different types of stablecoins, evaluate their regulation process, and discuss recent legislation surrounding the topic.

Features of Stablecoins

Stablecoins are typically tied to a currency or a basket of currencies and use different mechanisms to maintain their price. Functioning as representations of national currencies like the U.S. dollar, or currencies not pegged to the price of a commodity, payment stablecoins provide a reliable medium of exchange and store of value. Stable value makes the coins particularly well-suited for facilitating everyday transactions and cross-border payments, promising increased accessibility and efficiency in financial transactions. Additionally, increased stability could offer opportunities for widespread adoption of digital currencies, fostering innovation in micropayments, payroll processing, escrow services, remittances, and foreign exchange trading. While there are a number of self-proclaimed “stablecoins” that exist, many are stable in name only – such as “algorithmic” stablecoins – that lack effective stabilization mechanisms and behave more as synthetic derivatives. Currently, there are four main types of stablecoins.

- **Fiat-backed stablecoins:** Fiat currency, also known as fiat money, is a national currency that is issued by a government and is not backed by a commodity like gold or silver. Instead, its value is based on the public's trust in the currency's issuer, usually the country's central bank or government. Fiat-backed stablecoins are a type of cryptocurrency aligned to the value of a fiat currency, such as the US dollar. These stablecoins aim to maintain a steady value by being fully backed by reserves of the corresponding fiat currency. The process typically involves a centralized entity, such as a financial institution or a cryptocurrency company, holding fiat currency reserves in a bank account or other secure custodial

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arrangement. Each unit of the stablecoin is then issued and backed by an equivalent amount of the fiat currency held in the issuer's reserve. This type of stablecoin represents a significant development in the cryptocurrency ecosystem, offering stability, liquidity, and accessibility for users seeking a reliable digital currency solution.

- **Algorithmic Stablecoins:** Algorithmic stablecoins are a unique subset that aims to maintain an even value through algorithmic mechanisms rather than being backed by fiat currency or other assets. Unlike fiat-collateralized stablecoins, algorithmic stablecoins utilize complex algorithms to manage the token supply dynamically. One of the most well-known examples of an algorithmic stablecoin is Basis, formerly known as Basecoin. While this company/type of currency offers the potential for decentralization and scalability, its success ultimately depends on the effectiveness of the underlying algorithms and the ability to mitigate risks associated with market dynamics and manipulation.
- **Commodity-backed stablecoins:** Commodity-backed stablecoins derive their value from physical commodities such as precious metals or other tangible assets like oil or real estate. Unlike fiat-backed stablecoins, commodity-backed stablecoins are pegged to the value of specific commodities. The concept behind commodity-backed stablecoins is to provide consistency by anchoring the digital token's value to a tangible asset with intrinsic worth. Commodity-backed stablecoins offer a promising avenue for combining the benefits of digital currencies with the steadiness and security of tangible assets. While this type of stablecoin may not be as widely adopted as fiat-backed, it provides an alternative option for investors seeking diversification in the cryptocurrency market.
- **Crypto-backed stablecoins:** Crypto-backed stablecoins, also known as crypto-collateralized, are backed by other cryptocurrencies rather than traditional fiat currencies or physical assets. These stablecoins are designed to maintain a stable value by aligning with a basket of cryptocurrencies held as collateral. The primary mechanism behind crypto-backed stablecoins involves over-collateralization, where the stablecoin issuer holds a surplus of cryptocurrencies as collateral to support the stablecoin's value. Crypto-backed stablecoins have gained popularity and adoption within the cryptocurrency ecosystem. They offer a decentralized and transparent solution for maintaining stability in the cryptocurrency market, providing users with a reliable medium of exchange and store of value for conducting transactions.

Some have argued that stablecoins are a solution in search of a problem, given the wide availability and acceptance of the U.S. dollar; however, incumbent payment systems continue to suffer from frictions in settlement time, affordability, and access. On the other hand, numerous proponents foresee a future dominated by highly efficient electronic transactions.

Some attributes of well-regulated stablecoins include:

- **High Reserving and Redemption standards:** All stablecoins in circulation are fully 1:1 reserved and backed by cash and cash equivalents held at regulated financial institutions. Issuers and intermediaries redeem payment stablecoins in a timely manner after receiving a request. Reserves are held in segregated accounts and should not be used to fund corporate liabilities, or be pledged, loaned, or otherwise encumbered by the issuer.
- **Clear Disclosures:** Issuers should provide details on reserves at least monthly, have a top-tier accounting firm verify accuracy, and publish annual financial statement audits.
- **Consumer Protections:** Holders of payment stablecoins should have priority over all other creditors in a bankruptcy, including the Issuer or Virtual Asset Service Providers (e.g., exchanges, custodians, etc). Appropriately issued payment stablecoins should be disclaimed as neither securities nor commodities, but instead recognized as a form of regulated dollar payment instrument.
- **Adhere to Illicit Finance Norms:** Stablecoins that adhere to existing illicit finance standards – such as the Bank Secrecy Act and U.S. sanctions – are more traceable than bank deposits or physical cash, due to the open nature of distributed ledger technology.

Stablecoin Regulation

Stablecoins continue to be under scrutiny by regulators, given the rapid growth of the market and its potential to affect the broader financial system. In October 2021, the International Organization of Securities Commissions stated that stablecoins

should be regulated as financial market infrastructure alongside payment systems. The proposed rules would focus on stablecoins deemed systemically important by regulators, such as those with the potential to disrupt payment and settlement transactions.

Terra was the world's third-largest cryptocurrency ecosystem at the time and collapsed in three days, leaving nearly \$50 billion of market capital wiped out. The Terra collapse in May of 2022 showed the need for regulation that defines stablecoins and what potential risks are associated with it. Most major financial regulators are actively considering regulation for stablecoins and the broader crypto asset ecosystem. However, until financial regulators clarify obligations, consumers should recognize the inherent increased risks.

Stablecoin regulation currently varies by country. Some countries prohibit using stablecoins for payments or prevent banks from issuing them, while others are working to promote their use and propose new regulations. The regulation of stablecoins is highly fragmented in the broader digital asset industry. Increasingly, digital assets are regulated under existing banking, money transmissions, and payments and securities rules. Trying to navigate this regulation puzzle makes it incredibly challenging to innovate with legal certainty. Many markets, including the U.S., are ramping up regulatory efforts and are looking to amend existing rules to cover activities involving digital assets.

Recent Legislation

In July of 2023, the House Financial Services Committee passed on a bipartisan basis the Clarity for Payment Stablecoins Act which was the culmination of more than two years of technical work. The proposed bipartisan legislation would create a regulatory framework for payment of stablecoins that sets high reserving and redemption standards while enshrining America's anti-money laundering and sanctions rules. In April of 2024, the Lummis-Gillibrand Payment Stablecoin Act was introduced in the U.S. Senate with intentions to carve out space to grow safe, regulated stablecoins in America while preserving the U.S. dollar as the premier global currency. Also included in the bill are provisions establishing strict lanes for federal regulators, including provisions preserving the dual banking system. This aims to foster innovation by preventing overregulation and bolstering the authority of state regulators, thereby creating opportunities for stablecoin markets to grow in different states and localities around the country. Ultimately, the increased momentum suggests that Congress could enact legislation to establish a regulatory framework for stablecoins.

Stablecoin legislative proposals aim to establish a clear and appropriate regulatory framework that ensures market integrity and consumer protection while fostering innovation. Key principles for such a framework should include ensuring a level playing field for fintech innovators and traditional financial institutions, with regulatory standards that do not impede innovation. Transparency is crucial with regular third-party audits of reserve assets to maintain trust and stability. Recognizing the efficacy of state-level financial regulators, the framework would benefit from including state pathways that uphold high regulatory standards, leveraging existing frameworks for more localized and responsive oversight.

The purpose of stablecoins goes beyond being just a financial contract. It is the evolution of both conventional payment systems and traditional, fluctuating cryptocurrencies. Though questions of legislation and regulation remain, stablecoins have a considerable potential to change the global payment landscape. As stablecoins continue to "stabilize" and gain public trust, the financial sector's use of digital assets will keep evolving.

Links to Other Resources

- Akin Gump - Bipartisan Legislation Introduced in the [Senate to Establish a Regulatory Framework for Stablecoins](#)
- BIS - [Recommendations for the Regulation, Supervision and Oversight of Global Stablecoin Arrangements](#)
- Congressional Research Service - [Stablecoin Policy Issues for the 118th Congress | CRS Reports](#)

- Fidelity - [What is a stablecoin?](#)
- Forbes - [An Introduction To Stablecoins](#)
- Hedera - [What is a stablecoin? | Hedera](#)
- International Organization of Security Commissions - [Policy Recommendation for Crypto and Digital Asset Markets](#)
- Mastercard - [Stablecoins explained: An FAQ on these digital assets](#)