Written Statement of
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“Stablecoins: How Do They Work, How Are They Used, and What Are Their Risks?”

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Banking, Housing, and Urban Affairs

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Jai Massari Biography

My name is Jai Massari, and I am a partner in the Financial Institutions Group of Davis Polk & Wardwell LLP, resident in its Washington, DC office. I began my legal career in 2007, just before the financial crisis, as a law firm associate learning about and advising on a wide range of complex financial regulatory topics, including Title VII derivatives regulation, the Volcker Rule, and other key Dodd-Frank regulatory reform matters.

As the boundaries of financial services have pushed into cryptocurrency, so has my practice. For the past several years, I have been advising financial institutions, cryptocurrency firms, and technology platforms—from two-person start-ups to the largest banking organizations—on financial regulatory considerations relating to cryptocurrency activities. This includes advising stablecoin issuers and wallet service providers on the financial regulatory aspects of stablecoin activities. Today, I am presenting my own views as a practicing financial regulatory lawyer, not those of any client or my firm.
Chairman Brown, Ranking Member Toomey, and members of the Committee, thank you for inviting me to speak today on this interesting and complex topic.

Since the earliest days of our nation, as our economy has grown and transformed, so too has our understanding of money. The dramatic changes we are all familiar with have seen purses of gold and silver coins eventually replaced by wallets holding state and later national bank notes, then Federal Reserve notes alongside checkbooks tied to demand deposits, followed by the proliferation of credit and debit cards, and more recently the swift rise of payment apps.

Like the innovations in public and private money that preceded them, stablecoins squarely present the same core regulatory concerns as earlier forms of money—those of consumer protection, systemic stability, safety and soundness, and combating illicit finance. But with thoughtful regulation, stablecoins can perhaps offer benefits over the technologies that came before, including lower costs, faster services, new services made possible by programmability, opportunities to expand financial inclusiveness, greater traceability, and the potential for enhanced operational resiliency through the use of distributed networks.

The Committee is today asking the key questions: how do stablecoins work; how are they used now and how will they be used in the future; and what are the resulting risks? To this, I would add: what are the potential benefits? The answers to these questions form the basis for understanding how stablecoin activities should be regulated.

U.S. regulators have made important progress in examining these questions. As you know, the President’s Working Group on Financial Markets (PWG) published a policy statement on stablecoins in 2020.1 Along with the FDIC and OCC, the PWG also published a report last month on federal regulation of the issuance of stablecoins and related stablecoin activities.2 Indeed, regulators around the world have been thinking about these questions in earnest since 2019.3

I’ll focus my comments today on “true” or “payment” stablecoins as described in the PWG Report.4 As I’ve written previously,5 true stablecoins are non-interest bearing

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3 E.g., BANK FOR INTERNATIONAL SETTLEMENTS COMMITTEE ON PAYMENTS AND MARKET INFRASTRUCTURES & BOARD OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, APPLICATION OF THE PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES TO STABLECOIN ARRANGEMENTS (Oct. 2021); FINANCIAL STABILITY BOARD, REGULATION, SUPERVISION AND OVERSIGHT OF “GLOBAL STABLECOIN” ARRANGEMENTS (Oct. 2020); G20 FINANCE MINISTERS & CENTRAL BANK GOVERNORS MEETING, G20 PRESS RELEASE ON GLOBAL STABLECOINS (Oct. 2019); FINANCIAL STABILITY BOARD, REGULATORY ISSUES OF STABLECOINS (Oct. 2019); G7 WORKING GROUP ON STABLECOINS, INVESTIGATING THE IMPACT OF GLOBAL STABLECOINS (Oct. 2019).

4 PWG REPORT, supra note 2, at 2 (defining “payment stablecoins” as “those stablecoins that are designed to maintain a stable value relative to a fiat currency and, therefore, have the potential to be used as a widespread means of payment”). While there are many different types of stablecoins, including algorithmic stablecoins and stablecoins pegged to gold and other real assets, assessing the regulatory treatment of true stablecoins is an appropriate priority given their potential to play a wider role in consumer
financial instruments designed to maintain a stable value against a reference fiat currency—say one dollar. This reference value is also referred to as the stablecoin’s par value. A well-designed stablecoin typically holds its value through a pair of promises. First, the stablecoin issuer agrees to sell and buy them back at par value (perhaps for a fee). Second, the issuer agrees to hold a pool of safe assets—the “reserve”—that has an aggregate market value at least equal to 100% of the aggregate par value of the stablecoins. Such a reserve is designed to back the issuer’s obligation to repurchase stablecoins at par, and is replenished with the proceeds of stablecoin sales.

The reserve is meant to ensure that the issuer can always redeem outstanding stablecoins at their par value on demand. For this reason, reserve assets of a well-designed stablecoin would consist of cash and genuine cash equivalents, such as bank deposits and short-term U.S. government securities. This should enable the reserve to remain liquid even during stressed market conditions, minimizing the risk of loss if large numbers of stablecoin holders seek redemptions at once.6

The insight underlying a true stablecoin is not new. It’s instead a form of “narrow bank”—a concept that has been in the public discourse since at least the Great Depression.7 Narrow banks sometimes have not been considered as economically useful as fractional reserve banks. This is because they do not engage in maturity and liquidity transformation—that is, using short-term deposits to make long-term loans and investments—which is the core function of modern banking and the lifeblood of the real economy.8 But because narrow banks do not engage in maturity or liquidity transformation, they are generally considered safer than fractional reserve banks. We tolerate the risk traditional banking activities impose on the economy because of the benefits.

While stablecoin issuers have structural similarities to narrow banks, they provide potential new benefits that are worth recognizing. The basic business model for a stablecoin is to serve as a payment instrument. Today, stablecoins are used primarily in connection with cryptocurrency trading and decentralized finance (DeFi) applications.

and business payment activities outside of cryptocurrency trading. Id. From here, any references to “stablecoins” throughout this written statement mean “true stablecoins” or “payment stablecoins.”


6 Today, reserve assets vary among stablecoin issuers. For most U.S. dollar stablecoin issuers, their reserves are legally constrained by requirements under existing state money transmitter laws, with some making public commitments to maintain their reserves only in cash and genuine cash equivalents.


For the moment, therefore, they are largely on the margins of the banking system and the real economy.

Some, however, view stablecoins as having a potentially broader use in retail payment services.\textsuperscript{9} Payments using blockchain rails would complement existing payment systems grounded in the traditional banking sector such as cash, checks, credit and debit cards, and wire transfers. These incumbent technologies offer varying benefits and drawbacks. As stablecoins begin to play a role in retail payment transactions, they offer a way to decouple payment services from credit services, presenting us with the potential for increased competition from new entrants, expanded services, lower costs for consumers and greater opportunities for financial inclusion.

Particularly if they begin to realize this potential, and even more so if they approach systemic scale, stablecoins should be regulated in a manner that addresses the risks they present, which U.S. regulators have identified. As set out in the PWG Report, these include the risk of runs on poorly designed reserves, risks associated with the operation of payment systems generally, risks of scale, and risks arising from regulatory gaps.\textsuperscript{10}

There already appears to be broad agreement among U.S. policymakers, regulators, and the industry on the general principles of stablecoin regulation. Regulation of stablecoin issuers should include restrictions on permissible types of reserve assets to ensure sufficient short-term, liquid backing; auditing and transparency standards so regulators and the public can evaluate reserve composition; restrictions that preclude maturity and liquidity transformation activities in order to shield reserve assets from the associated risks; obligations to address illicit financing and sanctions considerations; and requirements to address operational risks arising from settling transfers on blockchain networks. U.S. financial regulators have addressed these topics before and, with Congressional guidance, can do so again.

However, requiring stablecoin issuers to be insured depository institutions (that is, insured banks)—as suggested in the PWG Report—is not necessary and, unless certain adjustments are made, is not workable. I will explain why.

An insured-depository requirement is unnecessary because stablecoins can be structured and regulated to avoid the risks that require deposit insurance and the application of traditional banking oversight in the first place. Banks—by design—are in the business of maturity and liquidity transformation. Banks take in deposits that can be withdrawn on demand, against which they hold some short-term liquid assets, like cash in a Federal Reserve Bank account, but more importantly they hold long-term, relatively illiquid assets, like 30-year mortgages and long-term corporate loans. This activity creates economic value in the form of increased money supply and credit.

\textsuperscript{9} See, e.g., PWG REPORT, supra note 2, at 8 (“Beyond digital asset trading, several existing stablecoin issuers and entities with stablecoin projects under development have the stated ambition for the stablecoins they create to be used widely by retail users to pay for goods and services, by corporations in the context of supply chain payments, and in the context of international remittances.”).

\textsuperscript{10} PWG REPORT, supra note 2, at 12–14.
But it also creates run risk and the need for deposit insurance. Limiting stablecoin reserves to short-term, liquid assets, and requiring the market value of those reserves to be no less than the par value of stablecoins outstanding, is an alternative way to avoid run risk—as U.S. policymakers have recognized since at least the 1930s.

An insured-depository requirement is unworkable, without adjustments to the existing bank regulatory framework, because banks are subject to leverage and risk-based capital ratios that are calibrated based on the assumption that a majority of their assets are relatively illiquid and riskier than cash and genuine cash equivalents. Leverage ratios, in particular, are designed to backstop risk-weighted capital requirements. They treat cash and cash equivalents as if they had the same risk-and-return profile as long-term consumer and business debt, which they do not.

To take an example, a stablecoin issuer subject to a 4% leverage ratio would need to hold $104 billion of cash and genuine cash equivalents against $100 billion of circulating stablecoins—$100 billion backing the stablecoins on a dollar-for-dollar basis and a cushion of $4 billion of required capital in the form of shareholders’ equity. A bank that engages in customary lending activities, such as credit card, real estate and business lending, is able to price its loan products to cover the cost of the required capital and still make a reasonable return. A stablecoin issuer, whose assets may be limited to zero-to-low interest paying cash and genuine cash equivalents such as bank deposits and short-term U.S. government securities, has no such ability. Therefore, unless Congress recalibrates the ratios to reflect the lower risk-and-return profile of stablecoin issuers who limit their reserve assets to cash and genuine cash equivalents, the stablecoin business model would be uneconomic for an insured depository institution—except perhaps as a sideline for a large, diversified financial services provider.

How, then, should stablecoins be regulated? Today, U.S. stablecoin issuers and digital wallet service providers are largely regulated by the states under money-transmitter regimes and trust-company authorities. New York regulates stablecoin activities under its special-purpose virtual currency licensing program, known as the BitLicense. Wyoming has developed its own special-purpose bank license to accommodate cryptocurrency custody and payments activities. The innovative work of state regulators has already played a key role in the expansion of stablecoin activities.

There is at present some federal regulation of stablecoin activities. U.S. stablecoin issuers and digital wallet providers are, for example, subject to the Bank Secrecy Act’s anti-money laundering requirements as money services businesses registered with FinCEN, the U.S. Treasury’s Financial Crimes Enforcement Network.

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11 E.g., Douglas W. Diamond & Philip H. Dybvig, Bank Runs, Deposit Insurance, and Liquidity, 91 J. Pol. Econ. 401 (1983) ("It is precisely the "transformation" of illiquid assets into liquid assets that is responsible both for the liquidity service provided by banks and for their susceptibility to runs.").


13 23 NYCRR Part 200.

But an expanded federal role may well be appropriate and useful. This could include an optional federal charter for stablecoin issuers that would preempt the need for state-by-state licensing in return for supervision by federal regulators. A new and well-designed federal charter could accommodate a business model premised on the issuance of stablecoins fully backed by short-term, liquid assets and the provision of related payments services. This charter could impose requirements for reserve asset composition while tailoring leverage ratios or risk-based capital requirements and other requirements to the nature of the business model. And it could restrict the stablecoin issuer from engaging in riskier activities, to minimize other claims on reserve assets. This option would likely be welcomed by many stablecoin issuers even though it would entail comprehensive federal oversight.

I would like to close by thanking the Committee for its focus on these important issues. The Committee’s work today in understanding how stablecoins work, how they can be used, and the risks they present is indispensable to developing a resilient regulatory framework. While I do not believe that stablecoin issuers should be limited to insured depository institutions, I strongly support common-sense regulation of stablecoins and their issuers in a way that takes account of their benefits and risks. And I am optimistic that there is much common ground among innovators, policymakers, regulators, and the public on these questions. This common ground can pave the way for a regulatory approach that safeguards consumers, the financial system and the broader economy, while continuing to promote innovation in this exciting and promising new financial technology.

I am happy to answer questions.