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What is Wrong with the EU Market in Crypto-Asset Regulation? Stablecoin between Innovation and Financial Stability

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Financial innovation, especially in relation to the blockchain, is one of the trendiest topics among experts and popular media, with resounding and rather vague promises to completely reshape finance. However, financial innovation often aims at handling old problems with the help of new technologies. Thus, for much we do not know about their benefits and risks, there is also a lot we

already know both in terms of risks they embed and in terms of the effectiveness of various regulatory responses.

Reasoning along these lines, in a recent article I show that stablecoins are a new and technologically advanced form of private money—a phenomenon known for centuries. Stablecoins are crypto assets that purport to maintain a stable value by referencing other physical or financial assets. As any form of private money, stablecoins can also be vulnerable to liquidity risk if not appropriately regulated.

Interestingly, on October 10th, 2022, the 'The Royal Swedish Academy of Sciences' has decided to award the Sveriges Riksbank Prize in Economic Sciences to Douglas W. Diamond, Philip H. Dybvig and Ben S. Bernanke 'for research on banks and financial crises'. This represents the perfect starting point to assess the efficiency of the recent Market in Crypto-Asset Regulation (MiCA) where, among other things, the EU policy-maker regulates stablecoins.

Diamond and Dybvig (1983) developed the standard model of 'bank runs', where banks act as financial intermediaries and engage in maturity and liquidity transformation. This intuition is applicable beyond chartered banks, so long as the financial intermediary performs maturity and liquidity transformation on its own account. Over the years, it has been applied to shadow banking and money market funds—among others. In my article, I demonstrate that a similar argument holds for stablecoins.

In the model, short-term creditors, such as depositors, are entitled to withdraw their money at all times. In contrast, the intermediary has long-term, illiquid assets. In normal times, creditors' withdrawals are uncorrelated, and the intermediary can easily satisfy their creditors. However, if creditors expect that all other creditors will withdraw at a specific point in time because they are unsure about the solvency of the intermediary, all creditors will have an incentive to run, making the insolvency risk material.

Crucially, applicable laws and regulations shape the possibility to perform maturity and liquidity transformation in good times, as well as to suddenly withdraw short-term claims in bad times. Afterall, the possibility to withdraw deposits on demand and at par is established contractually and banking regulation details the requirements to have a banking license and being able to enter in such contractual agreements. Similarly, the possibility to redeem the shares of Money Market Funds is provided by the article of association of the fund to redeem.

The whole post-crisis stream of financial reforms can be understood as an attempt to regulate the ability of chartered banks and other financial

intermediaries to engage in maturity and liquidity transformation. However, the regulation of financial intermediaries entails trade-offs between partly divergent policy goals: financial stability, investor protection, and regulatory competition (promoting innovation), all of which policymakers cannot achieve simultaneously.

Given this analytical framework, the question is if and how the MiCA considers the liquidity risk and hence the financial stability risk inherent to stablecoins. The analysis highlights that MiCA prioritises investor protection and regulatory competition at the expense of financial stability, despite claiming to achieve all of these goals.

For stablecoins referencing an official currency, such as the US Dollar or the Euro, the keys to their stability are:

1. the quality and quantity of the reserves on the asset side;
2. the rights given to the holders of the tokens on the liability side.

In this regard, the crucial provisions pertain to the obligations of the issuers on reserves (Article 32 and 34 MiCA) and the withdrawal rights of the holders of stablecoins (Article 35 MiCA).

The regulation establishes a general obligation for issuers whereby outstanding tokens should always match the amount of reserves and vice versa. The regulation requires that stablecoin issuers hold at least 30% of reserves in the form of the referenced currency and mandates the EBA to develop further liquidity requirements in secondary legislation. Moreover, the regulation allows issuers to invest their reserves in ‘high quality liquid asset(s)’ (HQLA), relying on secondary regulation to identify them exactly. Crucially, the designation as HQLA entails a large degree of discretion and is prone to mistakes; for instance, AAA Mortgage -backed securities were and to an extent still are considered HQLA. On the liability side, the regulation entrusts the holders of stablecoins with a general and absolute right to redeem their coins with no fee.

Piecing together the provisions related to the reserves and the rights of token-holders, it becomes apparent that the legal design of MiCA, which purportedly allows the issuers of stablecoins to intermediate finance and engage in liquidity and maturity transformation, may generate or bolster systemic risk should liquidity dry up.

To counter this risk, MiCA requires stablecoin issuers to hold 2% of equity (3% for significant issuers) and to draw up a ‘recovery plan’. These measures, albeit important, are likely to be ineffective. Regulatory capital is usually designed to

handle credit risk, which is minimal in stablecoins, whereas it does little to counter liquidity risk. The recovery plan should set up actions and procedures to ensure the resilience of the issuer should the situation quickly deteriorate. These procedures may include redemption fees and the temporary suspension of redemption. However, these 'early crisis management' tools are left largely in the hands of the issuer, who has an incentive to delay the recognition of the crisis to avoid panic. Therefore, they are likely to be used too late, which is 'optimal' from the perspective of the issuer but is socially inefficient.

The cryptocurrency commotion of May 2022 gives a clear measure of the magnitude of the problem. Following the collapse of Luna, a relatively small algorithmic stablecoin, the liquidity in the crypto economy dried up and the biggest stablecoin issuer, Tether, faced a run and lost its peg to the US Dollar. Crucially, the rules on redemption privately enforced by Tether were much more stringent than those imposed by MiCA. Tether currently only allows investors to withdraw at least 100k USDT at once and for a 0,1% liquidity fee, which can be conceptualised as a gate to redemption and should stop runs. However, as even this was not enough to prevent the run of May 2022, one can only imagine what would have happened if all retail investors could have redeemed their tokens for no fee.

Currently, several jurisdictions are working on comprehensive regulation of the crypto economy. If MiCA's approach of stablecoin regulation is confirmed, this may become a serious source of vulnerability for financial stability in the coming years.

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by Yuliya Guseva, Sangita Gazi, Douglas Eakeley

We Must Protect Investors and Our Banking System from the Crypto Industry

5 January 2024

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