Stablecoins

Why in News

The US is discussing launching a **formal review into whether Tether and other** stablecoins threaten **financial stability.**

- The first stablecoin, created in 2014, was Tether.

Key Points

- **About Stablecoins:**
  - A stablecoin is a type of **cryptocurrency** that is typically pegged to an **existing government-backed currency.**
    - A cryptocurrency is a **form of digital asset based on a network** that is distributed across a large number of computers.
  - Stablecoins hold a **bundle of assets in reserve**, usually **short-term securities** such as cash, government debt or **commercial paper**.
  - Stablecoins are useful because they **allow people to transact more seamlessly in cryptocurrencies** that function as investments, such as **Bitcoin**.
  - They form a **bridge** between old-world money and new-world crypto aslo they **promise to function like perfectly safe holdings**.
- **Types:**
  - **Fiat-collateralized Stablecoins:**
    - They are **collateralized by fiat money**, such as the US dollar, euro or the pound, on a 1:1 ratio.
    - **Examples:** Tether, Gemini Dollar, and TrueSD.
  - **Stablecoins Backed by Other Assets:**
    - There are a **few stablecoins**, which are **backed by a basket of multiple assets** (commercial papers, bonds, real estate, precious metals, etc).
    - The value of these stablecoins can **fluctuate over time subject to movement** in commodity and precious metal **prices.**
    - **Example:** Digix Gold, backed by physical gold.
  - **Crypto-Collateralized Stablecoins:**
    - Crypto-collateralized stablecoins are **more decentralised than their peers** and are backed by cryptocurrencies.
    - The flipside is **price volatility** and to address the risk of price volatility, these stablecoins are over-collateralized.
    - **Example**: Dai.
  - **Non-collateralized stablecoins:**
    - These stablecoins **do not have any backing and are decentralized** in the true

sense and the supply of **non-collateralized stablecoins** is governed by algorithms.
        - **Example**: Basis.
- **Concerns:**
    - **Related to Short term Debt:**
        - Many stablecoins are backed by **types of short-term debt** that are prone to periods of illiquidity, meaning that they can become hard or impossible to trade during times of trouble.
    - **Not all Stablecoins are Stable:**
        - Not all stablecoins are really 100% price-stable. Their values are **dependent on their underlying assets**.
    - **Asset Contagion Risk:**
        - There are **potential asset contagion risks** linked to the liquidation of stablecoin reserve holdings.
            - A **contagion** is the spread of an economic crisis from one market or region to another and can occur at both a domestic or international level.
        - The risks are primarily associated with collateralised stablecoins, varying based on the size, liquidity and riskiness of their asset holdings, as well as the transparency and governance of the operator.
    - **Risks to Financial Stability:**
        - While stablecoins have the potential to enhance the efficiency of the provision of financial services, they may also **generate risks to financial stability**, particularly if they are adopted at a significant scale.
    - **Lack of Accountability:**
        - They are not **transparent or auditable by everyone** and are operated just like non-bank financial intermediaries that provide services similar to traditional commercial banks, but outside normal banking regulation.
    - **Regulatory Challenge:**
        - International coordination of regulatory efforts across diverse economies, jurisdictions, legal systems, and different levels of economic development and needs is another regulatory challenge.
        - There is **not (yet) a uniform regulatory approach of regulators worldwide** relating to stablecoins.

Way Forward

- Stablecoins do not stand for a uniform category but represent a variety of crypto instruments that can vary significantly in legal, technical, functional and economic terms.
- So, in order to be **effective in limiting risks and not disturbing innovations** the stablecoin industry **must work together with the regulators** to come up with a framework that helps put them at ease while protecting this nascent industry from overregulation.

Source: IE