Digital Currencies
Governance Group

Stablecoins

DCGG Briefing Paper

Blockchain technology creates a transparent and accountable system through open-source decentralization. With regard to the stability of their value, some digital currencies' value can fluctuate rapidly. Stablecoins, as a specific type of digital currency, tackle the problems of extreme volatility and trading speculation as they retain a stable value through being pegged to reserve assets such as fiat currencies or exchange traded commodities like precious metals. Stablecoins are capable of bridging the gap between fiat currencies and digital currencies and contribute to building trust in digital payment systems.

What is A "Stablecoin"?

Stablecoin is a specific type of digital currency, designed to retain a stable value by being pegged to reserve assets such as fiat currencies or exchange traded commodities.

Stablecoins possess stable exchange rate and can be considered suitable for everyday use, due to being able to maintain purchasing power and having the lowest possible inflation.

Depending on their mechanism, there are three key types of stablecoins:

Fiat-Collateralized Stablecoins

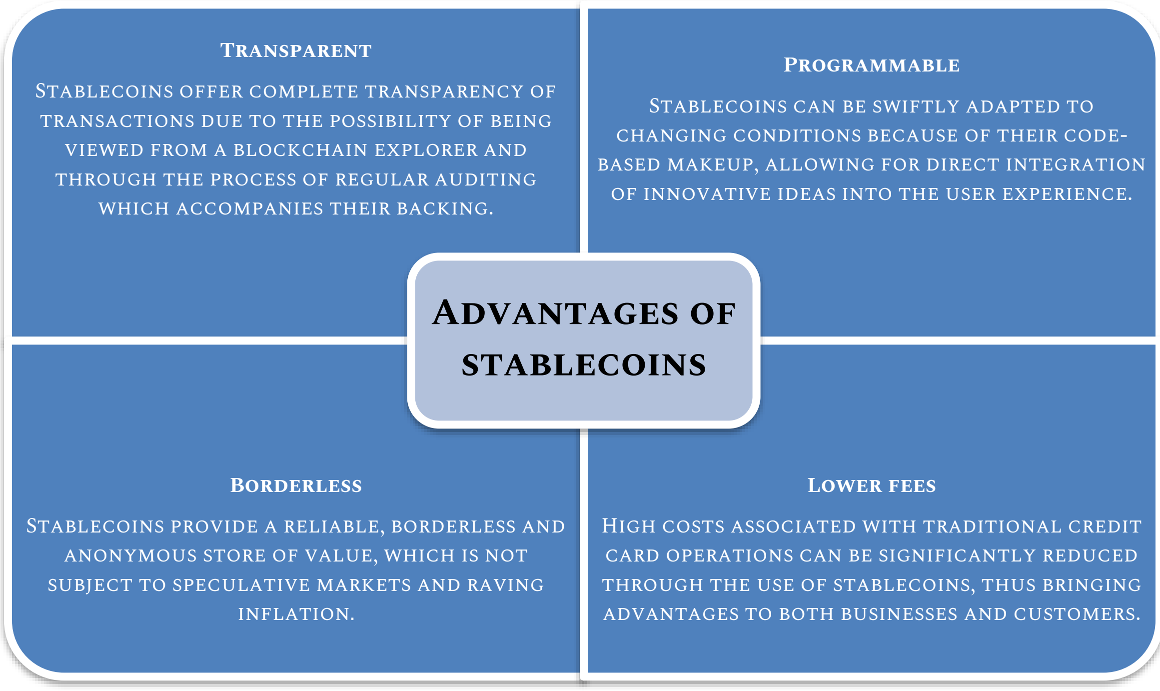
Pegged to a fiat currency reserve as collateral for the release of an appropriate number of stablecoins. The fiat reserve can include national currencies such as the U.S. dollar, precious metals, or other commodities such as oil. This method requires regular auditing and oversight by a custodian to provide compliance.

Crypto-Collateralized Stablecoins

Type of stablecoins that are backed by other digital currencies. Digital Currencies can be volatile and a stablecoin provider gives a security pledge.

Non-Collateralized (Algorithmic) Stablecoins

This type of stablecoins relies on a working mechanism (algorithm) instead of a reserve to maintain price stability. With this algorithm, volume supply is adjusted according to the current demand. Through the use of smart contracts on decentralised platforms, valuations can be managed, and supply of tokens can be increased or decreased.



CHALLENGES TO STABLECOINS

- ### Banks

Critics argue that stablecoins can undermine the banking system by taking its place as intermediaries. However, stablecoin providers would still need banks in order to store their funds, meaning that banks will not disappear if they adapt to the changing times.

- ### Seigniorage

Seigniorage is the central banks' profit from the difference between the manufacturing cost of the money and the currency's face value. Some argue that if stablecoins do not carry interest but at the same time are backed by fiat currencies, this can drain the profits of central banks. A solution to this problem is to promote competition, so that issuers of stablecoins start paying interest.

- ### Illicit activities

Critics of stablecoin argue that it can be used for illicit activities. However, new technologies give more ways of monitoring all activities related to stablecoin. Such a technology is the Zero-Knowledge Proof (ZKP) technology, which allows digital authentication without disclosing sensitive personal data. ZKP prevents the possibility of any information, either from the sender's or receiver's end, from being compromised. Considering that KYC compliance is a significant element in the fight against financial crime and money laundering and that Customer identification is the most critical aspect as it is the first step to better perform in the other stages of the process, the implementation of ZKP would guarantee transparency and prevent the use of digital networks for illicit activities.

- ## Monopolies

It can be argued that an emerging market of digital monopolies can arise. Some tech giants have developed networks (Facebook's Libra), with which they try to shut out competitors. They can monetize information, which would make it more difficult for small and emerging companies. In order to prevent this from happening, new laws and standards that regulate data protection, control, ownership and portability should be introduced.

- ## Consumer Protection

In the event of a bank run, customers' savings must be safe and protected. In order to achieve consumer protection and fiscal stability, a new legal framework should be created. This framework should define what kind of financial instruments are stablecoins. One possible approach is to define them as money market funds which guarantee fixed returns with the requirement that providers of MMF maintain sufficient liquidity and capital.

DCGG's position

In order for stablecoins to be successful in the future there is one absolute prerequisite - legal certainty. A sound legal basis in all jurisdictions where stablecoins operate and legal clarity on the nature of the claim of all participants - from stablecoin buyers to stablecoin providers would be an important step to take. Stablecoin is a payment system with global importance and, once specific guidelines are created, authorities in the different jurisdictions shall aim for their individual principles and rules to adhere to the international principles and standards. It is the role of public authorities to ensure that there is a playing field that encourages competition between the different providers and at the same time use technology-neutral regulatory approach. In order to create a prudent regulation for stablecoin issuers and consumers, the EU should produce specific requirements for banking license to be obtained by institutions that operate solely with stablecoins. Such a bank shall guarantee high liquidity for the purpose of loans and collaterals published on the blockchain to assure transparency and high level of consumers protection.

Stablecoins have a global nature, they exist in many countries and many more will start adopting them in the future. China is one of the fastest countries to make use of blockchain technology and during 2020 has made an announcement of the digital yuan pilot and included digital currency provisions in the scope of the law. Against the backdrop of China's progress, the EU is lagging behind. Another country, which has made progress is the UK. The financial policy committee of the Bank of England is to publish a report of effects of stablecoins, which will also address a Central Bank Digital Currency. The committee is seeking to show how the regulatory system should be adjusted to guarantee confidence in stablecoins while

simultaneously supporting innovation. Many countries lack a legal basis for stablecoins in their national legislations and they do not regard digital currencies as equals to fiat money due to their unstable value. This may leave some stablecoin providers unprotected in some jurisdictions. In order to achieve global regulations, legal rules shall be created in relation to the information that customers provide to stablecoin issuers. Stablecoin users shall know how their personal data is used and stored. Currently banks and credit companies are regulated by laws in every country around the world and a similar level of regulation shall apply to stablecoin providers worldwide.

At the European Union level, the legislation which is to govern the use of stablecoins as a category of digital currencies is the Markets in Crypto-assets Regulation (MiCA). We at the DCGG have

identified specific areas for improvement in MiCA that have the potential to strengthen Europe's future.

We believe that clearer differentiation is needed between e-money platforms, open domain stablecoins and enterprise projects that are backed in a fiscally appropriate way. In order to achieve this, we propose that MiCA should provide for Regulatory Technical Standards to be issued by the European Supervisory Authorities to address any ambiguity on the distinction between crypto assets, under MiCA, and financial instruments, should such ambiguity arise as the industry develops.

The MiCA regulation should provide more proportionate rules in order to create incentives for smaller firms to enter the market. The level of capital requirements should not be too high in order to enable market entrance. Disproportionate obligations imposed on companies by the legislation should be eased and innovation in the field of stablecoins should be encouraged.