Growing use of stablecoins

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Executive Summary

Regulators globally are discussing regulation of stablecoins in the wake of rapid growth in their aggregate market capitalization. The stablecoin ecosystem is distinguished by the separation of issuers and intermediaries. Stablecoins have the potential to reshape the payment services landscape.

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Rapid growth in market capitalization

Stablecoins' aggregate market capitalization at the start of 2022 stood at US$152.1bn, an increase of roughly fivefold from a year earlier and 25-fold from two years earlier[1]. This $152.1bn is equivalent to roughly 17% and 33% of Bitcoin and Ethereum's respective market capitalizations.

The term "stablecoin" is variously defined but it usually refers to a digital asset that uses distributed ledger technology and is designed to maintain a stable value relative to a specified traditional financial asset[2]. This stabilization is achieved by collateralizing stablecoins with assets such as bank deposits, financial assets (e.g., government bonds), commodities and/or cryptoassets.

Many existing stablecoins aim to maintain parity with the US dollar. Prominent USD-pegged stablecoins include Tether (USDT), issued by a Hong Kong company of the same name, and USD Coin (USDC), issued by Circle of the US. They have been trading since 2015 and 2018, respectively. Both are backed by financial assets.

Issuers and intermediaries' respective roles in US

In the US, stablecoin services such as custody, trade execution and wallet transfers are provided by virtual currency exchanges, not issuers. US exchanges are regulated primarily by state authorities. For example, virtual currency exchanges generally must obtain a BitLicense from New York State to operate in the state or do business with New York residents. State regulations usually

NOTE

1) Source: Coin Metrics, The Block.

2) Nikkei Online Edition reported on February 4, 2022, that Mitsui & Co. Digital Commodities plans to issue a gold-backed crypto currency named ZipangCoin (ZPG). Although its price volatility should be mild by virtue of its linkage to a physical asset, ZPG does not qualify as a stablecoin because it is not pegged 1:1 to a fiat currency.

construe the term "virtual currency" to encompass both cryptoassets and stablecoins[3]. If a virtual currency exchange sends or receives fiat currency transfers, it must obtain a money transmitter license (MTL) also.

3) In Japan, stablecoins are legally defined as currency assets, not cryptocurrencies.

Major exchanges like Coinbase consequently obtain both a BitLicense and MTLs from many if not all states so they can exchange and transmit both crypto and fiat currencies. Exchanges have also developed services that enable account-holding customers to sell Bitcoin or other cryptocurrencies in exchange for stablecoins instead of fiat currency. Such services have led to broader use of stablecoins. Additionally, some traders arbitrage price discrepancies between exchanges by opening accounts at multiple exchanges and using stablecoins to seamlessly transfer value between their accounts 24/7/365.

Stablecoins are on regulatory authorities' radar globally

With stablecoins likely to become widely used as a means of payment as discussed above, financial regulators globally have a strict attitude toward them. In response to the Libra initiative announced in 2019, the G20 has taken the position that global stablecoins (stablecoins that can be used across borders) should not be allowed unless they are appropriately designed in compliance with legal and regulatory standards/requirements.

The EU published a proposed stablecoin regulation in September 2020. In the US, the President's Working Group on Financial Markets released recommendations on stablecoins in November 2021. In Japan, the FSA's Study Group on Digital and Decentralized Finance published an interim report[4] last November on its stablecoin discussions to date. In January 2022, the Financial System Council's Payments Working Group published a report that discussed regulating stablecoins[5]. The latter report newly defined stablecoins as a type of digital money issued at a price linked to the value of a fiat currency (e.g., one coin = ¥1) and redeemable at its issuance price[6]. It also recommended regulatory changes.

One core element of the recommended changes is separation of issuers and intermediaries' respective functions. Electronic payment media in Japan have hitherto been predicated on the same party being responsible for both (1) providing the means to issue and redeem the payment medium and stabilize its value and (2) interfacing with customers for account management, transfers and

4) https://www.fsa.go.jp/news/r3/singi/20211117.html (in Japanese)

5) https://www.fsa.go.jp/singi/singi_kinyu/tosin/20220111/houkoku.pdf (in Japanese)

6) The report basically assumes that stablecoins will be backed by bank deposits, which implies that the FSA will first build a regulatory framework for stablecoins that use the price stabilization mechanism. Other issuer-related points discussed in the report include investment of custodial assets in financial markets by non-bank issuers. Additionally, the report states that securities such as government bonds and corporate bonds could be rightly construed as currency assets. At present, use of such securities as a means of payment is not being contemplated and security token offerings (STOs) using distributed ledger technology are outside the scope of the Working Group's ongoing discussions because STOs were addressed by a 2019 amendment to the Financial Instruments and Exchange Act. However, these issues may be revisited at a later date if Japanese stablecoins end up circulating widely overseas.

other transactions. In the US, by contrast, a stablecoin issuer is responsible for the first set of functions while intermediaries handle the second. In light of stablecoins' technological conduciveness to cross-border transactions as an online medium of exchange, the Working Group recommended that separate parties be responsible for the two sets of functions. From a user protection standpoint, the Working Group proposed stablecoins be collateralized with (i) bank deposits, (ii) receivables from money transmitters or (iii) beneficiary interests in a trust with a corpus consisting of demand deposits.

Japanese regulatory discussions of stablecoins in response to payment rails' evolution

Regarding the use of bank deposits to back stablecoins, a group of major Japanese banks that belong to the Digital Currency Forum (DCF) plan to issue a digital currency tentatively named DCJPY. The DCF published a whitepaper on the stablecoin last November on the assumption that it will initially be used solely within Japan. It will have two layers: a common layer and a business logic layer. The former is where its distributed ledger will be maintained by its issuers. The latter will allow users to programmatically customize it to their respective industry-specific use cases.

Regarding the use of trust beneficiary interests, the media reported on February 7, 2022, that Mitsubishi UFJ Trust and Banking (MUTB) is developing Progmat Coin, a platform for issuing and managing stablecoins, and plans to issue its own yen-pegged stablecoin as early as 2023[7]. MUTB is aiming for its stablecoin to be convertible into other stablecoins, though it has not disclosed any information about such convertibility as of the date of this writing. We accordingly assume that use of its stablecoin will likewise be confined to Japan initially. We surmise that MUTB will use a permissioned (private) distributed ledger, enable DVP[8] settlement of digital securities (security tokens) and allow users to instantly send remittances 24/7/365, unconstrained by the operating-hour limitations of legacy account systems and interbank payment networks.

In the money transmitter space, stablecoin remittances via class-2 transmitters will predominantly be small in value because class-2 is currently prohibited from sending or receiving remittances with a value in excess of ¥1mn. Class-1 money transmitters are not subject to any such maximum but they are subject to stricter

7) Per reports published by Nikkei Online Edition and CoinDesk Japan.

8) DVP: delivery vs. payment.

restrictions on how long they can retain possession of customers funds. They consequently may seek to use stablecoins as a bridge asset in B2B (international) remittances.

Customer-facing intermediaries will have a heavy compliance burden, including financial requirements and regulations on user protection, safeguarding of users' assets, AML/CFT and regulatory relationships. Upgrading IT systems and adding staff to handle this burden will be costly. Stablecoins will not only lower the cost of remittances relative to the status quo, they could play key role in markets for new digital assets such as security tokens and NFTs, the latter of which have made a big splash in the digital art market. They may also support new forms of transactions like automated royalty payments to copyright holders upon the resale of copyrighted works.

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