Intelligence MEMOS

From: Jeremy M. Kronick and Mark Zelmer

To: Canadian Crypto Watchers

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Re: **It's Time to Bring Stablecoins into the Regulatory Tent**

The knock-on effects from the failure of Silicon Valley Bank also spread to stablecoins.

The day after SVB's failure last month, USDC, the world's second-largest stablecoin, announced it had $3 billion on deposit with SVB and promptly, but briefly, lost its peg to the US dollar. Some people will see this as another nail in stablecoin's coffin. In our view, it's another example of why the federal government needs to establish a legal and regulatory framework for stablecoins that seek to serve as money. If it aims to be money, and it could be money, let's regulate it like money.

Bitcoin may get all the headlines, but without any asset backing it, it has no future as money.

Stablecoins do.

They are crypto assets in that they make use of blockchain but their values are pegged to national currencies or high-grade, tradable financial instruments. They play an important role in connecting traditional and crypto markets and can also be used like cash to pay for many financial market transactions. In other words, they are another form of private money, like your commercial bank deposits, but with additional benefits, such as real-time instantaneous settlement, ease of settling cross-border transactions, and lower costs, since stablecoins will force banks to be more competitive to attract deposits.

In our view, stablecoins are the likely future of crypto. But the securities regulation they're currently subject to, which focuses on investments, is unlikely to be sufficient for those stablecoins that do seek to be used as money. The federal government needs to regulate these new instruments that aspire to be money as if they were money. So far it has not.

Some will scoff at the idea of stablecoins going beyond financial markets and being used as money to pay for goods and services. The past 12 months have not been kind to the category. Several stablecoins failed because of shortcomings in managing the assets backing them (see FTX). USDC is simply the latest example, with the sudden demise of its banker, SVB. That shook public confidence in USDC's dollar peg until US authorities stepped in to insure all of SVB's deposits.

But USDC's unfortunate bank choice misses the point. If one believes in the innovative attributes that underpin stablecoins, the question becomes: what can be done to mitigate their risk?

Stablecoins that seek to be used as money in the real world need, like banks, rules to govern the assets that back them. Without such rules, some operators will look for ways to enhance their profits by investing in assets that are not necessarily always safe and liquid. Uninsured deposits in smaller, regional banks are simply the latest example.

Rules also need to cover consumer protection and transaction privacy, while guarding against money laundering and the financing of terrorism. Expectations need to be set regarding the reliability of stablecoin platforms in order to protect against cybersecurity threats. And we need rules governing how transactions are processed across stablecoin and other payment platforms. Without good regulation, the public will not have enough confidence in stablecoins to use them as money.

We offered detailed suggestions on how the federal and provincial governments could implement a regulatory framework for stablecoins in our recent C.D. Howe Institute paper.

The operating principles are simple: "Same risk, same activity, same regulation," and: "Don't re-invent the wheel."

Several straightforward adjustments to the *Bank Act* and its provincial counterparts, as well as to the federal *Retail Payment Activities Act* and its recently released draft regulations, could deliver the desired regulatory framework for stablecoins seeking to serve as money. For example, operators should be subject to the same prudential regulation as banks and other deposit-taking institutions –unless they restrict the assets backing their stablecoins to high-quality liquid assets, like deposits with the Bank of Canada, or treasury bills that are expected to be safe and liquid in good times and bad.

Canada has often been a leader in the development of efficient payment systems. Privately issued stablecoins based on blockchain technology offer the promise of major gains in payment processing, especially across national borders. But nothing is likely to happen without a domestic regulatory framework for these transactions. The federal government needs to take the lead – and it needs to do so now.

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