Stablecoins – Risks and Regulation

Mains: *GS III – Science and Technology- Effects of Liberalization on the Economy*

Why in News?

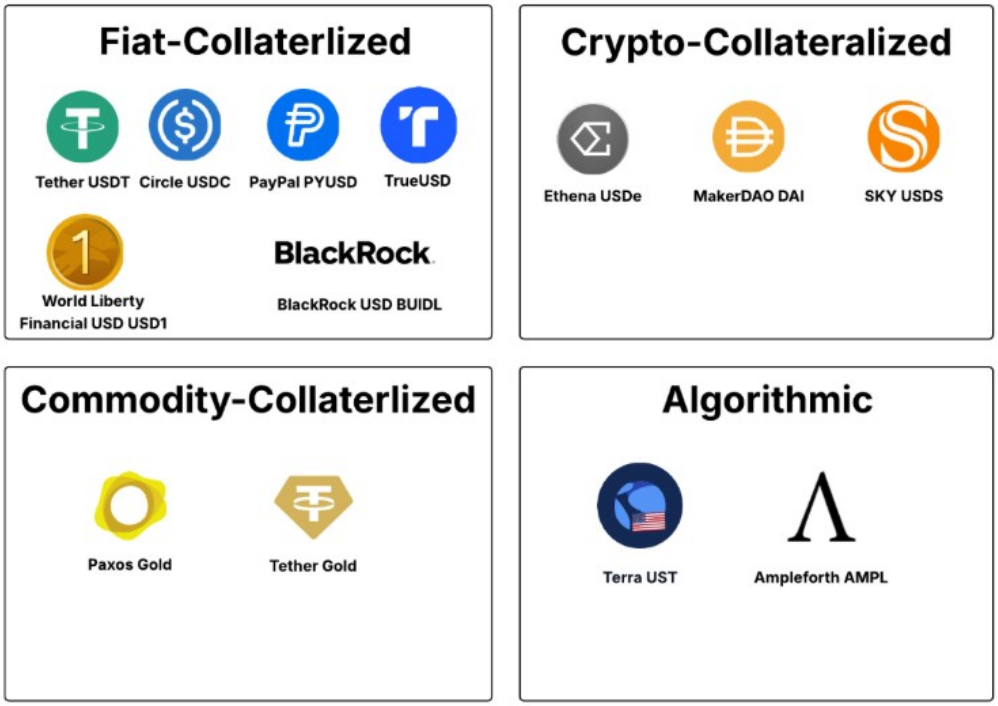
Recently, Bank of England places limits on the transaction of stablecoin transactions.

What are stablecoins?

- **Stablecoins** – They are a form of cryptocurrency designed to maintain a stable value in relation to a certain asset.
- Unlike Bitcoin and other such cryptocurrencies that experience price volatility, stablecoins are typically pegged to a traditional currency such as the US dollar.
- **Ownership** – Their ownership is simultaneously *registered in digital ledgers,* eliminating the costs and lengthy processing times involved with traditional cross-border transitions.
- **Uses** – They are not generally used for transactional purposes, but instead by crypto investors *to park their profits without converting them back into real money.*
- **Advantages** – They enable *cheap and fast transactions* without the need for intermediaries in traditional payment mechanisms.
- **Global market** – This April, Standard Chartered Bank estimated that the size of the stablecoins market *could increase tenfold to $2 trillion by 2028.*

What are the types of stablecoins?

- **Types** – There are primarily *four types of stablecoins*, of which three are pegged to a different asset, such as
    - **Fiat currency** – It means the government-issued currency authorised as legal tender.
    - **Commodities** – It includes gold, silver or oil.
    - **Cryptocurrencies**.
- **Algorithmic stablecoins –** It may be pegged to an asset, but are *typically regulated through a computerised algorithm*.
- This is similar to a currency peg, with more coins being generated if the stablecoin trades above its pegged value to cause a price reduction.



What are the risks associated with stablecoins?

- **Affects financial stability** – Stablecoins presently pose a threat to financial stability.
- There remains an ever-present 'run' risk, meaning *a risk of mass withdrawal of holdings simultaneously,* akin to a bank run during an economic crisis.
    - **For instance**, On May 11, 2022, the stablecoin TerraUSD (UST) crashed from its intended 1-to-1 peg to the US dollar by more than 60%, all but eliminating its dollar peg.
- Being an algorithmic stablecoin, the UST was not directly pegged to the dollar but through the related Luna token.
- According to a *Bloomberg* report, investors could (in theory) exchange one unit of the token, regardless of its current trading price, for $1 worth of Luna.
- This trade helped UST maintain its value at close to $1 and retain its status as the biggest algorithmic stablecoin by market value at the time.
- **Affects banking** – The Bank of England noted that stablecoin tokens could weaken the banking system by draining it of deposits.
- **Other risks** – In its latest annual economic report, the Bank for International Settlements (BIS), has identified three issues with stablecoins
- **Singleness** – Stablecoins traded in secondary markets, such as stock exchanges, usually have a slight deviation from the fiat currency they are pegged to, and may not be pegged at par.
- **Elasticity** – Stablecoins fail the test of elasticity, which implies adjusting the circulation of stablecoins to meet the market demand.
- The supply of stablecoins that can be issued depends on the issuer's balance sheet, which cannot be expanded at will, unless they have the requisite cash or assets to back them.
- Therefore, any additional supply would need to be fully paid for upfront by its holders, unlike banks, which can expand (and contract) their balance sheets within regulatory limits.

- Thus, the system cannot expand quickly to provide additional liquidity in case of high demand.
- **Integrity** – The free trading of stablecoins across borders, on different exchanges and into self-hosted wallets makes them vulnerable to the risks of non-compliance with Know Your Customer (KYC) norms.
- This raises the risks of money laundering, terror funding and other suspicious activity.

How have other countries treated stablecoins?

- **GENIUS act –** US introduced the GENIUS Act into law, which **introduced a regulatory framework** for stablecoins.
- The Guiding and Establishing National Innovation for US Stablecoins Act, or the GENIUS Act, is the country's first major regulatory legislation and contains three significant provisions –
    - *Only insured depository institutions*, such as banks, credit unions, bank subsidiaries etc, approved by the Federal Reserve and demonstrating the ability to comply with the relevant law *can issue stablecoins.*
    - Stablecoin *issuers must hold 1:1 reserves for any stablecoins issued*, in such assets approved by regulators, such as physical currency, US Treasury bills, repurchase agreements and other low-risk assets.
    - All stablecoin issuers *must comply with the Bank Secrecy Act*, ensuring that they implement measures protecting against money laundering (AML) and the financing of terrorism (CFT) and bolstering consumer protection.
- **MiCA** – The *European Union's Markets in Crypto-Assets Regulation (MiCA),* passed in December 2024.
- It addresses all e-money tokens (EMT), which are digital tokens backed by a single fiat currency, and asset-referenced tokens (ART), meaning a basket of assets, including physical assets and cryptocurrencies.
- While MiCA does not specifically focus on stablecoins, *it mandates that only authorised e-money institutions or credit institutions* can issue an EMT.
- On the other hand, ART issuers must be EU-based and authorised by regulators.
- **Stablecoin ordinance –** The stablecoin ordinance was passed in May 2025 in Hong Kong.
- It requires all stablecoin issuers backed by the Hong Kong dollar to *obtain a license from the Hong Kong Monetary Authority*.
- All stablecoins must be backed by high-quality, liquid reserve assets, with the market value of the reserve pool at par with the value of the stablecoins in circulation.
- Most importantly, *every issuer must implement measures against money laundering and financing of terrorism*, as well as regular audits and disclosure.

Reference

The Indian Express| Stablecoins



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