Stablecoin

This section provides a general explanation of innovative technological trends (DAO, DeFI, NFT, tokens, etc.) that may be related to the provision of financial services or similar activities.

This information does not constitute legal advice or an explanation. We recommend that related parties assess and legally qualify their activities in advance, if necessary, with the help of a professional legal adviser. Consumers of innovative solutions are advised to assess the risks they may be exposed to when using their financial means.
We also recommend that you consult the draft EU Regulation on Markets in Crypto-assets (MiCA) and related proposals.

A stablecoin is a type of virtual currency based on distributed ledger technology (DLT) whose value is supposed to be constant, i.e. backed by some asset or algorithm. Mostly, the value of stable virtual currencies is linked to the US dollar, but there are also stablecoins linked to other currencies.

There are two main ways to ensure the value of a stablecoin. The first is to secure its value with assets such as currencies, financial assets, commodities or other crypto assets. The second is the algorithmic backing option, where an algorithm adjusts the supply and demand of stable cryptocurrency to keep its price stable. Stable virtual currencies are issued by both centrally managed companies and decentralised organisations based on blockchain technology. A stablecoin can be held in decentralised wallets based on blockchain technology and on centralised platforms administered by third parties.

As a stablecoin, unlike other cryptocurrencies, is expected to have low volatility, its main function is to play the role of a fiat currency in the virtual currency market. The main difference between a stablecoin and a traditional currency is that it is based on a blockchain, which means that it can be used for transactions on the same basis, regardless of the location of the parties or the time of day. This makes the use of stablecoin attractive for many. Stable currencies are also used in various decentralized finance (DeFi) protocols, where parties can use stablecoin for purposes such as savings, with the objective of earning interest income, and borrowing. As with other virtual currencies, stablecoin is also used because of the anonymity of its storage and transactions, which increases its potential for money laundering and the purchase of illegal services and products.

According to a report published by the US Federal Reserve in January 2022, by September 2021 the supply of stablecoins in circulation linked to the dollar alone had risen to USD 130 billion. The most widely used stablecoin with the largest market capitalisation is Tether, which is also linked to the US dollar.

How is the stablecoin regulated?

Before the issuance of the ICO (initial coin offering), the Finantsinspektsioon recommends that a

legal analysis is carried out in order to determine the facts. As stablecoins are issued by both regulated and non-regulated organisations and backed by both regulated and non-regulated assets, there is no single legal definition. Some stable currencies, for example, non-interest-bearing currencies backed by a single fiat currency, may fall within the definition of e-money under the Payment Institutions and E-money Institutions Act, which requires issuers of such currencies to be authorised as an e-money institution. Similarly, various stable currencies may be classified as securities under the Securities Market Act, and service providers and some issuers may be subject to a virtual currency service provider licence under the Money Laundering and Terrorist Financing Prevention Act or, in the event of deposit-taking or lending activities, to a licence requirement under the Credit Institutions Act or Creditors and Credit Intermediaries Act, respectively.

In the future, the EU Regulation on Markets in Crypto-assets (MiCA) will divide stable currencies into two groups: e-money tokens, which are backed one-to-one in a stable currency, and asset-reference tokens, which are backed by another asset. However, an algorithmically-backed stablecoin would have to change its business model after the MiCA enters into force if it wants to continue promoting itself as a stablecoin. The MiCA will also set out the conditions under which both e-money tokens and asset-reference tokens are significant tokens. Such significant tokens will be supervised by the European Banking Authority (EBA) instead of national authorities.

Risks associated with holding a stablecoin:

Non-functioning algorithmic stabilization mechanism – The value of an algorithmic stablecoin is guaranteed not by collateral but by a system regulating its supply and demand. While most of the time this algorithm is able to do its job successfully, there are also cases where it stops working and the stablecoin loses its link to the fiat currency. For example, this happened in May 2022 with a stablecoin called TerraUSD, which lost its peg to the dollar, leading to a ‘stablecoin run’ – as the peg disappeared, people started to sell virtual currency en masse and its value dropped significantly. Because of this risk, an algorithmic stablecoin is generally considered riskier than asset-backed money. Therefore, before investing in stable currencies, it is important to verify their business continuity.

Asset-backed stablecoin risk – before investing in an asset-backed stablecoin, it is important to ensure the safety of the collateral portfolio, as stable currencies may be backed by assets of varying quality. The safest can be considered to be a one-to-one fiat currency-backed stablecoin, where the value of the collateral is expected to fluctuate the least. In the case of a stablecoin backed by other assets, such as bonds, commodities or virtual currencies, there is a risk that the value of a large part of the collateral will change and, therefore, the stablecoin will lose its peg to the currency, which could lead to a ‘stablecoin run’. The risk of a change in the value of the collateral can be considered particularly relevant in the event of a stablecoin backed by cryptocurrencies, where even one-to-one collateral may be insufficient to maintain stability.

As stablecoin is generally an unregulated asset, investors’ confidence that the currency is backed by sufficient collateral is often based on trust alone. It is likely that the issuer of the stablecoin will give the impression that the currency is backed one-to-one by some currency or other asset, but in reality there are far fewer collaterals. It is also possible that the collateral may be subject to a variety of unfavourable transactions, which may result in a decline in both the liquidity and the value of the collateral.

Cyber risks – As with other virtual currencies, there is a risk inherent in the underlying system of the stablecoin. For example, there may be attacks against virtual wallet providers with the aim of stealing

assets. There is also a risk that it could be manipulated by the stablecoin administrator. There is also the possibility that something will happen at the blockchain level, on which the stablecoin operates.

Stablecoin investment risk – The stablecoin is widely used on DeFi platforms to deposit it with the aim of earning interest. While the interest rates on deposits on these platforms can often be temptingly high and the loans they provide are over-guaranteed, there are various financial stability and cybersecurity risks associated with these protocols. More information about these is available in the section concerning the DeFi system of the Finantsinspektsioon.

Future of stablecoins

There are a number of areas where the wider adoption of the stablecoin could be beneficial in the future. For example, one of the objectives of decentralised transfer mechanisms in the stablecoin is to make daily financial transactions quicker and more favourable, in turn, making financial services available to more people. According to a report by the Bank for International Settlements (BIS), a financial system based on ‘smart contracts’ and stable currencies would also facilitate transactions, for example, on the Internet of Things.

However, the legal status of the different stable currencies needs to be clearly defined, and the concept of a stable virtual currency needs to be specified, before a more widespread adoption of the stablecoin can be encouraged. In particular, the addition of a clear legal framework would give a sense of security to consumers and reduce the associated risk of money laundering. There is reason to believe that the entry into force of the MiCA will lead to greater legal clarity in the EU on the treatment of stablecoins. The potential for central bank-issued digital currencies (CBDCs) to fulfil the functions of the stablecoin while being more transparent and centrally managed also needs to be analysed.