Banking with Stablecoins

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Timely and important conceptual contribution

- Stablecoin: What is new and what is not?
  - Narrow banks: moral hazard and incentive to deviate towards risky investment
  - Technology and use cases: heterogeneous preferences for means of payment - relative convenience yield
- Close form, theoretical model
  - A new one, no just a revision!
  - Better assumptions: e.g. endogenous convenience yield & symmetric competition
  - Assume that issuers are worse lenders than banks, but they could have better screening and monitoring technologies
- Main questions:
  - When is a stablecoin issuer's narrow-banking pledge credible?
  - How should it be regulated?

Main messages

- Stablecoin must be regulated:
  - Moral hazard undermines issuers' pledges

- Optimal regulation:
  - Penalizes deviations, restoring credibility
  - No penalty is optimal, so stablecoin are 'risky' shadow banks, if issuers' risky lending is efficient - if convenience yield is low enough
  - Prohibition on stablecoin interest payment is dominated, but if regulatory enforcement were costly or non-credible
  - Issuers prefer a smaller-than-optimal penalty: room for lobbying

- From a previous version:
  - Banking with stablecoins imply an intrinsically unstable system urging to be appropriately regulated

Where is the ‘banking’?

- Banks are now a passive benchmark
- No bank moral hazard
- Deposit insurance, a key asymmetry between deposits and stablecoins: results unchanged if premia are actuarially fair
  - What if premia are flat-rate (mispriced), as in practice?
- With a downward-sloping loan demand, would disintermediation cost matter?
  - Would the optimal regulation cutoff move left?
  - When would be it optimal to always set a positive penalty?

Optimal regulation 1

- Optimal regulation:
  - A cutoff on issuers' lending efficiency - convenience
    1. No penalty ➔ stablecoins circulate as uninsured shadow banks
    2. Any penalty above an optimal threshold will work ➔ set it to infinite

- How to implement optimal regulation:
  - If issuers' lending ability (or convenience) is not verifiable?
  - Given that the cutoff is contingent on the risk-free interest rate?

- Would a ban on stablecoin interest payments be the second-best constrained optimal regulation?

Optimal regulation 2

- Is no penalty really optimal?
  - Households may not realize that are not holding a stablecoin (pledge to redeem at parity) but an uninsured share in a shadow bank
  - Households' protection motives may add a social de-peg cost per unit of risky issuance ➔ optimal cutoff may change
  - Uninsured shadow banks that serve as payment instruments may have more welfare implications (e.g. runs, fire sales and payment externalities), which are worth modeling

- Same risk, same regulation?
  - No penalty below the cutoff imply that stablecoin issuers face the same (or more) risk than banks but not the same regulation

Optimal regulation 3

- A richer regulatory toolkit
  - Capital requirements interact via franchise value
  - Segregated, bankruptcy-remote reserves change the limited-liability payoff directly
- Penalty form and scale
  - In the model an infinite penalty is sufficient
  - In practice, penalties may be applied per day and related to size
- Implementation in small open economies
  - Supervisory capacity binds, exactly where the ban becomes constrained-optimal
  - For dollar stablecoins, the domestic regulator does not control the penalty at all

Other comments

- Reconsider the most natural assumption: convenience yield versus issuers' lending efficiency

- Market power changes the minimum penalty via charter value, but does not change optimal regulation: no penalty to one side of the cutoff and a sufficiently large one to the other

- Convenience is endogenous to safe investment of the issuer
  - For this to be possible households should be able to verify the assets
  - Convenience yield steaming from liquidity, digital and payment services may hold as long as the issuer does not default
  - In my view, qualitative results do not change under this assumption

Thank you …

… for your timely and relevant work, which provides key elements to think about stablecoins' risks and regulation!