

The Rise of Stablecoins and the Future of Finance

How Digitizing Stable Assets
Will Unlock the Potential of
Global Financial Markets



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“Stablecoins can revolutionize consumer finance and open access to critical financial services.”



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INTRODUCTION

The world is ready for regulated stablecoins

Market participants first issued stablecoins in 2014 by creating a type of cryptocurrency pegged to stable assets, such as the US dollar or commodities like gold. Originally intended to provide a convenient on- and off-ramp between fiat currencies and cryptocurrencies, stablecoins and their use cases have grown exponentially in less than a decade.

Their design enables stablecoins to possess the best qualities of crypto and fiat currency since they provide price stability and a steady valuation while offering the security and decentralized features associated with crypto.

Early stablecoin adopters primarily used stablecoins to:

- Buy, sell, hold and transfer value on crypto exchanges
- Earn yield in high interest-bearing accounts
- Engage in DeFi, such as through lending and providing liquidity

Stablecoins can also help address considerably larger challenges in the broader financial system, including:



Faster, more inclusive global banking: When used as a payment tool, stablecoins can provide for faster, more inclusive global banking since anyone can open a wallet on a public blockchain and make and receive payments.



Use as borderless money: Lower fees and higher-speed transactions reduce the need for intermediaries like banks to enable frictionless cross-border payments.



Store of value: Acting as a stable store of value, they can offer stability and protection against inflation to communities in areas with volatile fiat currencies.

Due to these use cases and a growing list of others, the adoption of stablecoins is accelerating. Some estimates see as much as \$5T of global assets moving to stablecoins and other digital money formats by 2030 [↗](#).

In the following pages, we will summarize the stablecoin landscape, explain how they are poised to improve the financial system and further explain the potential for an accelerated adoption due to the benefits of stablecoin regulatory frameworks and regulated stablecoins issued under these frameworks.



OVERVIEW

Stablecoins rise

Backed by a reserve asset like a fiat currency or a commodity, stablecoins are a class of cryptocurrency pegged to a stable value. For example, by definition, a US-dollar-backed stablecoin can be exchanged for a dollar from a trusted issuer.

Stablecoins can be regulated or unregulated. Below we will go into greater detail concerning the benefits around a regulated stablecoin, such as [USDP](#), which is inherently trustworthy due to regulatory requirements. Certain market events in 2022 demonstrated why the trust that is inherent in a regulated stablecoin is important versus the lack of transparency that can lead to issues with an unregulated stablecoin.

“There is a reasonable expectation in the industry that stablecoins could (and should) be complementary and part of this vision for the future of the payments system.”

ENGAGING WITH STABLECOINS?
MARCH 2023, [DELOITTE](#)

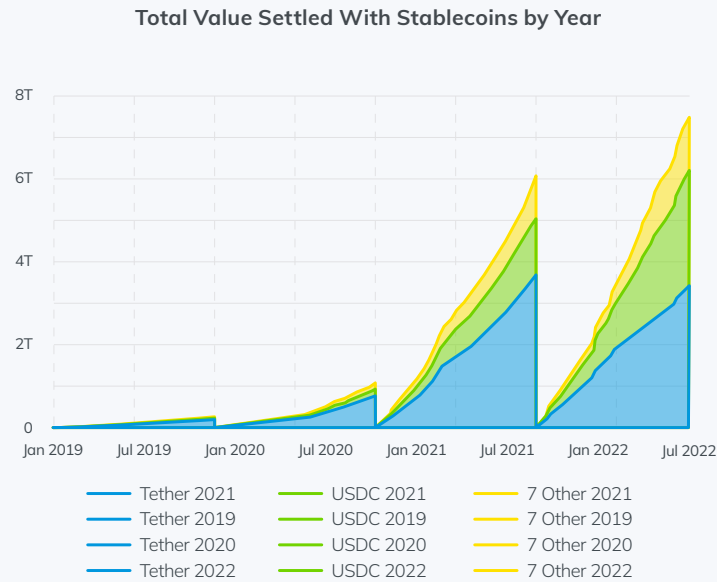
For instance, Terra’s algorithmic stablecoin TerraUSD or UST (now TerraClassicUSD), the then third-largest stablecoin in the world—and one that was unregulated—collapsed in May of 2022 and led to a great deal of loss to holders of that coin. Further, the collapse triggered panic selling

in other fiat-pegged cryptocurrencies, including Tether (USDT). Tether, the world’s largest stablecoin by market value and meant to be worth a dollar—also unregulated—[fell to](#) USD 0.95 on May 15th and regained its dollar peg in July of 2022. These events led to a great deal of crypto skepticism among critics unaware of the differences between a regulator-approved stablecoin like USDP and unregulated stablecoins that do not have to meet regulatory requirements aimed at providing safety and soundness.

Despite market uncertainty due to the general economic landscape, certain market events like those mentioned above, and crypto skepticism prompted by these events, the popularity and usage of stablecoins skyrocketed in 2022. Two factors that led to this surge were increased demand for digital assets and a practical desire to hedge against volatility in traditional markets. Focusing on the latter, stablecoins provided a haven for investors, allowing them to store their funds without worrying about market fluctuations.

As for the former, the growth of decentralized finance (DeFi), which deals exclusively in digital assets, opened up new opportunities for users to access various financial services without relying on traditional financial institutions. Grouped with the market’s exploration of these factors along with a number of other benefits of stablecoins, such as more efficient payment solutions, growth and usage in 2022 increased considerably despite market uncertainty.





Source: [CoinMetrics](#)

More specifically, in 2022, the surge in popularity of stablecoins as a digital asset for settlement and trading is represented by a total value settled topping [\\$7T](#).

This number is representative of the rising sentiment that stablecoins can provide end users with a fast, secure, and reliable form of digital asset settlement. With many enterprises looking for less volatile, more trustworthy financial innovations for their customers as a reaction to market turmoil, settlement hubs that use stablecoins such as USDP have become an appealing solution.

The overall increase in the adoption of stablecoins has led to a rise in market capitalization, with stablecoins reaching over \$1T in 2022. Considering some of the popularized market failings during the same time period, this growth shows stablecoins are here to stay and will continue to be an integral part of the financial system for years to come.

Regulated stablecoins, such as [USDP](#) and [PAXG](#), are the standard in trust and transparency. Being regulated, and issued under regulation, means that these stablecoins are backed 1:1 in fiat currency reserves and are fully redeemable at any time. This provides for the stability needed so that solutions that leverage stablecoins are sufficiently reliable and transparent to become increasingly popular among traders, investors and financial institutions alike.

Another important part of the stablecoin universe is central bank digital currencies (CBDCs). These are pegged to a nation's government-issued currency and represent a direct obligation of that country's central bank—rather than a private company's obligation, as with other stablecoins.

According to the Atlantic Council's Central Bank Digital Currency [Tracker](#), 114 countries, representing over 95 percent of global GDP, are exploring a CBDC. Sixty nations, an all-time high, are in an advanced exploration phase (development, pilot or launch).

In 2023, over 20 countries will take significant steps toward piloting a CBDC.



OUTLOOK

The high upside of stablecoins

While early adopter use cases such as buy, sell and hold are still relevant and are experiencing accelerating adoption rates, stablecoins have recently emerged as a multifaceted tool for addressing pain points in the financial system.



Protection of wealth: Stablecoins can offer financial stability in a world with high inflation. For example, [Mercado Libre](#) enables users to convert Latin American currencies—many of which experience high inflation rates—to Paxos' US-dollar-backed stablecoin, USDP.



Financial inclusion: Stablecoins allow anyone with a mobile device and an Internet connection access to US-dollar-backed stablecoins. This is important since a global estimate of 1.7 billion adults were unbanked in [2022](#).



Efficient money movement: Stablecoins remove friction in money movement, especially for international remittances, which lowers fees. Compared to traditional wire transfers, stablecoin transfers are instantaneous and cost-effective, and can happen 24/7.



Instantaneous settlement: Enterprise merchants who accept stablecoins can immediately access funds instead of waiting days for payments to arrive



Mercado Libre's Crypto Wallet Reaches [1M+ Users](#)

in their bank accounts. This immediate settlement is game-changing because it eliminates high capital requirements across the payments value chain.



Infrastructure interoperability: Blockchain-based systems can easily work together, removing the multi-day barriers to current transactions. This infrastructure, which stablecoins exist on, encourages and allows the creation of interoperable products that are impossible to build within the financial system's legacy architecture.



REGULATORY LANDSCAPE

Regulation and standard reserve practices

Regulated Stablecoins

Only 2 regulated stablecoins exist:



Regulated by the New York Department of Financial Services, which ensures compliance in:

-  Stablecoin reserve composition
-  Amount of reserve funds
-  Segregation of corporate assets

Unregulated Stablecoins

Top unregulated stablecoins by market cap:



Lack of a prudential regulator means:

-  No reserve composition requirements
-  No reserve oversight
-  Assets held on issuers' balance sheets

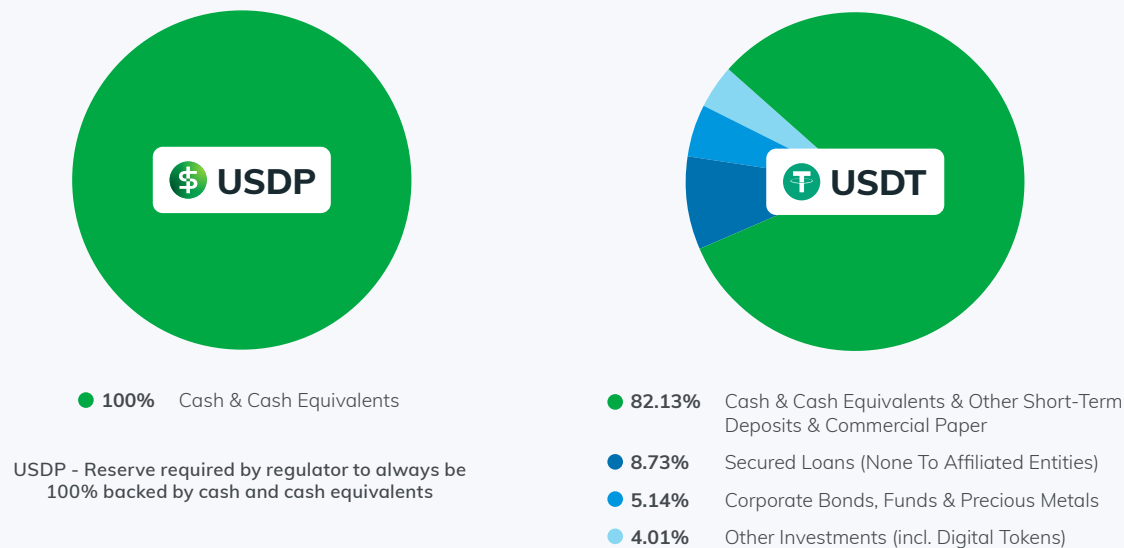
Regarding stablecoins, chief among a regulator's primary concerns is run risk, or the possibility that all holders of a stablecoin would try to redeem their holdings in exchange for fiat at the same time. Suppose a US dollar-backed stablecoin is held in cash reserves and overseen by a prudential regulator, just as USDP is. In this case, there isn't significant run risk because if everyone redeemed their stablecoins at once, every stablecoin holder would receive their equivalent in dollars.

However, if a stablecoin's reserves are even partially held in illiquid or volatile assets and stablecoin holders try to redeem their stablecoins for dollars simultaneously, the issuer could be forced to sell the reserve assets at a discount.

A run can occur if stablecoin holders know that reserve assets are illiquid and the market becomes aware of increased redemptions. Stablecoin holders might want to redeem their stablecoins for dollars before reserves are depleted, which creates even more pressure on the



Stablecoin Reserve Practices - USDP v USDT



Source : As of 5/4/23. [USDP Attestation reports](#); [USDT Attestation reports](#)

stablecoin issuer to liquidate assets at greater discounts. Depending on the asset type, broad-based sales at increasingly high discounts can impact the market's stability for the reserve assets. That type of run risk can spread across stablecoin issuers or other financial institutions that the market believes have similar risk profiles.

The New York Department of Financial Services (NYDFS) oversees regulated stablecoins such as USDP. With a focus on minimizing run risk, the NYDFS regulates, among other things, the following aspects of stablecoins that it supervises:

- **Stablecoin reserve composition:** The value of each stablecoin token must be tied directly to the value of the US dollar. Issuers must hold reserves in cash and cash equivalents (e.g., FDIC-insured bank accounts and short-term maturity US Treasury instruments).
- **Verification of the amount in reserve funds:** Reserve funds must always equal or exceed the number of issued stablecoins.
- **Segregation from corporate assets and protection of assets:** Reserves held by a regulated trust are fully segregated from corporate assets (specifically for the benefit of token holders)—and must be held bankruptcy-remote.



Trust companies are considered to be better suited for regulating digital assets because they offer more comprehensive oversight and stronger consumer protection measures.

Trusts are specialized financial institutions that are regulated by state banking authorities. They are subject to rigorous regulatory requirements, including capital reserve requirements and regular audits, which help to ensure that they are operating in a safe and sound manner.

When it comes to regulating crypto, trust companies have several advantages over money transmitter licenses (MTLs). Trust companies are subject to more stringent regulatory requirements than MTLs and are required to maintain higher levels of capital reserves, undergo more frequent audits and adhere to more robust consumer protection measures. Finally, trust companies offer a higher level of transparency and accountability than MTLs. Unregulated stablecoin issuers typically have MTLs, offering some consumer protection.

However, these issuers are not required by a regulator to maintain stablecoin reserves that equal or exceed outstanding tokens, meaning they might have fewer dollars in their reserve accounts than tokens outstanding at any given time. Further, they can keep illiquid or risky assets in their reserves. As a result, stablecoin holders might get less than their whole dollar back if they all decide to liquidate their holdings simultaneously. While unregulated stablecoins can choose to keep their reserves in cash or cash equivalents, no prudential regulator is forcing them to

Trust Charter vs. Money Transmitter License

	Trust Charter	Money Transmitter License
Qualified custodian	✓	✗
Required to hold customer funds segregated from company funds	✓	✗
Holds all client assets bankruptcy remote by law*	✓	✗
Cannot use customer funds to facilitate other business	✓	✗

*This is a distinguishing feature of Paxos-issued stablecoins from MTL-based and unregulated stablecoin issuers. If MTL-based and unregulated stablecoin issuers become insolvent customers would become exposed to delays, and courts could determine customer assets belong to the senior creditors of the issuer's bankruptcy estate.

maintain this reserve composition over time. The stablecoin issuer could change their reserves at any point in the future.

Finally, issuers hold unregulated stablecoin reserves on their balance sheets. If the issuer went bankrupt, issuers' reserves could be used to satisfy company debts instead of being returned to stablecoin holders.



CONCLUSION

Stablecoins will change everything

Regulated stablecoins offer users the best of both the crypto and fiat worlds. They offer the stability of the fiat or asset they represent, enabling instant, low-fee global transactions 24/7/365 while reliably holding their value. Markets can have immense confidence in regulated stablecoins where there's oversight over reserve composition, the amount of reserve funds and segregation from corporate assets.

As mainstream adoption of stablecoin scales, we will continue to see important benefits for the financial system. Stablecoins give unbanked individuals from around the world access to US dollars. Transfers are instantaneous and can happen anytime, which is game-changing for international remittance. Stablecoins allow individuals to store their wealth in USD to hedge against inflation. Stablecoin-settled transactions settle so quickly that merchants do not have to wait days for funds to land in their bank accounts, eliminating high capital requirements across the entire payments value chain. In many ways, stablecoins are the future of finance.

To learn more about stablecoins and how they can help your enterprise business grow, contact insights@paxos.com [↗](#).





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