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Stablecoins and DeFi

Passing the test

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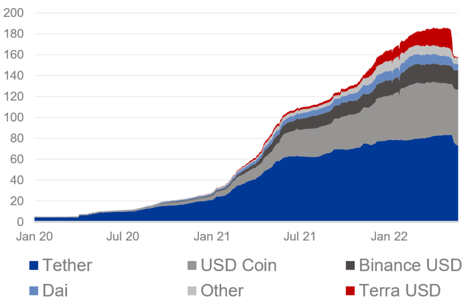
Stablecoins and the DeFi ecosystem have taken a hard hit recently. However, the current stress for cryptos caused by tighter monetary policy may reveal which services offer real value for customers. In fact, leading collateral-backed stablecoins have weathered the storm quite well. The ecosystem will probably face further losses but emerge consolidated and well positioned for continued growth.

Stablecoin market cap

USD bn, until 24 May 2022



Sources: CoinGecko, Deutsche Bank Research

Stablecoins and their decentralized finance (DeFi) ecosystem have taken a hard hit recently, following enormous growth last year. The Terra USD coin turned out to be anything but stable. In May, its value plummeted to 3 cents and the market capitalization collapsed from USD 18.6 bn to USD 300 m – a disastrous loss for many investors. Since monetary tightening started to bring down crypto valuations, financial stress has been cascading through DeFi, revealing high levels of leverage and interconnectedness. At the same time, the vision of decentral governance and non-intermediated finance is called ever more into question. Investors who had deposited crypto assets in Celsius, a lending protocol, found the “gates closed”: the application suspended withdrawals to prevent a meltdown – just like 20th-century banks shut their doors to depositors. Is restrictive monetary policy ringing the death bell for stablecoins and DeFi?

Monetary tightening is shaking up the industry and will reveal which assets and services offer real value to customers besides harbouring speculative money. Indeed, most established stablecoins have weathered the storm quite well. Leading collateralized stablecoins only experienced small, temporary deviations from their USD peg when Terra’s algorithmic price stabilization failed (as happened before with other algorithmic coins, like BasisCash). Although trading volumes and redemptions were high in May, the total stablecoin supply (excl. Terra) contracted by only about 6% or USD 9.7 bn and by another USD 5.4 bn since then. Nevertheless, investors have become more sensitive to risk. They pay more attention to the reliability of a stablecoin’s reserves. Since May, USD Coin, which is perceived as relatively transparent, is steadily gaining market share at the expense of Tether, which had been fined for misrepresenting collateral in 2021.

Going forward, stablecoin use may not remain limited to DeFi. In high-inflation countries, people are eager to seek rescue in stable foreign currencies. With stablecoins, dollarization goes digital. In Venezuela and Argentina, for example, USD-pegged stablecoins are used for protecting savings from inflation as well as for paying daily purchases via apps or cards.

Also, they are an alternative rail for remittances. But stablecoins offer more than stability and transferability. The distributed-ledger technology on which they run allows for new technical solutions. Programmable payments and the seamless integration with DLT-based corporate networks are future use cases, also in developed markets. Innovations employed in DeFi like settling trades in one transaction or exchanging currencies without order books (automated market makers) can improve efficiency in finance.

Current economic, legal and technical obstacles to mainstream use of stablecoins could be overcome in the medium term. From a European perspective, most stablecoins incur FX risk as they are pegged to the USD. This can be solved by EUR-pegged stablecoins which are likely to emerge once issuers are able to earn a positive return on EUR-denominated reserve assets. The absence of oversight and legal uncertainty is a problem for most institutional investors and retail users. But regulators in many jurisdictions are working to integrate stablecoins and DeFi into their legal frameworks to protect the integrity of payments, financial stability and consumers. This will help increase trust and spur adoption by larger client groups. Legal certainty will also make it easier for established financial firms to develop or buy DLT-based services for their own product range. Services offered by trusted financial providers might especially increase retail adoption of stablecoins.

Decentralization of technology and governance as well as open access are purportedly the DNA of DeFi. However, secure permissionless blockchains come at the cost of reduced efficiency. Often, governance is not distributed but in the hands of communities which are opaque to outsiders. Many DeFi applications and the most successful stablecoins are run by registered companies anyway. Chances are that the ecosystem will move to more “centralized”, traditional ownership structures and permissioned access on its way to offer high-volume, efficient and secure services to a broader client base. A large network with many users and high processing capacity is a necessary condition for success. However, proof-of-stake might improve efficiency while safeguarding a permissionless blockchain. Ethereum will become the first large blockchain to rely on this consensus mechanism by the end of this year.

If stablecoins became an important means of payment, tighter regulatory scrutiny could be ahead. Central banks will closely watch the monetary implications. If stablecoins are collateralized by bank deposits, there is little impact on the money supply in the economy. Retail clients would simply exchange deposits for stablecoins and the deposits would end up on custody bank accounts of the stablecoin issuer. For banks, though, this would mean fewer retail deposits, weaker net stable funding ratios and subsequently a lower capacity to lend. However, if stablecoins are collateralized by debt such as commercial paper, “money” can be created outside of the banking sector. Stablecoins do not (yet) count into the official money supply, but they have many features of money. In fact, they are more money-like than money market fund (MMF) shares which are part of M3, structured in a similar way but lacking transferability. While both MMFs and asset-backed stablecoins engage in maturity and liquidity transformation to create “money” from debt, the former are subject to regulatory oversight and have received central bank liquidity support in times of crisis. Stablecoin issuance might enlarge the effective money supply or simply shift money creation from depository institutions to capital markets and non-bank issuers. Tighter regulatory scrutiny could also loom in case of competition issues. These could arise if there is only one dominant stablecoin and limited interoperability between networks.

Innovation will determine whether stablecoins are competitive as a means of storage. Remuneration (besides stability) will be key. So far, stablecoin issuers keep the interest income from reserve assets. In the EU, it will be prohibited to issue interest-bearing stablecoins. Bank deposits, by contrast, offer interest income and are protected by deposit insurance. Currently, stablecoins only earn a return if invested in DeFi, but at the coinholder's risk. Money market fund shares could evolve into remunerated stablecoins if funds shifted their technical infrastructure to DLT to enable easy peer-to-peer exchange of shares.

Overall, stablecoins and the DeFi ecosystem will probably pass their first test in the form of restrictive monetary policy and stagnating crypto valuations. Further losses must be expected, but stablecoins are likely to emerge consolidated, more mature and well positioned to grow their business. Upcoming regulation is set to make them more attractive to a large potential customer base. And innovation is ongoing. Seamless digital access to credit and other financial products (DeFi?) could be a selling point. But success is not guaranteed. Stablecoins will compete with bank deposits, e-money, (probably) digital cash and tokenized deposits. Potential users will have a broad choice. While corporate users are sensitive to issuer and operational risks, retail clients care most for convenience and no charges, regardless of the underlying arrangements. Innovation in payments and money is far from being limited to stablecoins: the heat is on.