

Financial Research Advisory Committee Meeting

April 7, 2022

Discussion Topic: Assessing the Potential Threats to Digital Currencies From Digital Assets

It has become common to divide the analysis of digital assets into four broad categories: (i) unbacked assets such as Bitcoin, (ii) stablecoins that are backed by non-crypto assets, (iii) central bank digital currencies, and (iv) smart contracts and decentralized finance.

At a conceptual level, the financial stability issues related to the first two of these categories are analogous to those arising from existing arrangements. Trading in unbacked crypto assets such as Bitcoin, for example, is in some ways similar to trading in a commodity. In principle, the exposure of financial institutions to crypto assets through direct holdings, derivatives trading, or counterparty exposure can be evaluated similarly to those related to traditional assets. Unbacked crypto assets may carry extra risks, including higher price volatility, greater cybersecurity risk, and the possibility that some assets or classes could become worthless. Similarly, the financial stability issues that arise from stablecoins backed by non-crypto assets are similar to those arising from money market mutual funds and other short-term investment vehicles. In this category, a lack of transparency regarding the assets backing some stablecoins and a lack of clear accounting and reporting standards are sources of additional risk.

Different concerns arise when evaluating the risks associated with the possible introduction of stablecoins credibly backed by short-term government debt or a central bank digital currency (CBDC). In this case, the availability of a new type of safe asset may make investors more likely to pull money out of traditional financial institutions, particularly in times of stress. While this type of risk does not have a clear current analog, it can be evaluated by looking at relevant historical episodes or using well-established theoretical frameworks. The financial stability risks associated with the fourth category, smart contracts, and decentralized finance, appear to be the most difficult to evaluate at this point. While the amount of trade in this category is currently small, it has the potential to grow rapidly.

The OFR has worked to evaluate the financial stability risks arising from digital assets in three ways. The first has been to understand the most appropriate conceptual framework for each type of asset, as described above. Second, we have begun to monitor some market activity related to digital assets. The work on conceptual frameworks and market monitoring has been reported on in OFR's [2021 Annual Report to Congress](#) and financial stability assessments the OFR provides quarterly to the FSOC. Third, some OFR staff have been working on long-term research projects related to stablecoins and CBDC.

Questions for the committee:

- 1) What types of risk might be overlooked by conceptual frameworks that rely on analogies to existing arrangements? That is, what blind spots could arise when thinking about digital assets in these (traditional) ways?
- 2) While a large amount of data related to digital assets is publicly available, interpreting this data is challenging. How are traditional financial institutions evaluating value and risks related to digital assets? What sources are institutions looking at for data on market activity, counterparties, acquisition targets, etc.? How do they evaluate what data is reliable?
- 3) How is innovation in digital assets pressuring traditional financial institutions to respond? Are important indirect risks to financial stability arising as traditional institutions compete with fintech firms and other new developments?
- 4) To the extent that traditional financial institutions engage with digital assets, are they more likely to interact directly or through intermediaries/custodians? Are there certain intermediaries that are widely used? Are firms using or accepting digital assets directly as collateral?