OP-ED

Inevitable flows into USDC amid banking crisis?

Opinion Note by Fadi Aboualfa,
Head of Research, Copper.co

As the FDIC looks to possibly increase the deposit insurance threshold of $250,000, Circle's USDC is mathematically an exponentially better asset to hold, even at a de-pegged rate.

If the Fed however plans to rescue all depositors in the future by means of Quantitative Easing (QE), then Bitcoin might see quick recovery as the world has learnt from the lessons of 2020.

Either way, flows could inevitably be moving into digital assets as investors begin to weigh risk and possible commercial banking and central banking hedges.

Perhaps not a headline most would expect to read as the US continues to wake up to several back-to-back banking failures, one of which, Silicon Valley Bank (SVB), affected cryptocurrency markets and showcased for the first time that systemic contagion can work both ways.

SVB was holding $3.3bn of Circle's cash, the issuer of the most trusted stablecoin on the market on the back of its US domicile, regulatory approach and monthly attestations proving their reserves and composition of one-to-one backing, dollar for dollar.

It's all very transparent as crypto industry participants required centralised organisations to be. This was the only way to build trust in the tokenised-cash-equivalent-token in an ecosystem whose agenda is to be as 'trustless' as possible.

Although news around the potential failure of SVB began to unravel on the weekend, decentralised markets working round the clock quickly saw USDC de-peg to as low as $0.88 to the dollar, losing the company its prized parity medallion for the first time.

Markets weren't being irrational by any means. At the time, SVB's failure would have meant that Circle would have a shortfall of $3,299,750,000 after it would be able to recoup a mere $250,000 that is insured by the Federal Deposit Insurance Corp (FDIC). This was approximately 8% of Circle's total reserves.

However, the Federal Reserve, the FDIC, and the Office of the Comptroller of the Currency (OCC), came sweeping in with a rescue plan to provide liquidity against the assets that the failing banks held. In essence, value of the assets owned by the banks were considered cash-equivalent as they would be held-to-maturity (HTM).

USDC met parity once again, and markets saw some faith that regulators can step in to maintain market integrity in times of stress. But the expanding balance sheet at the Federal Reserve harkens back to memories of the pandemic-era and Bitcoin too has made a grand comeback as it eyes the $30,000 range for the first time in nearly a year, and almost double this cycle's low.

The latest news is that the FDIC has begun to assess whether it should move to insure deposits above the current $250,000 threshold as jitters still linger after the Wall Street Journal published an article that highlighted a study that discussed how nearly 200 other banks could potentially be in a similar position to SVB.

USDC = 80% CBDC?

Circle has done everything it can in the meantime to alleviate pressures. It reminded its holders that the company has relationships and reserves sitting with Global Systemically Important Banks (G-SIB), as well as the smaller banks that serviced the cryptocurrency industry.

Circle also refreshed people's memory that 80% of the reserves are not actually cash, but short-dated Treasury Bills managed by Blackrock, the world's largest asset manager (see table) →

Circle Reserve Fund (USDXX)

PAR $	IDENTIFIER	YIELD/COUPON	FINAL MATURITY
4,994,000,000.00	912796Z93	4.63	04-Apr-23
4,497,600,000.00	912796CW7	4.75	02-May-23
3,230,000,000.00	912796CU1	4.74	18-Apr-23
2,900,000,000.00	912796YU7	4.68	13-Apr-23
2,634,000,000.00	912796Z77	4.61	21-Mar-23
2,100,000,000.00	912796CT4	4.7	11-Apr-23
2,000,000,000.00	912796YN3	4.52	06-Apr-23
1,500,000,000.00	912797FE2	4.54	16-May-23
1,285,000,000.00	912796Z85	4.6	28-Mar-23
993,000,000.00	912796ZF9	4.82	25-May-23
513,000,000.00	912796CV9	4.76	25-Apr-23
500,000,000.00	912796ZE2	4.74	11-May-23
350,000,000.00	912796U31	4.37	23-Mar-23

Source: Blackrock, As of 17 March 2023

With Circle's reserve composition being short-dated T-Bills, then isn't this a near equivalence to a Central Bank Digital Currency (CBDC)? In different terms, had Circle's composition been 100% T-Bill reserves, would USDC not be a direct liability of the Federal Reserve, and a de facto CBDC by extension?

But even under the current composition of 80% T-Bills, 20% Cash, this means that USDC has a price floor of $0.8 to the dollar.

Just as a thought experiment, let us argue that there is only a single commercial bank everyone relies on that fails.

In essence, anyone holding above $312,500 at this bank would be better off holding USDC at a de-pegged rate of $0.8, then wait to recover the $250,000 from a bank under administration by the FDIC.

This becomes an exponentially stronger argument for business and large sums. For example, a deposit account holding $10,250,000.00 would see a $10mn loss from their bank deposit, but only a $2,050,000 loss holding USDC at the discounted rate if all of Circle's cash reserves were to disappear.

The options don't seem to be many. If the Federal Reserve does issue a CBDC, which at this point seems like a long shot, bank runs that kicked off this very latest crisis could happen even faster.

In such a scenario, USDC might be a very good hedge for large depositors.

In the case that the Federal Reserve does issue a CBDC, and a bank run occurs leading to a bank failure, it either has the option to let them fail, which will inevitably lead more people to move into CBDC spiralling events out of control or bail out the banks through QE leading to inflation and the rise of Bitcoin as seen after COVID.

The options might not be many, and not perfect by any means, but there are some possible paths to hedge against either bank failures or QE (see table) →

TOKEN	COUNTERPARTY AND FINANCIAL RISK CONSIDERATIONS
USDC	A maximum 20% value loss due to cash reserves being wiped out in case of total banking partner collapse.
Dai	Contract and hacking risks, some exposure to fiat-backed stablecoins including USDC, USDT, GUSD, etc. Some de-pegging/volatility.
LUSD	Total Loss in event of hack of underlying locked Ethereum that holds the peg of the minted stablecoin. No loss or exposure to banking although LUSD cannot be off-ramped without USDC or other fiat-backed bridging asset.
Bitcoin	Inverse relation with DXY. In case of bank failure/QE, Bitcoin did see massive price increase in 2020. This may or not play out again however in 2023 is proving to do just that.