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# Stablecoins in Georgia: International Regulatory Practices and Policy Recommendations for the Georgian Government

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# EXECUTIVE SUMMARY

Stablecoins are a subgroup of cryptocurrencies that promise price stability in an otherwise volatile market. Over the last decade, they have gained increasing popularity in the cryptocurrency industry. According to Coin Metrics, in 2022, a total value of US$7 trillion was settled in stablecoins (Andrade & Waters, 2022). Interestingly, it was in this same year that major economies such as the United States and the European Union (EU) introduced the most significant stablecoin legislation to date. In this respect, Georgia is trailing behind as the crypto-related laws the country passed in 2022 are not sufficiently comprehensive and somewhat ambiguous, leaving some doubt as to whether they even include stablecoins. The main goal of this paper is to analyze the existing flaws in the Georgian legislation and suggest ways in which stablecoin regulation should be developed in the country, with several policy recommendations offered to the Georgian government.

First, the paper recommends arriving at a clear definition of stablecoins. This could be achieved by either expanding the existing virtual asset definition or by formulating a new definition specific to stablecoins. In addition, the paper advises against Georgian legislation addressing crypto-backed and algorithmic stablecoins due to them having stabilization mechanisms different from fiat-backed tokens. Accordingly, the paper recommends that these types of stablecoin be excluded from the legislation until further assessment. The second recommendation of the paper is that the National Bank of Georgia (NBG) should allow payments in Georgian Lari (GEL) stablecoins that are sufficiently backed by reserves, following the practices of the EU and the United States. The NBG could treat stablecoins as 'electronic money' under the Law of Georgia on Payment Systems and Payment Services or create a new license for entities willing to issue stablecoins. The second option would necessitate modifying Article 34 of the Law on the National Bank of Georgia to make stablecoins legal tender.

In addition, if the NBG chooses the second option of creating a stablecoin issuer license, it would have to devise a new framework tailored to stablecoins. Such a framework would mandate licensed issuers to hold sufficient reserve assets, which are taken into custody by other legal entities. The issuers should also be required to publicly disclose reserves, mainly consisting of highly liquid assets. Lastly, in the event of insolvency, token holders must be given priority over other creditors, ensuring they receive full compensation.

# INTRODUCTION

Over the past few years, stablecoins have proven to be one of the most important use cases for cryptocurrency technology (Cannelis, 2022). As of 5 January 2023, Tether (USDT) and USD Coin (USDC) stablecoins were two of the top five cryptocurrencies in terms of market capitalization.[1] According to CoinMarketCap, stablecoins have a share of over 17% in the total cryptocurrency market.[2]

There are several reasons why stablecoins have gained traction in the cryptocurrency space. As the name suggests, the most important factor is their promised stability. Stablecoins are pegged to the value of a specific asset, such as a fiat currency, commodity, or cryptocurrency. Therefore, by design, they should maintain a stable price. For example, the mentioned USDT and USDC tokens are pegged to the value of the US Dollar, meaning their prices are always close to US$1.[3] That means they are less volatile than traditional cryptocurrencies like Bitcoin (BTC) or Ether (ETH), which can fluctuate significantly over short periods. Apart from stability, stablecoins can also offer users a cheap and fast way of transferring funds. Due to the underlying blockchain technology, stablecoins, like some other cryptocurrencies, can be transferred from one address to another almost instantly with minimal fees.

These characteristics of stablecoins could have significant positive implications for the international financial system. Indeed, international bodies like the Committee on Payments and Market Infrastructures (CPMI) are actively researching the potential role of stablecoins in cutting cross-border payment costs (Schikler, 2022).

Nevertheless, stablecoins gained widespread attention in 2022, not primarily for their favorable characteristics but rather their inherent risks. In May 2022, the collapse of the TerraUSD (UST) stablecoin, which was valued at US$18 billion at the time, led to the evaporation of a US$60 billion Terra ecosystem (Sandor & Genç, 2022). Thousands of investors suffered losses damaged, and the crypto bear market was exacerbated.[4] As expected, regulators, including the United States Secretary of the Treasury, Janet Yellen, called for the development of a regulatory framework for stablecoins (Wright, 2022). Interestingly, the United States has not yet adopted digital asset regulation at a federal level. That said, throughout 2022, three bills were submitted to the United States Congress, two of which address stablecoins.

However, no major economy appears closer to adopting a comprehensive crypto-

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1 See https://coinmarketcap.com/

2 See https://coinmarketcap.com/view/stablecoin/

3 The prices are not always strictly US$1, but stabilization mechanisms ensure that any deviation stays extremely insignificant. For example, at the time of writing, one USDT token was worth US$0.9998, while one USDC was US$0.9999.

4 See https://www.coingecko.com/en/global-charts

currency regulation than the EU where the MiCA regulation is expected to enter into force in April 2023 (Singh, 2023). While addressing the broader cryptocurrency sector, MiCA also introduces new rules for stablecoin issuers. Its rules are much more comprehensive and detailed than those of the three US bills. That is why MiCA, so far, has the greatest potential to become the global regulatory standard.

The Georgian government also passed virtual asset laws in 2022. In particular, the Organic Law of Georgia on the National Bank of Georgia and the Law on Facilitating the Prevention of Money Laundering and Financing of Terrorism have been modified to include definitions of "virtual asset," "virtual asset service provider" (VASP), and the "anti-money laundering/combating the financing of terrorism (AML/CFT) obligations of VASPs. However, as will be discussed in the following chapters, the adopted legislation does not provide any clarity with respect to stablecoins and stablecoin issuers.

In addition, to the best of the author's knowledge, there are no successful Georgian Lari (GEL) stablecoins on the market. For example, one such stablecoin called New Lari (nGEL) has only been transacted nine times in almost two years.[5] Another GEL stablecoin, Georgian Crypto Bank (LARI), issued in June 2022, had had only 14 transactions as of 5 January 2023.[6] It could be argued that the absence of clear regulations coupled with a lack of trust in the judicial system[7] are among the main reasons why there have not yet been any successful GEL stablecoins. Therefore, it is of critical importance to analyze the current legal framework to pinpoint viable areas for improvement.

This paper thoroughly examines the existing Georgian cryptocurrency laws to identify their primary shortcomings. Moreover, it analyzes the bills proposed in the EU and the United States. After examining the local regulatory environment, comparing it to international practices, and considering the idiosyncrasies of the Georgian economy, the paper also proposes amendments to improve the existing policy.

However, before making any conclusions about the regulation of a particular technology, it is essential first to understand how it operates. With that in mind, the next paragraph examines how various types of stablecoin work.

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5 See https://etherscan.io/address/0xf7dB73eF42b6fB4627756871F463D0B311Ec79C8

6 See https://bscscan.com/address/0x447fc35564fd8fc4e10d5ec93a27b9031746245f

7 Read this blog by Guram Imnadze for more on the Georgian judicial system: https://courtwatch.ge/en/articles/trust-of-the-court/

## HOW DO STABLECOINS WORK?

As mentioned above, all stablecoins are designed to maintain a stable price. They can be classified into four categories based on the type of collateral and stabilization mechanisms they use: fiat-backed, crypto-backed, algorithmic, and commodity-backed. This paper does not address commodity-backed stablecoins, as they do not reference the value of a fiat currency like GEL.

### FIAT-BACKED STABLECOINS

In a typical arrangement, a fiat-backed stablecoin is backed by reserves of the fiat currency it is referencing. For example, if a token purports to maintain a stable price of US$1, it will have USD reserves as collateral. Ideally, the reserves should primarily consist of cash and cash equivalents (i.e. liquid assets).

Most of these tokens work in a very straightforward manner. First, a customer deposits fiat into the issuer's bank account. Then, the issuer issues the equal value in tokens minus a small commission fee (known as "minting") and transfers the tokens to the customer's cryptocurrency wallet address. This is how the fiat currency of the traditional finance world is transformed into a crypto-asset. When customers want their fiat back, they send the tokens back to the issuer. The issuer then takes the tokens out of circulation (known as "burning") and provides the customer with fiat. Since this process is usually facilitated by centralized entities like the issuer and its bank, the cryptocurrency community refers to fiat-backed stablecoins as centralized stablecoins.

The issuer usually promises to maintain reserves on par with outstanding tokens to avoid liquidity problems when customers require redemptions. If the minting and burning mechanism works as promised and the promise of full reserves is honored, the stablecoin should not lose its peg to the fiat currency it is referencing. However, because the reserves are kept in traditional bank accounts and not on a transparent blockchain, the customers cannot verify the validity of a full reserve claim.

In fact, the cryptocurrency community and regulators have long been concerned about the integrity of fiat-backed stablecoin reserves. For example, on 15 October 2021, the United States Commodity Futures Trading Commission (CFTC) fined Tether, the issuer of the largest stablecoin, USDT, US$41 million for making misleading statements about its reserves (Robinson, 2021). Namely, the CFTC claimed that from 2016 to 2018, Tether kept full reserves only for 27.6% of the time.[8] Because of this and other regulatory controversies, Tether now conducts a quarterly attestation of its

[8] See https://www.cftc.gov/PressRoom/PressReleases/8450-21

reserves. Moreover, the company promised to move to monthly attestations in early 2023.[9] These attestations will be performed by BDO Italia, a member of the BDO organization, which is ranked among the top five global accounting firms. Considering Tether's case, it would appear that the only way for fiat-backed stablecoin issuers to allay public concerns about their reserves would be to arrange regular attestations by a trusted auditor.

Given the importance of transparency in the fiat-backed stablecoin system, the EU and the US legislation mentioned above mandate the issuers to have their tokens fully backed by collateral and provide regular attestations. Moreover, they require the issuers to have liquid assets in their reserves.[10] Pertinently, Tether underwent heavy criticism for having commercial paper among its reserve assets, so in October 2022 the company announced that all of its commercial paper holdings had been replaced by safe and liquid US Treasury bills.[11]

Despite concerns about the quantity and quality of the reserves of fiat-backed stablecoins, they remain the most significant part of the stablecoin sector. At the time of writing, eight out of the top 10 stablecoins were fiat-backed.12 This type of token represents more than 93% of the total market share. Therefore, it is only logical that the proposed stablecoin regulations would mainly apply to the issuers of fiat-backed tokens.

## CRYPTO-BACKED STABLECOINS

On the very first page of the Bitcoin whitepaper, the pseudonymous creator of Bitcoin, Satoshi Nakamoto, emphasized the need to eliminate trust in electronic payment systems (Nakamoto, 2008). In addition, he underscored the vulnerabilities of the trust-based traditional financial system in his first blog post introducing Bitcoin to the public (Nakamoto, 2009), stating the following:

> *"The root problem with conventional currency is all the trust that's required to make it work. The central bank must be trusted not to debase the currency, but the history of fiat currencies is full of breaches of that trust. Banks must be trusted to hold our money and transfer it electronically, but they lend it out in waves of credit bubbles with barely a fraction in reserve. We have to trust them with our privacy, trust them not to let identity thieves drain our accounts."*

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9 See https://tether.to/en/tether-announces-alignment-with-top-five-accounting-firm-and-confirms-attestations-will-now-be-completed-by-bdo-italia/

10 These requirements will be discussed in more detail below.

11 See https://tether.to/en/tether-slashes-commercial-paper-to-zero/.

12 See https://coinmarketcap.com/view/stablecoin.

However, the typical fiat-collateralized model requires trust from holders in the issuers that they maintain full and liquid reserves. The holders must also trust the banks holding their funds and auditors performing reserve attestations. It is easy to see why many in the cryptocurrency community dislike this model. Arguably, the fiat-backed model goes against the very ethos of the cryptocurrency industry.

Crypto-backed stablecoins are designed to operate in a trustless and decentralized manner. Like their centralized counterparts, they are pegged to some reference value, usually a fiat currency like the US Dollar. However, unlike centralized stablecoins, their reserves consist of other cryptocurrencies. More importantly, when obtaining crypto-backed stablecoins, users do not interact with other parties like issuers or banks. Instead, the process is fully automated by employing smart contracts. A smart contract is a code that is automatically executed after certain conditions are met on a blockchain. While fiat-backed stablecoins also use smart contracts in some of their operations, crypto-backed stablecoins are entirely dependent on them.

Their smart contracts are programmed to automatically mint and send new tokens to a person who deposits a certain amount of cryptocurrency. This model is more akin to a borrowing and lending process. A user willing to acquire this type of stablecoin should lock cryptocurrency in a smart contract as collateral. Then, to get the collateral back, the user should repay the "loan" by sending the stablecoin back to the smart contract. Crucially, these stablecoins are overcollateralized, meaning that the locked cryptocurrency should be larger in value than the obtained tokens. The overcollateralization helps to protect the system from the price fluctuations of the locked cryptocurrencies. If the collateral value decreases below a certain threshold, it will be automatically liquidated by the smart contract.

To understand better how this system functions, it is helpful to examine the process of obtaining the popular crypto-backed stablecoin Dai (DAI).[13] Dai has a market capitalization of over US$5.7 billion and is the largest crypto-backed stablecoin in the market.[14] To mint Dai tokens, one should lock a cryptocurrency like ETH in a smart contract. At the time of writing, the minimum collateral ratio for ETH was 170%.[15] This means that to get US$100 worth of Dai, one would need to lock in at least US$170 worth of ETH as collateral. It is advisable for borrowers to lock more ETH as collateral than the minimum requirement because if the collateral's value falls below 170% of the borrowed tokens, it will be liquidated. Whenever borrowers want to get their collateral back, they repay the "loan" with Dai tokens. This stabilization mechanism, while much more complicated than that of USDT and other fiat-backed stablecoins, guarantees price stability without centralized intermediar-

[13] Dai, like USDT, can be bought on exchanges. One does not need to interact with Tether or Dai smart contracts to get USDT and DAI tokens, respectively. The processes described in this chapter explain how USDT and Dai tokens enter circulation.

[14] See https://coinmarketcap.com/view/stablecoin/. Data up to date as of 6 January 2023.

[15] See https://oasis.app/#borrow.

ies. In addition, the mechanism is more transparent than the centralized approach. Public blockchains, by nature, allow anyone to view the assets that support a crypto-backed stablecoin's peg.[16]

Thus, subjecting these stablecoins to rules like maintaining full liquid reserves or regular reserve attestations is redundant. The transparency of public blockchains, allowing users to audit the system in real time, and the code behind smart contracts, both guarantee that these goals are automatically achieved. That said, the complex stabilization mechanism of crypto-backed stablecoins may discourage potential users from buying them. Arguably, their relatively low adoption to date could be attributed to concerns over potential risks associated with smart contract vulnerabilities.

## ALGORITHMIC STABLECOINS

Similar to crypto-backed stablecoins, algorithmic stablecoins should maintain a stable value relative to a specific fiat currency or an asset in a decentralized manner. However, they are not backed by fiat or other cryptocurrency reserves. Here, stability is achieved using smart contracts and other algorithmic mechanisms. Typically, the tokens are burned when the value drops below a certain price of a reference asset (i.e. supply is contracted) and minted when it increases above the price (i.e. supply is expanded). Integral to this mechanism is another token in the system, which supports the mint and burn process. In fact, if the support token's price decreases sharply, the stabilization process becomes ineffective.

Algorithmic stablecoins gained significant attention in May 2022 when TerraUSD (UST) lost its peg of US$1. At its peak, UST was the third-largest stablecoin in the market (Kelly, 2022). However, soon after reaching its highest valuation of US$18 billion, the algorithmic token dropped below the price of US$1. The de-pegging was accompanied by a drop in the price of Luna, UST's support token. As mentioned above, when the price of the support token decreases significantly, the stabilization mechanism stops working. As a result, the US$60 billion Terra ecosystem collapsed in less than a week.[17]

The failure of UST proved that the algorithmic model has significant inherent risks. The dependence on the value of a support token, which is greatly influenced by a volatile market, is a major vulnerability. In fact, Terra was not the first algorithmic stablecoin to collapse due to this problem (Kessler & Nelson, 2022).

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[16] For example, see the composition of Dai's collateral https://daistats.com/#/collateral.

[17] See more about UST's collapse here: https://niccarter.info/wp-content/uploads/All-Falls-Down-Whitepaper-2022-06-11.pdf

A strict regulatory response followed the UST fiasco. Specifically, according to one of the drafts of the House Financial Services Committee's stablecoin bill, the issuance of algorithmic stablecoins would be banned for two years in the United States (Versprille, 2022).

A comparison chart is presented below, highlighting the key parameters that distinguish the three types of stablecoin.

**Table N1**

| **Parameters** | **Fiat-backed Stablecoins** | **Crypto-backed Stablecoins** | **Algorithmic Stablecoins** |
|---|---|---|---|
| Backing | Fiat currency | Cryptocurrencies | No reserves |
| Stability Mechanism | Central entity manages reserves | Underlying contracts guarantee overcollateralization | Algorithms adjust the outstanding token supply |
| Decentralization | Centralized | Highly decentralized | Fully decentralized (ideally) |
| Risks | Insufficient reserves | Price volatility of cryptocurrency reserves | Volatility of the stablecoin and its support token |

# CURRENT REGULATORY ENVIRONMENT IN GEORGIA

## PUBLIC RULING N201

Georgian regulators had not addressed cryptocurrencies before 28 June 2019, when the Ministry of Finance of Georgia (MoF) issued the Public Ruling N201, which clarifies the taxation rules for cryptocurrency miners.[18] While Ruling N201 is not a law per se, it is nevertheless significant as it marks the Georgian government's first attempt to define cryptocurrencies and is also relevant for taxation purposes.

According to the document, *"a crypto-asset is a digital asset stored and exchanged electronically within a peer-to-peer network that does not require a trusted intermediary, functions through a distributed ledger technology, and uses cryptographic methods. Crypto-asset is a digital representation of value; its issuance and exchange happens through a decentralized consensus mechanism, without a central trusted issuer and controlling entity, and its proof of ownership is confirmed cryptographically."*[19]

While this definition includes cryptocurrencies like BTC and ETH and crypto-backed and algorithmic stablecoins like DAI and UST, it excludes fiat-backed stablecoins. This is because one of the characteristics of a crypto-asset defined by the Ruling is that it is issued without a centralized issuer. While this is true for decentralized cryptocurrencies, including crypto-collateralized and algorithmic stablecoins, the fiat-backed model usually requires the existence of an issuing company. Therefore, the definition does not seem to include a stablecoin referencing Georgian Lari, backed by GEL reserves held in a commercial bank.

Interestingly, in subsequent sections, the Ruling adopts the European Central Bank (ECB) definition of virtual currency. The 2015 report of the ECB defines virtual currency as *"a digital representation of value, not issued by a central bank, credit institution or e-money institution, which, in some circumstances, can be used as an alternative to money."*[20] The MoF shares this definition of virtual currency, stating that it also includes crypto-assets. The ECB's definition does not exclude fiat-backed stablecoins from being classified as crypto-assets. However, by simultaneously defining cryptocurrencies as digital assets without centralized issuers, Ruling N201 raises questions as to whether fiat-backed stablecoins are included in its definition.

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18 See https://matsne.gov.ge/ka/document/view/4601215?publication=0.

19 Please note that this is the author's translation of the official definition, which is only available in the Georgian language.

20 See https://www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemesen.pdf.

In addition, the document does not consider crypto-assets as legal means of payment. It is in accordance with Article 34 of the Organic Law of Georgia on the National Bank of Georgia, which sets GEL as the only legal tender in the country.[21] Moreover, the ruling exempts the exchange of crypto-assets for fiat currencies from VAT and personal income tax. As of January 2023, this is the only guidance on cryptocurrency taxation in Georgia.

## THE TAX CODE OF GEORGIA

The July 2021 updates to the Tax Code of Georgia (TCG) make a brief reference to cryptocurrencies. Namely, the TCG states that *"cryptography currencies (crypto-assets) shall not be considered as goods."* However, the Code does not provide any further definition of crypto-assets.[22]

## 2022 AMENDMENTS

The most important legislation influencing the cryptocurrency market in Georgia was passed in September 2022 and entered into force on 1 January 2023. The laws that were initiated by the National Bank of Georgia (NBG) amended the Organic Law of Georgia on the National Bank of Georgia[23] and the Law of Georgia on Facilitating the Prevention of Money Laundering and the Financing of Terrorism.[24] According to the explanatory notes of the AML/CFT legislation amendments,[25] the changes were made in response to the 2020 report of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (Moneyval).[26] The report reviewed Georgia's measures for AML/CFT and their compliance with the recommendations of the Financial Action Task Force (FATF), a highly influential intergovernmental organization that sets global money laundering and terrorism financing prevention standards. According to its report, one of the main areas where Georgia failed to comply with the FATF recommendations was the non-existence of the VASP regulation.

The explanatory notes state that the regulatory gap can exacerbate terrorism financing and money laundering risks because of the inherent characteristics of virtual assets. Moreover, the notes claim that the existence of these risks could hinder Georgia's aspiration to join the Single Euro Payments Area (SEPA). The regulation is

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21 See https://www.matsne.gov.ge/en/document/view/101044?publication=38.

22 See https://matsne.gov.ge/en/document/view/1043717?publication=175.

23 See https://www.matsne.gov.ge/ka/document/view/101044?publication=51

24 See https://matsne.gov.ge/en/document/view/4690334?publication=0

25 See https://info.parliament.ge/file/1/BillReviewContent/304462

26 See https://rm.coe.int/moneyval-2020-20-5th-round-mer-georgia/1680a03271

designed to mitigate those risks by introducing registration, reporting, and monitoring rules for VASPs. In addition, the NBG law defines the NBG as the primary controlling entity of VASPs.

While these rules are extremely important for the Georgian cryptocurrency market, it is unclear whether they apply to stablecoins and stablecoin issuers. According to the part of the legislation that amends the existing NBG law, a 'virtual asset' is defined as *"a digital representation of value, which is fungible and non-unique, is a tool for digital transfers or trading, and is used for investing and/or payment purposes. A virtual asset does not include digital representations of funds, securities, and other financial instruments."*[27] [28] In an interview with the author, NBG representatives stated that this definition includes stablecoins. However, according to the Law of Georgia on Payment Systems and Payment Services, the term 'funds' includes banknotes, coins, and money on payment and bank accounts.[29] Moreover, the interviewed NBG representatives confirmed that 'funds' can also be understood as 'cash and cash equivalents.' Essentially, stablecoins referencing official currencies like USD, EUR, or GEL are exactly digital representations of cash and cash equivalents. Therefore, the language of the definition clearly contradicts the representatives' position that stablecoins are included in the legislation. Unfortunately, the legislative experts who worked on the law have not provided further explanations on this matter to the public. Therefore, the virtual asset definition remains ambiguous until more guidance.

It must also be mentioned that the NBG amendment, like the MoF Ruling, considers virtual assets as illegal means of payment. This is interesting because the virtual asset definition acknowledges they can be used for payments.

## LAW ON PAYMENT SYSTEMS AND PAYMENT SERVICES

The Law of Georgia on Payment Systems and Payment Services is another piece of legislation with significant implications for stablecoins.[30] That is because the Law defines 'electronic money' and 'electronic money providers.' It is crucial here to examine what these terms mean under the Law and whether they apply to stablecoins and stablecoin issuers, respectively.

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27 See https://www.matsne.gov.ge/ka/document/view/5562437?publication=0

28 Please note that this is the author's translation of the official definition, which is only available in the Georgian language.

29 See the definition of „ფულადი სახსრები": https://www.matsne.gov.ge/ka/document/view/1673253?publication=16

30 See: https://matsne.gov.ge/en/document/view/1673253?publication=2. Note that the original version of the document has not been fully translated into English.

According to the legislation, 'electronic money' is *"a value equivalent to funds received by an electronic money provider from users for carrying out payment service transactions, which is stored on payment instruments and which is recognized as a means of payment by its issuer and other persons. The ratio of electronic money and the funds received in its stead, as set by the electronic money provider, shall be the same at all stages of the activity of the provider."* As for an 'electronic money provider,' the Law defines the term as *"a payment service provider who issues electronic money under the legislation of Georgia."* The two definitions do not seem to exclude stablecoins and their issuers. However, it would be wrong to make any assumptions without examining the meaning of 'payment service' under this law because the definitions of 'electronic money provider' and 'electronic money' are both linked to the concept of 'payment service.'

The actions falling under the definition of 'payment service' and those that are not included in the term are specified in Article 13 of the law. The seven services that are considered a 'payment service' are:[31]

*"a) services that ensure the debiting of funds from the payer's account and related transactions;*

*b) services related to the crediting of funds to the payee's account and related transactions;*

*c) making payments through direct debits (including one-off orders), payment cards, or any other electronic means, or credit transfers (including standing orders) within the funds or credit resources of a payment service user;*

*d) issuing and/or acquiring payment instruments, including electronic money instruments;*

*e) remittances;*

*f) issuing electronic money, executing payment transactions by means of electronic money through a mobile phone, internet, or any other electronic device;*

*g) executing payment transactions based on the consent of the payer given by means of telecommunication, digital, or IT devices, to or in favour of the telecommunication, IT system, or network operator that acts as an intermediary between the payer and the payee, as well as between the user and the supplier of goods or services."*

Arguably, stablecoin issuers conduct at least one of these services (for example, a, b, d, e, and f). As for the 11 services (13 in the Georgian version) that are not considered payment services, stablecoin issuers do not seem to perform any of them (see Article 13(2)). Therefore, stablecoin issuers can be considered 'payment service providers' and are thus 'electronic money providers,' meaning stablecoins can be regarded as

[31] There are eight services in the Georgian version of the bill.

'electronic money' within this law. Accordingly, it is worthwhile to examine what this law requires from electronic money providers.

First, if an entity is not a commercial bank or a microfinance organization, it should register under the NBG to become a payment service provider (i.e. an electronic money provider). According to the 2017 Order of the NBG, 'electronic money' should be issued on par with funds received from customers.[32] In addition, customers' funds must be segregated from providers' funds and held in NBG-licensed commercial banks. Furthermore, the funds must be held in cash and/or in a form of bank guarantee. Moreover, Article 18 of the Law of Georgia on Payment Systems and Payment Services prohibits the use of customers funds for a provider's liabilities, while electronic money providers must always hold capital at least equal to the threshold set by the NBG.

These requirements resonate with many of the rules in proposed international stablecoin legislations.

[32] See shorturl.at/aitlX

# INTERNATIONAL REGULATORY PRACTICES

## MARKETS IN CRYPTO-ASSETS (MICA) REGULATION

As mentioned previously, one of the primary factors that spurred the adoption of the amendments to the NBG and AML/CFT legislation in Georgia was the country's desire to join the SEPA as part of its efforts to adopt financial regulations in accordance with EU practices. Therefore, it is critical to understand how the EU regulates stablecoins.

The MiCA regulation, first introduced to the European Parliament in September 2020, is the most comprehensive digital asset regulation proposed in any of the world's major economies to date.[33] The proposed legislation is also the closest to being enacted. An almost-400-page text, it addresses many critical issues in the cryptocurrency sector. Importantly, a significant portion of the bill is dedicated to stablecoins and stablecoin issuers. Interestingly, MiCA considers the widespread adoption of stablecoins a threat to financial stability because a popular stablecoin could pose a challenge to the maintenance of monetary sovereignty.

MiCA divides cryptocurrencies into three categories: crypto-assets, electronic money tokens, and asset-referenced tokens. A 'crypto-asset' *"means a digital representation of a value or a right which may be transferred and stored electronically, using distributed ledger technology or similar technology."* This definition encompasses non-stable cryptocurrencies, like BTC and ETH. The remaining two categories cover stablecoins.

Meanwhile, MiCA defines an 'electronic money token' or an 'e-money token' as "a type of crypto-asset that purports to maintain a stable value by referencing to the value of one official currency." The second type of stablecoin is an asset-referenced token (ART). According to the bill, an ART "means a type of crypto-asset that is not an electronic money token and that purports to maintain a stable value by referencing to any other value or right or a combination thereof, including one or more official currencies."

While e-money tokens and ARTs are both stablecoins, they differ in several ways. First, e-money tokens must reference only one official currency and be backed with reserves denominated in that currency. For example, a stablecoin pegged to the Euro, which only has EUR reserves, would be considered an e-money token. On the other hand, ARTs can reference more than one official currency, commodity, or some other value. Moreover, ARTs are backed by a basket of assets. One example of an ART is the above-mentioned DAI stablecoin. Even though DAI's price is pegged to US$1, its reserves consist of different cryptocurrencies.[34] Another example of an ART is Paxos

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[33] See https://www.europarl.europa.eu/RegData/commissions/econ/inag/2022/10-05/ECON_AG(2022)737216_EN.pdf

[34] See for DAI reserves: https://daistats.com/#/

Gold (PAXG), a stablecoin pegged to the value of one ounce of a London Good Delivery gold bar. Therefore, e-money tokens are fiat-backed stablecoins, while ARTs cover all other stablecoin categories.

Some have speculated that the introduction of the ART category to MiCA is a response to Meta's failed Libra project.[35] The latter set out to issue a token referencing a basket of official currencies. However, the European regulators were concerned about the possible emergence of a token issued by one of the largest technology conglomerates and thus included extensive requirements for ART issuers in the text.

## Requirements for Asset-referenced Token (ART) Issuers

According to Article 15, entities willing to issue ARTs within the EU should apply to a competent authority of the EU Member State in which they seek authorization. The requirements do not apply when the total outstanding value of an ART never exceeds EUR 5 million over a period of 12 months. On the other hand, whenever the use of an ART as a means of exchange exceeds 1 million transactions or EUR 200 million daily, the issuer must stop issuing the token and present a plan to decrease the number of transactions below the threshold.[36] This provision most probably addresses the threat of a popular EUR stablecoin replacing the Euro as the preferred payment method within the EU.

Important documents required to be presented include the articles of association, a program of operations, a description of cybersecurity measures, and a crypto-asset whitepaper. The latter is a document that presents a comprehensive description of a project, and it is common practice within the cryptocurrency community to publish one before beginning a project. While publishing whitepapers has untill now been voluntary, MiCA mandates all ART issuers to present the document to authorities and publish it on their websites. With respect to the actual text, whitepapers should include information about the issuer, underlying technology, and reserve assets.

Article 31 demands that ART issuers always hold at least whichever of the following is highest: EUR 350,000 or 2% of the average amount of reserves in their own capital. Moreover, based on idiosyncratic risks, authorities in EU Member States can mandate issuers to hold up to 20% more capital than the standard requirements. Interestingly, if an issuer is already registered as a credit institution (i.e. as a bank or a savings association) within the EU, it is exempted from these capital requirements.

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[35] See https://medium.com/coinmonks/asset-referenced-tokens-under-the-eus-proposed-markets-in-crypto- assets-regulation-458c317577bb#_ftnref1

[36] See Article 19b.

ART issuers are required to hold reserve assets at least equal in value to the outstanding tokens.[37] MiCA states that the reserves should be composed of assets that address liquidity risks associated with holders' redemption rights. It also mentions that the reserves in official currency referenced by an ART should not be less than 30% of the total. However, it does not specify the types of asset that can be included in the reserves. Instead, the bill requires the European Banking Authority (EBA) to come up with technical reserve details within one year of the enactment of the legislation.[38] Moreover, the regulated entities must disclose the value and composition of reserve assets on their websites. These entities should also conduct independent audits of the reserves to assess their compliance with the MiCA rules, the results of which must also be published on their website. Furthermore, the ART issuers must clearly explain the stabilization mechanisms they use.

According to Article 33, ART issuers are prohibited from being custodians of their reserve assets. Instead, the custodian must be a different legal entity than the issuer. Pertinently, custodians can be crypto-asset service providers (cryptocurrency exchanges) when reserves are crypto-assets, credit institutions for all assets, and investment firms for financial instruments. More importantly, Article 33 statest that *"the reserve of assets shall be insulated from the issuer's estate, and from the reserve of assets of other tokens, in the interest of the holders of tokens under relevant law, such that creditors of the issuers have no recourse on the reserve of assets, in particular in the event of insolvency."* This rule guarantees that the token holders are prioritized over the issuer's creditors and are made whole in the case of the issuer's insolvency.

MiCA allows ART issuers to invest part of their reserve assets in highly liquid financial instruments with minimal market risks.[39] However, the legislation does not specify the types of financial instrument. Like in the case of reserve assets, MiCA mandates the EBA to publish the technical standards of financial instruments within one year of the enactment of the law. In addition, ART issuers are prohibited from paying interest to token holders in relation to the tokens they hold.

In Article 39, MiCA introduces a subcategory of 'significant asset-referenced tokens' and provides additional rules for their issuers. It stipulates that an ART will be reclassified as a significant ART when at least three of the following conditions are met:

- The number of holders is more than 10 million;
- The market capitalization of the ART is more than EUR 5 billion;
- The number and value of daily transactions exceed 500,000 or EUR 500 million, respectively;

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[37] See Article 32.

[38] The EBA is an independent EU agency working to safeguard the integrity, efficiency, and orderly functioning of the EU banking sector.

[39] See Article 34.

- The ART has international significance, including its use for payments and remittances;
- It is interconnected with the financial system; and/or
- The ART issuer also issues at least one ART or e-money token and provides at least one crypto-asset service.

Competent authorities of EU the member states should provide the EBA with information relevant to the above-mentioned criteria. After analyzing the information, the EBA should decide whether a given ART qualifies as significant. If it decides that the ART is significant, the supervisory responsibilities shall be transferred from the competent authority to the EBA. Significant ART issuers have to comply with relatively stricter rules. In particular, the capital requirement percentage mentioned above is increased to 3% of the average amount of reserves. Moreover, the percentage of reserves in the currency the ART is referencing should not be less than 60%.

## Requirements for Electronic Money or E-money Token Issuers

MiCA does not offer a separate registration regime for e-money token issuers as it does for ARTs.[40] Instead, the legislation limits the issuance of e-money tokens to credit institutions and electronic money institutions that publish a whitepaper. 'Electronic money institutions' are defined in Directive 2009/110/EC of the European Parliament.[41] Thus, entities that are not commercial banks or other credit institutions and are willing to issue e-money tokens must register as electronic money institutions with the competent authorities of relevant member states and comply with the rules of the Directive.

It means that the issuers must have at least EUR 350 000 of initial capital at the time of registration. The Directive also states that *"the own funds of an electronic money institution for the activity of issuing electronic money shall amount to at least 2% of the average outstanding electronic money."* In addition, MiCA requires the outstanding tokens to be issued *"at par value and on the receipt of funds."* Thus, e-money token issuers, like ART issuers, must hold 2% of reserve assets in their capital. In addition, MiCA, through Directive 2009/110/EC, requires e-money token issuers to always hold funds in secure, liquid, and low-risk assets. These assets include *"debt securities issued or guaranteed by central governments, issued by central banks, international organisations, multilateral development banks or Member States' regional government."*[42]

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40 See Title IV.

41 See https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:267:0007:0017:EN:PDF

42 See Annex I of Directive 2006/49/EC of the European Parliament: https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:177:0201:0255:EN:PDF

The reserve assets must always be used in the interest of token holders and not the creditors of issuers. In addition, e-money token issuers cannot grant holders interest.

MiCA also introduces a subcategory of 'significant e-money token issuers.' The EBA should assess the significance of an issuer based on the same criteria defined for ART issuers.

The chart presented below compares the main parameters that differentiate the two categories of stablecoin as defined in MiCA.

**Table N2**

| Parameters | Electronic money (e-money) tokens | Asset-referenced tokens (ARTs) |
|---|---|---|
| *Referenced value* | One official currency (e.g. EUR or USD) | One or more official currency, commodity, or other value (e.g., EUR, USD, Gold, or BTC) |
| *Allowed reserves* | Official currency an e-money token is referencing | Currencies, commodity, or other value (e.g., EUR, Gold, or BTC) |
| *Allowed issuers* | Credit institution and electronic money institutions | Credit institutions and entities authorized under MiCA rules |

## LUMMIS-GILLIBRAND RESPONSIBLE FINANCIAL INNOVATION ACT

In June 2022, U.S. Senators Cynthia Lummis (R-WY) and Kirsten Gillibrand (D-NY) introduced the "Lummis-Gillibrand Responsible Financial Innovation Act" to Congress.[43] The Act is the first major digital assets legislation proposed at a federal level in the United States. Importantly for the purposes of this paper, the bill addresses stablecoins.[44]

The bill defines a 'payment stablecoin' as a digital asset that is redeemable on demand on a one-to-one basis for either USD or a foreign country's legal tender, issued by a business entity, backed by one or more financial assets (excluding other digital assets), and intended to be used as a medium of exchange.[45] The exclusion of digital assets from reserve assets means that the definition does not include crypto-backed or algorithmic stablecoins and is limited to fiat-backed stablecoins. Moreover, the bill seems to regard stablecoins primarily as payment tools.

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43 See full text: https://www.congress.gov/117/bills/s4356/BILLS-117s4356is.pdf

44 See "Title VI – Responsible Payments Innovation."

45 This is the author's summary of the definition. See Section 101 of the bill for the full definition.

First, the bill grants depository institutions the right to issue payment stablecoins. The term 'depository institution' includes banks, savings banks, credit unions, and savings associations insured under the Federal Deposit Insurance Act.[46] According to the bill, depository institutions must maintain 100% of the value of outstanding tokens in their reserves. The reserves must consist of high-quality and liquid assets, including the United States coins and currency, demand deposits at a depository institution, balances held at a Federal Reserve bank, and the United States Treasury bills. In addition, each month, a depository institution must publicly disclose the description of reserve assets, their value, and the number of tokens in circulation. Depository institutions willing to issue stablecoins must apply at least six months before the intended issuance to an appropriate banking agency. The application must explain the safety practices of the institution that will guarantee the redemption of all outstanding stablecoins. In the event of an institution's insolvency, token holders have priority over all other creditors. The bill also requires appropriate banking agencies to devise capital requirements tailored for depository institutions issuing payment stablecoins. In addition, it provides a path for institutions willing to solely engage in stablecoin activities to obtain a bank charter from the Office of the Comptroller of the Currency (OCC).[47]

The Lummis-Gillibrand Responsible Financial Innovation Act also allows non-depository institutions to issue stablecoins. These entities must comply with the same reserve and disclosure requirements as depository institutions. However, the bill does not provide any further guidelines for non-depository issuers.

## STABLECOIN TRUST ACT OF 2022

In December 2022, Senator Pat Toomey (R-PA) introduced the first federal legislation tailored for stablecoins.[48] The "Stablecoin Transparency of Reserves and Uniform Safe Transactions Act of 2022" or the "Stablecoin Trust Act of 2022," like the Lummis-Gillibrand Act, uses the term 'payment stablecoin.' A 'payment stablecoin' is a digital asset designed to maintain a stable value relative to a fiat currency or currencies, is convertible to a fiat currency by the issuer, is designed to be used as a medium of exchange, is issued by a centralized entity, does not pay interest to token holders, and is recorded on a public distributed ledger (i.e. blockchain).[49] The fact that a payment stablecoin must be issued and redeemed by a centralized entity excludes crypto-backed and algorithmic stablecoins.

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46 See for the full definition of a 'depository institution': https://www.law.cornell.edu/definitions/uscode.php?width=840&height=800&iframe=true&def_id=12-USC-331634992-1187737481&term_occur=999&term_src=

47 The OCC is a government agency that oversees and regulates national banks in the United States.

48 See full text: https://www.banking.senate.gov/imo/media/doc/stablecoin_trust_act.pdf

49 This is the author's summary of the definition. See Section 2(9) of the bill for the full definition.

Section 3 of the bill allows money-transmitting businesses, non-depository trust companies, depository institutions, and national trust banks to issue payment stablecoins. More importantly, it establishes a new federally-licensed entity called a 'national limited payment stablecoin issuer.'[50] An entity seeking to obtain a 'national limited payment stablecoin issuer' license should apply to the OCC. The license grants the right to perform activities related to stablecoin issuance but does not allow other activities like issuing loans. The OCC is designated as the supervisor of the licensed entities and can impose additional regulations covering issues like capital (i.e. not exceeding six months of operating expenses) and liquidity requirements.

Section 4 requires all payment stablecoin issuers to maintain at all times at least 100% of the value of outstanding tokens in reserve assets. The permissible reserve assets are the United States coins and currency, any deposit within an insured depository institution, and level 1 high-quality liquid assets.[51] Issuers must disclose the assets backing outstanding tokens on a monthly basis. Moreover, they are obliged to go through quarterly attestations by accounting firms to show that their assets do not diverge from those disclosed, and must publish the results. The payment stablecoin issuers should also adopt policies for redeeming the tokens and specify whether they will meet redemption requests on demand or with a time lag. Lastly, in the event of insolvency, claims of token holders must be prioritized over claims of other creditors.

[50] See Section 6.

[51] See for what is included in level 1 high-quality liquid assets: https://www.law.cornell.edu/cfr/text/12/249.20

# POLICY RECOMMENDATIONS

## CRAFT A CLEAR DEFINITION OF A STABLECOIN

The 2022 amendments in the legislation marked a positive step forward for the Georgian cryptocurrency industry. For instance, major players in the cryptocurrency market, such as Binance, have previously avoided involvement in the Georgian market due to the absence of a regulatory framework (Tolordava, 2022). However, the new legislation lacks any guidance for potential stablecoin issuers.

As noted earlier, it remains unclear whether stablecoins are defined by the law at all, and it is crucial that lawmakers address this problem. While it has been confirmed in the interviews with NBG representatives that stablecoins are included under virtual assets, the language of the definition says the opposite. Therefore, to eliminate the ambiguity surrounding the definition, lawmakers must either modify it or introduce an additional definition tailored for stablecoins. On the other hand, it must be noted that the legal definition of 'electronic money' in the Law of Georgia on Payment Systems and Payment Services is very close to the essence of fiat-backed stablecoins.

In addition, it is the recommendation of this paper that the lawmakers follow the path chosen by United States senators and not address crypto-backed and algorithmic stablecoins, for the reasons outlined below:

- As discussed above, their stabilization mechanisms are significantly different from those of fiat-backed tokens, and they cannot be subject to the same rules as centralized entities. For example, while MiCA's ARTs include crypto-backed stablecoins, the reserve requirements of the regulation are clearly superfluous. Crypto-backed and decentralized stablecoins, like DAI, automatically comply with rules of full and liquid reserve assets and regular attestations.
- Moreover, the non-existence of a central issuer makes registration and authorization requirements extremely complicated. Therefore, based on the idiosyncrasies of the underlying technology, it is advised that the crypto-backed and algorithmic stablecoins are excluded from the Georgian legislation until further assessment.

Lawmakers have the option of either not defining these stablecoins or defining them and clarifying that they are exempt from the regulations.

## ALLOW PAYMENTS IN STABLECOINS

The European and American bills discussed above designate fiat-backed stablecoins as the legal means of payment. It is recommended that the NBG should take into account the European and American practices, and allow payments in GEL stablecoins that are sufficiently backed (100% in the case of European and American laws)

by GEL reserves. This requirement eliminates the money-multiplier effect stablecoins could have otherwise.[52] Therefore, the NBG does not have to worry about the potential negative influence a sufficiently-backed GEL stablecoin might have on monetary sovereignty and financial stability. Indeed, the NBG can recognize stablecoins as a means of payment by adopting either European or American practices.

As mentioned in MiCA's text, "the function of such crypto-assets [e-money tokens] is very similar to the function of electronic money… and [they] are likely to be used for making payments." In fact, treating GEL-backed stablecoins as 'electronic money' under the Law of Georgia on Payment Systems and Payment Services would be one way of allowing payments in stablecoins. As illustrated above, stablecoins meet the legislation's requirements to be classified as electronic money. In addition, one can easily observe that the requirements for electronic money providers are close to those outlined in Directive 2009/110/EC of the European Parliament for 'electronic money institutions.' Therefore, stablecoin issuers registered as 'electronic money providers' would be subject to similar regulations as 'e-money token issuers' under MiCA.

Another option to allow the use of stablecoins in payments would be to follow the path set out by American lawmakers and create a new entity like the 'national limited payment stablecoin issuer' of the "Stablecoin Trust Act of 2022." This would require crafting a new regulatory framework for these entities. While devising the framework, the NBG should take into account the recommendations delineated below.

## RESERVE, DISCLOSURE, AND CUSTODY REQUIREMENTS

The new legislation should mandate that authorized stablecoin issuers always hold sufficient reserve assets in relation to the value of outstanding tokens. Crucially, the reserve requirement eliminates all potential vulnerabilities of a fiat-backed stablecoin system. There is no risk of issuers not meeting their redemption obligations and damaging token holders. In addition, as noted above, forbidding fractional reserves eradicates any potential money-multiplier effects that might arise from the widespread usage of stablecoins. The issuers must also be required to publicly disclose the composition and value of reserve assets. Moreover, to enhance transparency and build trust in the issuer, the NBG should establish a timeframe for regular reserve audits conducted by an accounting firm. Importantly, because of the transparent nature of blockchain technology, it is possible to monitor stablecoin reserves in real time.

To avoid significant delays in the redemption process, the reserves must predominantly consist of safe and highly liquid assets. The NBG defines 'liquid assets' as funds

[52] Without the 100% reserve requirement, stablecoin issuers could issue more stablecoins than they have underlying reserves to back, which would increase the money supply and lead to a money-multiplier effect.

(cash and cash equivalents) and assets that can be promptly converted into funds.[53] However, it should devise a more specific list of assets that can be considered safe and liquid.

It is recommended that new legislation, like the Law on Payment Systems and Payment Services, mandate the segregation of reserve assets from issuers' funds. The funds should be taken into custody by legal entities other than the issuer (e.g. commercial banks). Furthermore, the issuers must be prohibited from using the assets for their liabilities except for redemptions. Lastly, the token holders must always be prioritized over other creditors of issuers in the event of insolvency. These rules will guarantee that the holders are always made whole.

## OTHER REQUIREMENTS

MiCA, the Lummis-Gillibrand Responsible Financial Innovation Act, and the Stablecoin Trust Act of 2022 include many relatively minor provisions that should also be addressed in the new Georgian stablecoin legislation. First, the NBG should compile a list of required documentation for entities seeking to obtain an issuing license. It should also decide whether the issuing entities should maintain own funds and establish specific capital requirements.

Moreover, the three bills allow other financial institutions like commercial banks to issue stablecoins. According to Article 48 of the Law on the National Bank of Georgia, the NBG is designated as the supervisor of numerous types of entity within the financial sector, including commercial banks, banking groups, non-depository institutions, and micro-finance organizations. It is advised that the NBG should assess and decide whether it will allow some of these entities to issue stablecoins without applying for a separate stablecoin issuer license.

Finally, the NBG should evaluate whether creating a subgroup of significant stablecoin issuers is necessary. For instance, Article 17 of the Law on Payment Systems and Payment Services defines the term 'significant payment service provider.' A payment service provider is considered significant if the electronic money issued by the provider surpasses the limits set by the NBG. Meanwhile, the NBG is allowed to impose additional requirements on significant payment service providers. Similar rules could be included in the new stablecoin legislation. However, the NBG would have to establish clear criteria for designating a stablecoin issuer as 'significant.'

[53] See: https://matsne.gov.ge/ka/document/view/1332907?publication=0

## ESTABLISH A PUBLIC-PRIVATE STAKEHOLDER FORMAT

The last recommendation of this paper for the NBG is to create a stakeholder format to discuss and analyze the potential stablecoin legislation in Georgia. The stakeholders should include representatives of the cryptocurrency and FinTech industry, legal and IT professionals, government officials, and academics. The primary goal of this format would be to ensure that all stakeholders are consulted and involved in the process of developing a regulatory framework for stablecoins.

Stablecoins have the potential to transform the payment system in Georgia. Instead of discouraging innovation through unclear rulemaking, the NBG could initiate pilot projects or sandbox environments in which stablecoin payment services can be tested in a safe and controlled environment. Importantly, the insights gained from the stakeholder format can be applied to create an effective framework for Digital Lari that the NBG is currently developing.[54]

## CONCLUSION

Stablecoins have become increasingly important in the cryptocurrency market, offering potential benefits to the broader financial sector. Despite a tumultuous year in the cryptocurrency industry in 2022, the total stablecoin market is still valued above US$100 billion in early 2023.[55] However, the existing Georgian digital assets legislation is limited, and it is unclear whether it defines stablecoins.

Therefore, the first recommendation of this paper is for the NBG to provide a clear definition of a stablecoin. It has been suggested that the new legislation only regulates fiat-backed stablecoins and does not address crypto-backed and algorithmic stablecoins. In addition, it is advised that Georgian lawmakers establish stablecoins as legal means of payment. This could be achieved by considering them as 'electronic money' under the Law on Payment Systems and Payment Services or crafting a new regulatory framework that creates a license for stablecoin issuers.

To guarantee that the new legislation does not introduce vulnerabilities to the financial system, the NBG should establish a set of reserve, custody, and disclosure requirements similar to those outlined in the EU's MiCA regulation, and the Lummis-Gillibrand Responsible Financial Innovation Act and the Stablecoin TRUST Act of 2022 in the United States. These requirements would help to ensure that stablecoin issuers hold sufficient reserves, secure customer assets, and provide transparent information to the public, helping to protect consumers and promote financial stability.

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[54] See: https://nbg.gov.ge/en/media/news/the-national-bank-of-georgia-advances-digital-lari-project-and- finalizes-expression-of-int

[55] See: https://coinmarketcap.com/view/stablecoin/

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