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PayPal's High Stakes Stablecoin Bet

What's Happening: PayPal's (PYPL) announcement in August that it was introducing a multi-use stablecoin, PayPal USD (PYUSD), has set off a wave of questions among lawmakers, regulators, payment system competitors, and crypto advocates, all of whom have been struggling to find consensus on governmental oversight of digital assets broadly, but especially for this particular class of tokens.

Why It Matters: PayPal is looking to return to its core business as a payments company but is also making a bet on how it believes the payment system is going to evolve while trying to ensure that it has a significant role in that new infrastructure. In the current payment system, PayPal is only a middleman, albeit a successful one, between merchants, consumers, and banks, but it does not own the so-called "rails" infrastructure upon which payments are transferred and relies on banks as well as card networks, such as **Visa (V)** and **MasterCard (MA)**. **With PYUSD, PayPal is looking to provide its customers with a product that it believes will be faster, safer, and more seamless in a Web3 universe and will give it larger ownership of the payment system itself, with its token being the only stablecoin supported within PayPal's network.** PayPal is carefully toeing the line on the (limited) existing regulatory framework and is looking to use this emphasis on best practices to make its token a bridge to consumers with little to no prior crypto experience.

What's Next: Any widespread adoption of PYUSD will likely take time and will primarily rely on the development of the greater Web3 universe where consumers would need such a product compared to continuing to use fiat currency via PayPal's traditional product offerings. In the meantime, **the current battle over the regulation of stablecoins is likely to remain at an impasse at least until after the November 2024 elections**, with advocates of a federalist regulatory regime closer to the current limited state-based system digging in their heels against proponents of the Federal Reserve Board having jurisdiction over stablecoin-issuing entities. Interestingly, if PayPal's move into stablecoins pays off and there is widespread user adoption and/or increased competition from other payment system operators, this could spur Congress to act. **Any expansion of federal regulation, while likely costly to PayPal in terms of necessitating changes to how it may operate PYUSD, could be beneficial for the company in the longer term, as it will receive a head start over its competitors as well as further validate**

stablecoins as a financial product that is perceived as both safe and useful for consumers.

PayPal's Stablecoin: PYUSD

In the depths of August, **PayPal (PYPL)** announced that it was going to offer a US dollar-backed stablecoin, called PayPal USD (PYUSD), for broad use by its US customers. Consumers with a PayPal account (and eventually a Venmo account) would be able to: transfer PYUSD between PayPal and certain external wallets; send payments to other PayPal customers; fund purchases at checkout; and convert any of the other cryptocurrencies PayPal supports to and from PYUSD.

PYUSD is issued in a partnership with Paxos Trust Company. In terms of regulation, PayPal is a state-licensed money transmitting company – it does not have a bank charter or Federal Deposit Insurance Corporation insurance, although it partners with traditional banks for some of its financial products. Paxos Trust is a New York State-regulated crypto trust company overseen by the New York State Department of Financial Services (NYDFS). PayPal also has a BitLicense from the NYDFS, allowing it to conduct crypto business activities in New York State.

PayPal's reserves to backup PYUSD consist of US dollar deposits, US Treasurys, and similar cash equivalents. **Currently, with interest rates at a relatively high level, PayPal is able to earn returns on this collateral, essentially risk-free, by selling PYUSD to consumers and then pocketing the interest from the reserves backing the consumer's stablecoin purchase.** This financial benefit will decrease as rates eventually go down in the future, but it is helpful in generating revenue in the early days of this product's offering. Additionally, by encouraging customers to hold their money with PayPal via PYUSD, the company is able to make an argument that it is responding to regulatory critiques that it puts customer funds at risk because PayPal and Venmo do not have deposit insurance. **By backing up a customer's tokens dollar for dollar with cash equivalents, PayPal has found a way to give greater safety to customer funds while also increasing its own revenue stream.**

Starting in September, Paxos will publish monthly public reserve reports for PYUSD that detail the various financial instruments backing the token. There will also be regular independent third-party attestations from an accounting firm, following internationally recognized standards.

During the announcement in August, PayPal President and CEO Dan Schulman emphasized the ease of use of PYUSD as well as his firm's emphasis on "responsible innovation and compliance." He said, "The shift toward digital currencies requires a stable instrument that is both digitally native and easily connected to fiat currency like the U.S. dollar. Our commitment to responsible innovation and compliance, and our track record delivering new experiences to our customers, provides the foundation necessary to contribute to the growth of digital payments through PayPal USD."

In its press release, PayPal also emphasized that it was building a “bridge” between fiat money and Web3 for consumers, merchants, and crypto developers. The company also stated that the token was “designed to reduce friction for in-experience payments in virtual environments, facilitate fast transfers of value to support friends and family, send remittances or conduct international payments, enable direct flows to developers and creators, and foster the continued expansion into digital assets by the largest brands in the world.”

While merchants and consumers may decide that a trusted payment company like PayPal is the easiest and safest way to enter into the world of crypto, developers and many others in the DeFi ecosystem were harsher in their views of PayPal’s announcement. CoinDesk featured an op-ed from a crypto industry exec, Guy Vider, who was critical of several of the aspects of PYUSD, most notably how the token clashes with the concept of crypto as a decentralized framework.

Vider starts his criticism with the token’s purpose in his mind – that it is purchased only from PayPal and sold back only to PayPal – which creates a “walled garden or a closed loop of financial activity.” Due to what Vider calls PayPal’s “history of censorship, unilateral account closures, asset seizures and general lack of transparency,” this is a considerable concern for DeFi advocates.

Other, more technical problems with PYUSD from the perspective of crypto advocates are actually elements that will likely make the token more appealing to government regulators. These include several functions, including “wipeFrozenAddress,” “pause,” and “assetProtection.” These functions are meant to allow PayPal to control certain aspects of the use of their tokens by creating a lockable blacklist, destroying tokens, and stopping transfers or trades at any time.

While many DeFi advocates may scoff at using a token that retains these types of controls, the fact that they are less attractive to those concerned about parent-company intervention could make it more appealing for the vast majority of consumers who do not want to worry about using a financial product that is attractive to criminals, political activists, or government skeptics. **As Vider says, these functions “serve to position PYUSD more as a digital version of traditional fiat currency rather than the intended decentralized stablecoin it wants to be.” We believe a digital version of traditional fiat currency is precisely what PayPal intends.**

We would liken the adoption of PYUSD to consumers purchasing Toyota Prius hybrid automobiles a decade ago. Such a purchase was a first step in moving towards electric vehicles or, in PayPal’s case, digital assets. With the Prius, consumers wanted the benefits of a hybrid but demanded the certainty of owning a trusted brand like Toyota. Consumers may want the benefits of digital assets, but most have no desire or need to utilize DeFi products absent the level of trust that PayPal commands.

Death Knell of Super Apps and Owning the “Rails”

For years now, several varieties of tech companies have had a goal of creating a “super app” modeled on the two Chinese firms **WeChat (TCEHY)** and **Alipay (BABA)**. Among the companies that at one time or another contemplated this move are **Block (SQ), X (formerly Twitter), Meta (META), Snap (SNAP), TikTok,** and **Apple (AAPL)**, to name a few. Federal regulators, particularly the Consumer Financial Protection Bureau (CFPB), have been hugely concerned with these initiatives and, in reaction, have begun multiple inquiries and have produced several reports outlining their findings. While Elon Musk and his social media company X remain the most high-profile firm pushing forward with the super app goal, other firms like PayPal appear to have decided to change tack due to the inherent challenges in creating such a product and gaining market share, as well as the inevitable regulatory blowback that will result.

This new focus by PayPal on stablecoins is likely an admission that its attempt to create a super app is over, at least for now. Instead, PayPal is looking to return to its core business as a payments company while also trying to increase its share of ownership of the next-generation payment system.

PayPal does not “own” the infrastructure that transmits payments and is dependent on banks and card networks to service its customers. **By making PYUSD the only token supported within PayPal’s vast network of customers and merchants, the company hopes to create a rival infrastructure that can be used when Web3 becomes more prominent. While critics from the DeFi community may take issue with the closed nature of this stablecoin, it is exactly this closed loop that will give PayPal more control and a greater share of the revenue from its customer base.**

While likely not central to its business decision, the regulatory scrutiny relating to super apps and the fact that X and the ever-controversial Elon Musk are so vocally pushing forward with this concept make it less appealing to a company like PayPal, which has carefully cultivated its image with its customers as well as politicians and the regulatory community in Washington, DC over many years. **While PayPal has had its share of controversies and has been subject to some of the same inquiries as other large tech firms, it does not share the reputational baggage of many of its peer firms.**

Why PayPal’s PYUSD is Not Meta’s Libra

In terms of regulatory and political reactions to PayPal’s announcement, the reviews were decidedly mixed, which is the best the company could hope for in the current climate and far better than Meta’s treatment when it announced its since failed crypto project, Libra, in 2019. **The critical difference between the reaction to Meta and PayPal is that Meta had already courted significant controversy with its role in the 2016 elections, its data privacy practices, and its voracious acquisitions of potential competitors, including Instagram and WhatsApp.** PayPal’s public controversies, by contrast, have been more limited in scope and have had far less staying power.

While Mark Zuckerberg is a household name and he has had numerous high-profile negative interactions testifying before multiple committees in Congress, hardly anyone outside the company or its investor base knows about any of the current executives from PayPal – which is generally preferable when developing and maintaining a reputation in Washington, DC. Instead, the company is well known in Washington for its diverse product offerings, the ability for its products to be used in political campaign infrastructure, and how PayPal works with certain favored segments of the voting public, such as small businesses.

Congressional Response

Compared to how Meta's Libra project was immediately attacked by members of Congress from both political parties (a rare showing of bipartisanship during the Trump era), there was substantial praise for PayPal's announcement amongst crypto-friendly Republicans, including senior House Financial Services Committee members. Committee Chair Patrick McHenry (R-NC) cheered PayPal's announcement saying, "This announcement is a clear signal that stablecoins – if issued under a clear regulatory framework – hold, promise as a pillar of our 21st-century payments system… Clear regulations and robust consumer protections are essential to enabling stablecoins to achieve their full potential. Congress is making significant, bipartisan progress on legislation to ensure the U.S. leads the financial system of the future. We must finish the job." The manner in which PayPal has adopted existing regulations and best practices was also noticeable, in contrast to Meta's approach with Libra. It also does not hurt that the state-based regulatory structure that PayPal is using is promoted by McHenry and is currently the basis for his stablecoin legislation.

At the end of July, before Congress recessed for its August break, McHenry was able to push through committee his stablecoin bill, entitled "Clarity for Payment Stablecoins Act." This markup saw Democrats walk out of the vote as part of the procedural hurdles that they attempted to put up to stop Republicans from moving forward with the legislation. McHenry expressed disappointment that a genuine bipartisan deal was not able to be struck and placed blame on "the White House's unwillingness to compromise," leading to negotiations falling apart. The stablecoin measure ultimately cleared the committee 34-16, with some rank-and-file Democrats crossing the aisle, but the committee's Democratic leadership remained opposed.

House Financial Services Committee Ranking Member Maxine Waters (D-CA) vociferously opposed McHenry's stablecoin bill in large part because it did not have a sufficiently robust role for the Federal Reserve Board to regulate stablecoin issuers, as well as their conduct. **While Waters did not have anything negative to say about PayPal as a company when its announcement was made, she remains adamant that the regulatory structure they are utilizing needs reform.**

Waters issued a statement saying, "Given PayPal's size and reach, Federal oversight and enforcement of its stablecoin operations is essential in order to guarantee consumer protections and alleviate financial stability concerns. Without legislation on the books that establish clear and strong consumer protections at the Federal level, consumers are at greater risk of harm at the hands of bad actors…Stablecoins represent the issuance of a new form of money, making it integral that there are Federal guardrails. As our central bank, the Federal Reserve handles monetary policy and our money supply, and they must be able to do their job. Additionally, when the President's Working Group on Financial Markets called on Congress to pass legislation to improve the oversight and regulation of stablecoins, they emphasized the need for Federal, not state, prudential authority over stablecoins to address risks like stablecoin runs, systemic risk, and concentration of economic power…**Specifically, the Republican bill gives stablecoins like PayPal USD that are issued under state regimes a seal of approval, but blocks the Federal Reserve from overseeing or enforcing any Federal standards**. Moreover, the Republican bill undermines the Fed's role as our central bank, making it harder to protect the economy against inflation or support maximum employment if stablecoins are broadly adopted."

Regulatory Response

More recently, Federal Reserve Board Vice Chair for Supervision Michael Barr gave a blistering speech attacking the lack of Fed oversight over stablecoins and insisting that there be a federal regulatory component in any legislation passed by Congress.

In his speech, Barr said, "When an asset is pegged to a government-issued currency, it is a form of private money. When that asset is also used as a means of payment and a store of value, it borrows the trust of the central bank. So, the Federal Reserve has a strong interest in ensuring that any stablecoin offerings operate within an appropriate federal prudential oversight framework, so they do not threaten financial stability or payments system integrity." Barr went on to discuss the guidance that the Fed has issued for Fed-supervised banks that require them to obtain a supervisory non-objection before "issuing, holding, or transacting in dollar tokens." Since PayPal does not have a bank charter, it does not fall under the Fed's supervisory authority.

Barr went on to discuss the Fed's fears over this lack of authority to regulate non-bank stablecoin issuers. He said, "But there are big risks when the Federal Reserve does not have direct supervisory and regulatory authority. I remain deeply concerned about stablecoin issuance without strong federal oversight. As I mentioned earlier, stablecoins are a form of money, and the ultimate source of credibility in money is the central bank. If non-federally regulated stablecoins were to become a widespread means of payment and store of value, they could pose significant risks to financial stability, monetary policy, and the U.S. payments system."

Barr then touched upon McHenry's legislation, which is why Waters has resolutely opposed McHenry's federalist framework. Barr said, "It is important to get the legislative and regulatory framework right before significant risks emerge. We appreciate the work Congress has been doing on this important issue and look forward to further engagement to ensure that there is a robust federal framework for all stablecoins."

This opposition from the Fed to the current structure of stablecoin regulation used by PayPal and McHenry's legislation means there will almost certainly be an impasse in passing any bill to update the regulatory architecture for stablecoins for at least the next year, if not longer.

The most likely scenario for stablecoin legislation becoming law will depend on who wins the 2024 elections for the White House and control of Congress. Should Republicans take over the White House, House of Representatives, and Senate, there is a chance that legislation similar to McHenry's gathers more momentum. Despite greater odds of success, however, any bill will still need 60 votes in the Senate, which will almost certainly need to include Democrats, who are likely to still be concerned with a lack of federal supervision. If Democrats retain control of the White House and take the House, but Republicans control the Senate, then there is a better chance for some type of compromise in this area, although crypto supporters would fight hard to maintain regulation closer to McHenry's legislation and they may prefer a stalemate as it would effectively maintain a state-based system.

In the meantime, as both legislative and regulatory impasses continue on stablecoin oversight in Washington, PayPal's bet on stablecoins will continue to play out, including whether the company is joined by copycats also looking to expand their potential ownership of the payment system in a world in which mass adoption of Web3 becomes a reality.

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