Regulators Focus on Terra and Its UST Stablecoin

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In its just-released Financial Stability Report, the Board of Governors of the Federal Reserve System reveals that it has its eye on stablecoins, which now amount to more than $180 billion in the cryptocurrency market. The Fed has identified stablecoins as potentially backed by volatile assets that can make them a challenge to remain pegged to the U.S. dollar.

To illustrate what the Fed highlighted in its Report, and even specifically discussed by Janet Yellen during a Senate Banking Committee meeting, the third-largest stablecoin, terraUSD (UST) recently lost its U.S. dollar peg in spectacular fashion. UST is backed by Bitcoin (precisely the type of volatile asset that the Fed highlights in its Report), and minted and burned by its sister token LUNA. Because UST is backed by Bitcoin, the only way for LUNA to reestablish the 1:1 U.S. dollar peg is to sell Bitcoin. Given the current macroeconomic conditions in which Bitcoin has lost a
significant percentage of its value since LUNA initially purchased it to back its UST stablecoin, LUNA was forced to sell a substantial portion of its Bitcoin holdings at a hefty loss to save a plummeting UST, which fell from $0.995 to $0.60 in a matter of hours, and has continued to decline in value. Consequently, LUNA itself fell more than 50% on the day as it was forced to sell hundreds of millions of dollars in Bitcoin in a failed effort to reestablish the 1:1 USD to UST peg. Over the next several days, LUNA declined in value to $0.00001 (from a high of over $115).

Given the sharpening regulatory focus on stablecoins, we will continue to monitor developments in this area.

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