

Terra's stablecoin flop raises questions about regulatory role

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The spectacular plunge and trading halts of the algorithmic stablecoin TerraUSD are touching off a debate among lawmakers over whether, and how much, the government should get involved.

As Terra crashed last week, prominent Republicans said the asset class shouldn't be regulated at all because of its limited reach into traditional financial markets and uncertain impact. Democrats are calling for regulatory rules that would protect investors, an acknowledgment that any legislation is likely to stall in the current Congress.

Terra had been the largest "algorithmic" stablecoin, a digital asset designed to always maintain a value of \$1 through market incentives rather than backing by cash or securities. Typical stablecoins, such as dollar-pegged Tether and USD Coin, hold liquid assets in reserve.

Terra's organizers were forced to halt the blockchain, the digital ledger on which transactions are recorded, after the [coin](#) fell to about 10 cents late Thursday. The plunge was fast, even in the cryptocurrency world, with billions of dollars in value wiped out within a few days. Some cryptocurrency trading platforms similarly discontinued trading of Terra and its "pair," Luna, citing the need to protect their customers.

Terraform Labs, the company behind the coin, said on Twitter it is developing a recovery plan. TerraUSD was trading at about 11 cents on Monday.

The Senate Banking ranking Republican, Patrick J. Toomey of Pennsylvania, said the events did little to justify regulating Terra or other algorithmic stablecoins because they don't pose risk to the financial system.

"If there's no [systemic risk](#), then it really should be up to consumers," Toomey said. "What we want is for consumers to know what they're doing, what risks they're taking, and then markets can figure out what are good investments and what are bad investments. Honestly, it will probably take some failures in this space in order for the market to discover what works."

But the coin's freefall caught the attention of Treasury Secretary Janet L. Yellen, who said at a Senate Banking Committee hearing on May 10 that the situation underscores the need for legislation to govern stablecoins.

"I think that simply illustrates that this is a rapidly growing product and there are risks to [financial stability](#). We need a framework that's appropriate," she said, urging Democrats and Republicans to work together on a solution.

Sen. Cynthia Lummis, R-Wyo., who's been dubbed Congress' "Crypto Queen," said last month that a better understanding of the impact algorithmic stablecoins have on the financial system is needed before rules are set.

"They are fundamentally different than other stablecoins, mainly because they do not have as strong of a connection to the traditional financial industry," Lummis said. "There may come a time where that need for regulation changes, but we shouldn't start with a heavy hand."

On the other side is Senate Banking Chairman Sherrod Brown, D-Ohio, who cast doubt on whether Democrats and Republicans could find common ground on the issue.

"Their whole caucus are believers in cryptocurrency," Brown said. "I know that because of the cryptocurrency ... lobby here, we can't pass any legislation that would protect the public, but we can work with the SEC, the Fed and FDIC."

Brown said TerraUSD's price decline "underscores the seriousness of its threat to the [financial system](#), because it's unregulated. I mean, there's just too many examples in the cryptocurrency world of that potential."

Ashley Ebersole, a partner at law firm Bryan Cave Leighton Paisner

LLP and a former Securities and Exchange Commission attorney, said TerraUSD's instability illustrates concerns regulators have expressed about stablecoins that are not backed by currency reserves or other collateral.

Observers like Ryan Clements, assistant law professor at the University of Calgary, said the situation shows the flaws in the system.

"Algorithmic stablecoins are inherently fragile," he said in an email. "I had previously warned in months leading up to the failure that there were many vulnerabilities in this ecosystem."

How it works

TerraUSD and a sister coin with free-floating value, Luna, are locked in a relationship meant to keep the stablecoin's dollar value. If the price of Terra rises above \$1 because of investor demand, a Luna holder can swap \$1 worth of Luna for that coin, making a profit from the higher price, which pushes the value back to \$1. Conversely, when the coin drops, traders can make a profit by swapping it for \$1 worth of Luna. This reduces the supply, raising the price.

But this system relies on the ability to mint ever increasing supplies of Luna to make the transaction worthwhile. Last week, Luna lost 99 percent of its value, forcing the system to create trillions of Luna coins to keep up.

"Once trust and investor demand evaporate, they quickly fail in a death spiral—and we saw that with UST / Luna," Clements wrote. "Going forward I hope that there are thoughtful regulatory discussions and policy formation in this space, as I'm sure there have been some tragic losses by unsuspecting retail investors in both coins that didn't understand how fragile their so called 'stablecoin' was to begin with."

A [computer algorithm](#) that relies on arbitrage between two tokens doesn't magically provide stability, because both tokens still depend on liquidity, Vivian Fang, professor of accounting at the University of Minnesota's Carlson School of Management, said in an email.

"This model is intrinsically flawed, and stability should be a necessary condition for a stablecoin," Fang said. She warned that claims of high returns for investing in or lending cryptocurrency should raise red flags.

Still, others expect the coin to recover.

Ed DeLeon, CEO of decentralized finance ecosystem Anatha, called TerraUSD's price decline a "short term de-peg" caused by a coordinated effort to profit off the decline.

He said in an email the effort involved short sales on a combination of TerraUSD, Luna and Bitcoin, while moving large sums of the digital assets in rapid succession. Short sales aim to profit from an asset's price decline.

"The designs so far are working as intended and we expect to see UST recapture dollar parity in the near term," such as one or two weeks if the coordinated effort stops, DeLeon said.

In the meantime, lawmakers can't agree on regulation for even the more stable version of these coins—the ones backed by real assets.

Toomey differentiated between the two varieties.

"It's important to distinguish between algorithmic stablecoins or some other kind of mechanism versus the stablecoins that are backed by cash and cash equivalents," he said, arguing that Congress should focus its efforts on the ones backed by reserve assets because they are more likely

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