UST's rise and fall... and why we need regulation in the crypto space

By Lucinde Rhoodie and Kara Meiring 3 Jun 2022

What are stablecoins, what happened to UST, what does this say about regulation in the cryptc market, and why should we care?

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It has become clear that blockchain technology and the cryptocurrencies it supports are here to stay. It is time to seriously start considering if and how these crypto markets should be regulated. Although the nove and legal uncertainty surrounding the crypto markets can seem daunting, it is also an extremely exciting fie to get involved in and allows for interesting debates around what our executive and legislative branches ought to do. This is especially so in light of the recent crash of the once promising UST stable coin, which had serious and devastating effects on a large number of investors and companies in the crypto space.

What are stablecoins?

For once, the name says it all – stablecoins are a type of cryptocurrency that are more stable than other cryptocurrencies, which are notorious for their volatility. In the same way that fiat currencies like the dollar used to be backed by gold, the idea behind stablecoins is that they are pegged to types of assets, such a other currencies or valuable metals. At the moment, most stablecoins are pegged to a fiat currency, most commonly the US dollar, which means that they are not subject to the steep rising and falling of other cryptocurrencies such as Bitcoin. In a nutshell, it is the type of cryptocurrency you could tell your parents tc invest in, without fear that they would wake up to a 30% decrease (or increase) in the value of their investment overnight.

Stablecoins are particularly useful in instances where it is difficult and expensive to transact in standard fia currencies, potentially as a result of exchange rates or high fees related to transferring money abroad.

Additionally, where there are certain fees attached to purchasing cryptocurrencies (mainly as a result of th price fluctuations), these fees are a lot smaller, or in some cases non-existent, when purchasing stablecoi The stablecoin market has been extremely fast growing over the past year, as many view stablecoins as a safer, more reliable entry into the crypto market.

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Before the events of May this year, UST was the largest decentralised stablecoin, with a market capitalisation of almost $200m in 2021. However, unlike other stablecoins which were directly pegged to t dollar (ie. there were actual dollar reserves in place backing the price of the coin), UST was linked to a tok called Luna, through an innovative algorithm that used the relationship between UST and Luna to keep US pegged to the US dollar (ie. UST was supposed to retain a value of $1 for every 1 UST).

What happened to UST?

On 8 May 2022, this carefully curated system came crashing down, when UST lost its peg to the dollar an people started panicking. By 13 May, the price of Luna had gone done by 99.9%. Where it had once exchanged hands at a value of $199, it is now trading at around $0.000112. This in turn had dire consequences for the price of UST, which dropped to lows of $0.023485 – disastrous for a coin that was supposed to never drop below $1.

At the date of writing, there is still no official explanation for why this happened, but many suspect that it resulted from a coordinated attack by so called "whales" (people or entities owning a disproportionally larg amount of a specific cryptocurrency). Essentially, a massive amount of UST (approximately $2bn worth) w pulled out of the market at once and large amounts were sold off, causing a huge dip in the price. This resulted in something akin to a "run on the banks", with people rushing to exchange their UST for increasin amounts of Luna, causing hyperinflation in the process.

This crash has reportedly wiped out over $15bn in crypto assets and many individual investors and crypto based companies have been severely affected. This means real life consequences, with many people losing their jobs, large portions of their investments and potentially their life savings.

The question is then, could this have been prevented if there had been more regulation and legal oversigh in the market?

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The case for regulation

Calls for more regulation in the crypto markets are likely to increase following the UST crash, especially given the sentiment that stablecoins in particular should be the first candidate for regulation. This is particularly so because the types of people and companies who look to invest in and build on stablecoin markets are specifically looking for the type of stability that regulation could bring, unlike with other cryptocurrencies where investors might prefer to speculate and play the market for short-term gains. Apart from the potential support for regulation from stablecoin investors, another important aspect that makes it a good candidate for regulation is the fact that it is supposed to be backed by reserves, to prevent the types of price fluctuations other cryptocurrencies experience. This provides a more tangible point of departure f regulation, that is, creating a regulatory framework around these reserves.

One form of regulation could thus be for the legislature to require that the issuers of stablecoins have a certain amount of cash reserves to prevent against potential “stablecoin runs”. Additionally, certain regulations should be in place to require stablecoin issues to have a publicly available risk mitigation strate in place that meets certain predetermined criteria. This could assist investors in assessing the level of risk they are taking on when purchasing the stablecoins, but would also protect investors with only a low-level understanding of the mitigation strategy from investing.

A further, and perhaps more unpopular regulatory requirement, would be to have a type of stop mechanisr in place to prevent investors from withdrawing large amounts of their assets all at once and thereby causin large price fluctuations and panic selling. This could potentially involve setting up a regulatory body similar the South African Takeover Regulation Panel, which would then regulate trades involving more than a certa percentage of the market capital of a specific coin. A more regulated market invariably means a more stab market, which benefits long-term investors and tech companies looking to build their products around som type of stablecoin.

The US could potentially lead the way in setting regulatory guidelines for the crypto markets, with US President Joe Biden signing an executive order in March this year directing government agencies to cooperate on a regulatory framework. The order specifically seeks to “support technological advances an ensure responsible development and use of digital assets” and to “explore a US central bank digital currency”. While it would be interesting to see how the US goes about developing and implementing regulatory measures, South Africa should also be taking steps to develop its own regulatory framework. According to data published by Luno in September 2019, around 15% of South Africans own some form cryptocurrency, and this number is likely to rise.

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