Overview of stablecoins

Cryptocurrencies present lucrative opportunities to investors, but are subject to volatility. On the other hand, stablecoins, as the name suggests, provide a degree of measurable stability in uncertain economic times and highly volatile markets. In this piece, we'll explore the different ways in which stablecoins seek to achieve a fixed price and look at the potential that they offer to the savvy trader.

Defining stablecoins

Anyone with a basic working knowledge of cryptocurrency will be familiar with the market fluctuations and instability associated with the asset class. However, what sets stablecoins apart from other digital currencies is that they are designed to be used as a store of value with minimum price fluctuation. This serves a practical purpose in turbulent times or bear markets when traders want to avoid losing money on their investments. To maintain these functions, digital tokens are pegged to the value of another stable asset, most commonly a major fiat currency, like the US dollar.

Stablecoins: A blueprint for the future?

To fully understand the potential of this digital currency, we first have to understand the capabilities of blockchain technology and the promise that it holds.

Many of the financial services we rely upon for investment or daily transactions are controlled by institutions that also yield a great deal of control over the economy. Blockchain is a distributed technology and it provides a truly secure, transparent and stable platform. Cryptocurrencies are the digital tokens that are based upon the digital ledger that is the blockchain, but they themselves are far from stable, and have been subject to frequent spikes, crashes and coin splits.

This could potentially hinder the widespread adoption of cryptocurrency, both as an investment class and as a form of money in the future. If businesses are unable to use coins and tokens for everyday transactions or capitalise on market trends because the underlying cryptocurrency deviates significantly in a short period of time, then crypto will forwever be viewed by the mainstream as a speculative investment and a novel medium of exchange with questionable reliability for real world applications. For example, few people would buy their groceries with a Bitcoin if they believed the Bitcoin would drastically increase in value in just a few months. (And, alternatively, few merchants would accept the coin as payment if there was a concern that the value of the coins would plummet over the weekend). Furthermore, the inherent risks in these crypto assets - above and beyond simple volatility - would continue to dissuade institutional investors because the fundamentals in the market would be too weak to warrant significant capital allocation.

For some, stablecoins represent a new hope in a world where many believe that there is no such thing as stable money.

These global tokens have low volatility against the world's most important national currencies and are therefore are an attractive tool for a variety of use cases; from offering

opportunity to mitigate risk in a portfolio to offering a stable store of value to facilitate low-risk exchange on the blockchain, there's a lot of reasons to be excited about stablecoins.

However, not all stablecoins are created equal, and there are several different types of stablecoins that beg to be understood. We explore these in more detail below.

<u>Non-Collateralized</u>

Non-collateralized stablecoins as the name suggests, are stablecoins that are not backed by any fiat currencies or commodities. Instead they are sustained by the expectation they will maintain a certain value and one of a variety of protocols to maintain a peg. A typical method of achieving price stability relies upon sophisticated (though often unproven) algorithms. The seigniorage shares method is one of the most common types of stablecoin that falls under this category. It is algorithmically governed by smart contracts that expand and contract the supply of the non-collateralized stablecoin in very much the same way that central banks do, though mostly in a decentralized manner.

Here are some of the stablecoins that fall under this category:

<u>Basis</u>

Basis is a stablecoin with an algorithmic central bank. It works by adjusting supply depending on market demands. When the demand rises, more Basis is created to meet the supply, thereby decreasing the price. On the other hand, a complementary protocol buys back more Basis when demand falls. As such, Basis controls the supply of the tokens in the economy to meet the demand and maintain a consistent price for the token.

Technology enthusiasts have touted Basis as a promising decentralised token, and the project has accordingly attracted significant attention (and investment). However, this decentralization is, in another sense, its weakness. The lack of collateralization puts necessary pressure on the token's algorithm, and if there were to be an issue with the stability of the token, token holders would have no collateral to pursue to recoup their investment.

<u>Fragments</u>

Fragments is an algorithmic reserve and monetary supply policy for creating low volatility Ethereum standard tokens. It stabilizes its purchasing power by increasing and decreasing the supply of its USD Fragments token in response to demand. When demand increases, it capitalizes a reserve and then splits and distributes those tokens into wallets. When demand falls, the reserve automatically purchases tokens and removes them from the supply in exchange for bonds.

The stability of this token is managed autonomously and this provides the advantage of quick adaptability. However, it also faces the same challenges of other non-collateralized tokens, in which faith must be placed in the mechanism of maintaining price stability. This

means that if things were to go sideways, token holders would have no centralized entity to pursue to recover value loss.

Crypto-collateralized

Crypto-collateralized stablecoins are backed by cryptocurrency reserves. Instead of backing units of a stablecoin 1:1 with fiat or another store of value, crypto-collateralized stablecoins hold a ratio greater than 1:1 of a cryptocurrency (or a basket of cryptocurrencies). These types of stablecoins issue units of a stablecoin supported by the cryptocurrency held.

MakerDAO

Dai is the decentralized token that MakerDAO uses and it is backed by Ethereum's Ether. It uses a system of smart contracts and price oracles built on the Ethereum platform to regulate the price of Dai creation and therefore the value of Dai. When the price of Dai is too low, the base price increases. It decreases when the price of Dai is too high. The system regulates the cost of creating more Dai relative to demand in an attempt to balance its price.

When the price of Ethereum decreases, MakerDAO liquidates ETH collateral in anticipation so the value of Ether backing Dai doesn't drop below 1:1.

It was one of the first stablecoins in the blockchain space, which means it is well-established and this gives it an early mover advantage. However, the risk here is that the value of the collateral backing the Dai is highly volatile itself, and in the event of wild market fluctuation (as is not uncommon in cryptomarkets), there is a risk that the collateral will not be sufficient to maintain the peg.

Collateralized by fiat

Fiat stablecoins are backed by a conventional currency such as the US dollar or Euro. Reserves are held by a central entity and deposits are taken in US dollars or another viable currency by that third party (or its fiduciary agents). In the case of a 1:1 pegged token that is fully backed, a stablecoin is issued for every unit of currency deposited. Others maintain a fractional reserve and therefore operate somewhere between a collateralized coin and an algorithmic coin. Some of the best known fiat-backed stablecoins include Tether and TrueUSD.

Tether

Tether is one of the 10 largest cryptocurrencies by market cap, and has the most significant trading volume of any cryptocurrency. This token pegs to the value of the US dollar and it was designed to be used in the same way as US dollars. It effectively converts dollars into digital currency, to anchor or "tether" the value of the coin to the price of the national currency. Its token is known as USDT and it claims that for every USDT there is one US dollar stored as a reserve in Tether's bank account.

As a well integrated and established stablecoin, traders can benefit from the stability of investing in a cryptocurrency that comes close to a 1:1 exchange from fiat to crypto. It is not trustless and has in the past refused audits, which has created a fair bit of controversy.

TrueUSD

TrustToken is a platform that tokenizes real-world assets, and the first application of their platform was TrueUSD - effectively tokenized US dollars - which launched as an ERC20 token in March 2018. US dollars are held in the bank accounts of the company's fiduciary agents, and it was one of the first tokens to allow for redeemability of the token for the underlying fiat currency, as well. Other competitors have since followed suit.

This token is also audited on a regular basis, which helps to provide a degree of security for users in demonstrating the full existence of the collateral.

Although this model is well-regarded and has mainstream appeal, there are risks associated with having centralized and large stores of fiat currency within the traditional banking system, particularly in an uncertain legal and regulatory environment. Availability and access may become a problem in the future because banks are not generally equipped to hold hundreds of millions of dollars in liquid accounts and time will tell if they (and associated institutions) continue to support such a structure.

Tokenized Commodities / Precious Metals

These types of tokens are often lumped into the same category as stablecoins because they maintain 'stability' relative to the price of a precious metal or physical commodity. Some are simply pegged to the price of the asset (i.e. a gram of gold or a fraction of a diamond) while others are actually tokenized versions of the asset itself, and represent a legal claim to the asset. They make it possible to purchase these commodities by providing a digitized version of those assets so that the investor does not have to physically own or store it.

DigixDAO

An example of a commodity-collateralized stablecoin is DigixDAO. It has two cryptocurrencies, Digix Gold (DGX) and DigixDAO (DGD). The stablecoins are backed by bars of gold. Although DGX can be redeemed for gold, this is not the case with DGD.

One of the main advantages of DGX is that its backed by gold, which has outperformed any other store of value throughout history in terms of maintaining purchasing power over the long run.

However, these 'tokenized gold' coins are gold-price stable, and in dollar terms expose investors to the volatility in the price of gold. Price stability relative to the price of gold is not that valuable, because no investor measures their portfolio in terms of grams of gold. Instead, it is the price stability relative to a unit of account that matters - and that is almost without exception a major fiat currency.

Dollar Pegged, Collateralized by Gold

USDVault Stablecoin

This is a unique model of stablecoin, designed by the team at Vault. Under this model, USDVault tokens are fully backed by the world's most trusted store of value throughout history - LBMA grade gold bullion, stored in Swiss Vaults - plus a gold hedge. This ensures that tokens are stable to the price of the US dollar. Furthermore, tokens are redeemable for gold bullion or US dollars via Vault's fiduciary partners, ensuring that token holders can securely exit cryptomarkets into their chosen non-crypto asset.

One of the major advantages of the USDVault stablecoin is that it allows investors to store funds during periods of instability, and achieve stability to the US dollar. Furthermore, the model is highly scalable and secure by design - the value backing the tokens is securely stored as gold bullion in Swiss vaults. The operations and backing are to be subject to regular audits, and operational partners include industry leaders in fiduciary services, vaulting, and precious metals operations.

The gold bullion represents a centralized store of value backing the tokens. While some may see the centralized aspect of the platform as a drawback, the team at Vault is committed to working transparently with the best-in-class companies to perform all aspects of the company's operations. In this way, the token appeals to institutional capital and serious investors who see legal accountability and recognizable agents as a value add. This ensures that token holders have legal recourse were there to be any question to the value of their tokens, claimed malfeasance, or a counterparty issue.

Conclusion

Stablecoins represent the next evolution of digital currency. Regardless of which category they fall into, it is clear that stablecoins fill a valuable role in cryptoasset markets, offering a haven of safety from the wild fluctuations and volatility that belie most cryptocurrencies.

At this moment, the most promise seems to be in stablecoins that have solid and reliable collateralization with real-world assets. These tokens are great for investors who want legal recourse and security in their investments, not just price stability. This puts a lot of emphasis on the fiduciaries and counterparties in the setup, so regular auditing and reputable partnerships are important.

The team at Vault is optimistic that within the world of collateralized tokens there is room for many models of collateralization. While there is an elegant simplicity to fiat backing of a fiat-pegged token, the team sees a compelling advantage to adding an additional level of security in the model employed by USDVault. By fully collateralizing tokens with gold bullion and securely storing that bullion in vaults in Switzerland, the USDVault model ensures the highest standard of protection possible of the underlying asset backing the tokens. And, in the process, the company is reinventing the gold standard on the blockchain.