INVESTMENT FUNDAMENTALS

Stablecoins.

Stablecoins are a form of cryptocurrency (crypto) designed to hold a fixed value relative to traditional currencies (e.g., U.S. dollars) or commodities (e.g., gold). These coins serve a similar function to that of money market funds in traditional finance, providing crypto investors with a stable vehicle in which to park their proceeds between trades. Despite their claims of stability, these coins, like other cryptocurrencies, still carry substantial risks.

Stablecoins are cryptocurrencies, issued by governments or private companies, whose underlying value is tied (or "pegged") to a reference asset such as a currency or commodity. While there are several approaches to stablecoins (off-chain collateralized stablecoins, on-chain collateralized stablecoins, and algorithmic stablecoins), this piece will focus on off-chain collateralized stablecoins. As the name suggests, these are crypto tokens backed by assets that are not on a blockchain (or "off-chain"), such as U.S. dollars or gold bars.

Off-chain currency-backed stablecoins seek to maintain their value by holding assets in reserve that match the value of the given stablecoins in circulation. Ideally, this would be the reference asset itself, as the tokens are designed to be redeemable on demand in exchange for a pre-established quantity of the currency[i]. In the case of dollar-backed coins, this is typically a 1:1 ratio, or $1 per coin. The same applies to commodity-backed stablecoins, but with reference commodities in place of currencies (e.g., one troy ounce of gold per coin).

In other words, if a stablecoin is pegged to the U.S. dollar, the coin's issuer should be holding a dollar (or something of equal value) for every one of their coins in the marketplace. If a given stablecoin is pegged to an ounce of gold, the coin's creator should be holding an ounce of gold for every coin in existence. The theory is that if these stablecoins are fully collateralized—that is, backed by assets that match 100% of their value—they should be much less risky than other cryptocurrencies. That is the idea anyway.

In some cases, stablecoin skeptics have raised concerns over whether these cryptocurrencies' issuers actually hold the assets to back their claims. In one notable example, Tether, the world's largest stablecoin by volume, has struggled to provide audits to verify their reserves. The company was also fined by both the Commodity Futures Trading Commission[ii] and the New York State Attorney General[iii] over false statements about their coins' backing. If this is the case, and the coins don't actually hold the underlying collateral in their reserves, the coins' value risks falling below that of their reference asset or "breaking their peg."

While stablecoins are marketed as a safer alternative to more traditional cryptocurrencies, there is still the potential for investors to lose their principal if a stablecoin breaks its peg—after all, this has happened before. Despite their outward claims of stability, risks still abound in this corner of the crypto space. While the coins' issuers may claim to hold collateral commensurate with the value of their outstanding tokens, in some cases they have been hard-pressed to prove this through an audit. Despite any promises of safety, investors should still exhibit extreme caution when investing in these so-called stable vehicles.

Glossary

Algorithmic stablecoins are not backed by collateral, relying instead on complex computer coding (algorithms) and market forces to arrive at a stable value by adjusting the available supply of tokens.

Off-chain collateralized stablecoins are crypto tokens backed by assets that are not on a blockchain (or "off-chain"), such as U.S. dollars or gold bars.

On-chain collateralized stablecoins are crypto tokens backed by assets on the blockchain (or "on-chain"), such as cryptocurrencies (e.g., bitcoin).

Important information

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[i] Depending on the issuer, restrictions may apply.

[ii] https://www.cftc.gov/PressRoom/PressReleases/8450-21

[iii] https://ag.ny.gov/press-release/2021/attorney-general-james-ends-virtual-currency-trading-platform-bitfinexs-illegal