STABLECOINS

Our definitive guide to stablecoins

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WHAT IS A STABLECOIN?

Stablecoin refers to a class of cryptocurrencies which offer price stability and/or are backed by reserve asset(s). Stablecoins attempt to offer cryptocurrency users and enthusiasts the best of both worlds: instant processing and security of cryptocurrency payments and the volatility-free stable valuations of fiat currencies.

Stablecoins were initially created by cryptocurrency exchanges. These coins provide traders with a stable currency as a placeholder to store value in-between trades.

Stablecoins are a much more usable store of value, unit of account, and medium of exchange. Even while the crypto market is falling heavily to the downside, stablecoins are a good store of value during periods of volatility.

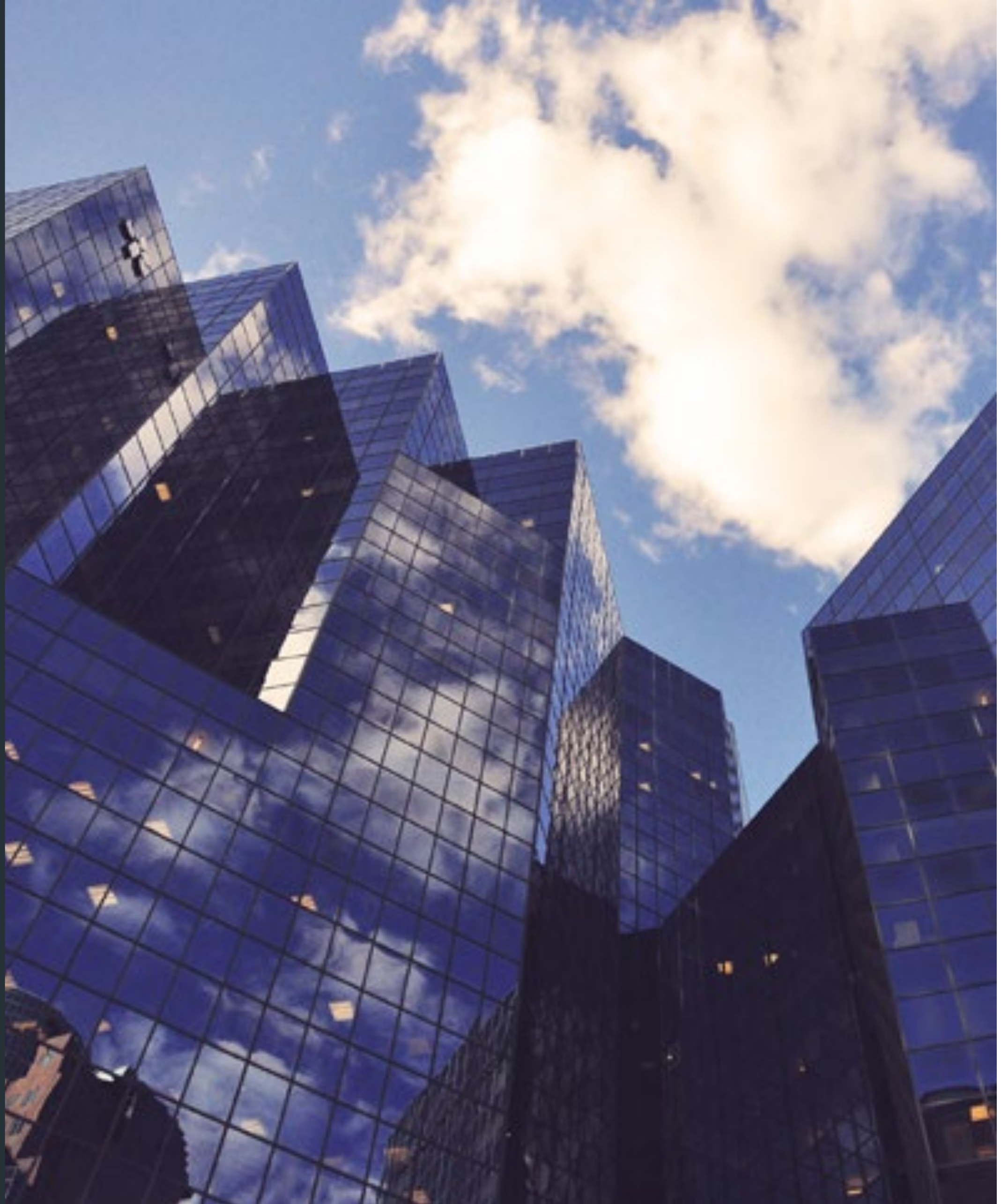
Types of stablecoins

Stablecoins, as any other cryptocurrency, have alternative models for governance. There are two major stablecoin types:

1. Centralised stablecoins where the supply is controlled by a company or small group of people
2. Decentralised stablecoins where the supply is controlled by the market (users) and transactions

Both types of stablecoins have the same purposes. Firstly, they allow users to quickly change from one cryptocurrency to another without losing too much value due to volatility. They also allow users to store cryptocurrency linked to a fiat-backed asset like the U.S. Dollar (USD).

However, both types of coins use different mechanisms. The first usually implies users must trust a central party to restrict and allow the flow of money going into the market. The second implies decentralised trust and governance, meaning there are smart contracts operating in the background making sure the supply is always bound to a certain price.



What are stablecoins backed by?

There are alternative models that support stablecoins. They are usually backed by:

1. **Fiat-currencies such as the USD or Euro.** Many cryptocurrency users rely on mechanisms to store some of their value in a non-volatile cryptocurrency form while they perform trades.

2. **Assets** such as gold, oil, bonds or any other commodities deemed valuable, which can endow stablecoins with a certain degree of stability. Holders of commodity-backed stablecoins can redeem their stablecoins at the conversion rate to take possession of real assets.

The cost of maintaining the stability of the stablecoin is equivalent to the cost of maintaining the backing reserve of the exchange-traded commodity. The cost of legal compliance, maintaining licenses, auditors and the business infrastructure required by the regulator.

3. **Cryptocurrencies, such as BTC and/or ETH.** This is usually in bulk since the reserve **cryptocurrency may be prone to high volatility.**

4. **Seniorage or algorithms** representing a programmable solution to the supply, price and volatility metrics. These stablecoins are fully digitalised and non-reliant on any types of collateral as their supply and target price are controlled only by the program code. These algorithms usually include a Distributed Autonomous Organisation (DAO) as a way to allow token holders to vote on governance decisions.

Stablecoins are becoming a popular choice for investors as they offer the best of both worlds. They minimise the volatility that often sees other currencies plunge into bear markets, resulting in huge losses for investors. It's yet to be seen whether stablecoins will take more market share than Bitcoin.

WHAT ARE THE RISKS AND BENEFITS OF STABLECOINS?

While stablecoins are becoming more popular through the benefits they offer, there is still a number of risks to be aware of. Below, we take a look at both sides of the coin.

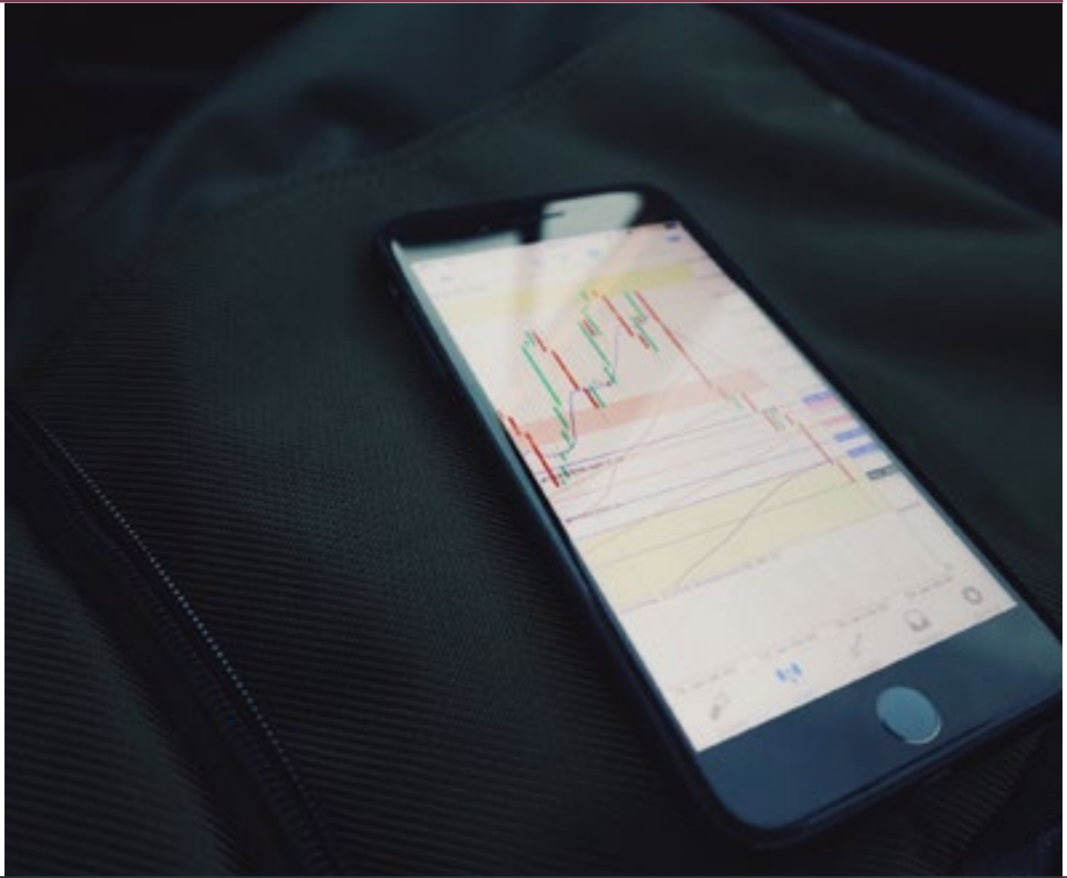
Benefits of stablecoins

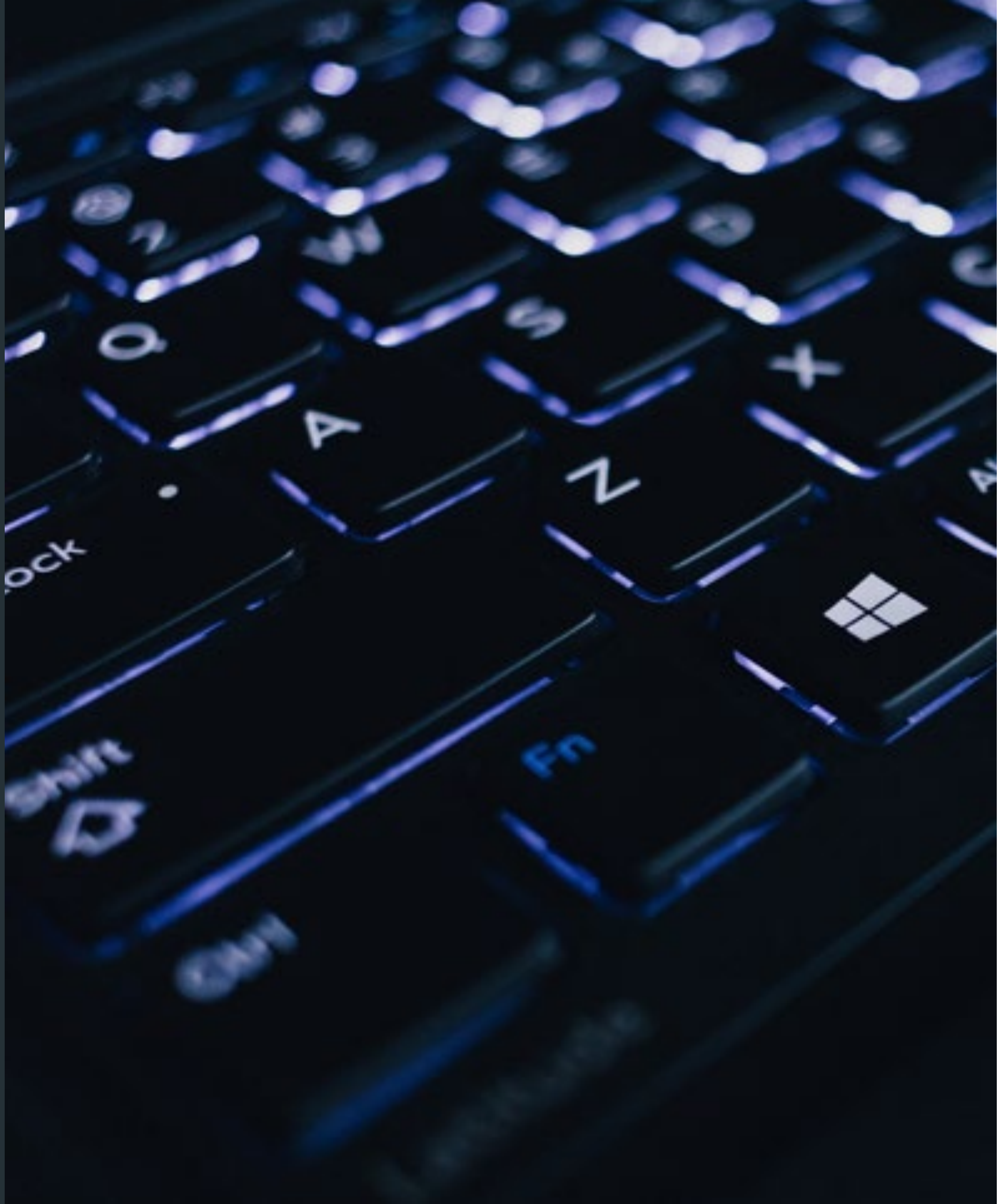
There are many benefits to using stablecoins, with some of the most important ones listed below.

1. **Global commerce opportunity**
   This feature will be especially important for people living in countries with unstable monetary systems, such as Argentina, where residents are often exposed to rampant inflation and uncertainty. Even when these citizens seek to move their capital to more stable stores of value, restrictive capital control laws often prevent them from using non-native currencies in transactions outside the country.

2. **Decentralised financial services**
   The adoption of stablecoins will support capital market formation and usher in new applications for decentralised finance on the blockchain. These include lending and derivatives markets because without borders and volatility, it becomes easier to lend money.

3. **Great tool for traders**
   Traders and investors can change between cryptocurrencies, without being exposed to asset volatility. Stablecoins enable traders to keep value stable against a fiat currency, usually the dollar, while they're in-between trades.





Risks of stablecoins

Although there are many benefits to stablecoins, there are a number of risks to be aware of. We explore each of them below.

1. **Counter-party risk**
   By trusting a third-party to print money and keep a cryptocurrency stable, the dollars could be fractionally reserved instead of fully backed. In this case, a bank run could cause the price of the coin to drop dramatically.

2. **Centralisation risk**
   Accounts can be embezzled, blocked, or accessed by unauthorised third parties. Centralisation risks mean the same monetary issues fiat-currencies face when a central authority has the power to print money without oversight. This can potentially lead to hyperinflation.

3. **Algorithm manipulations**
   As most decentralised stablecoins live within smart contracts in protocols like Ethereum or Stellar, there's a risk the algorithm which keeps the currency stable fails. Algorithms could even be manipulated by a third-party. Because "code is law", updates to the network can have an impact on previous smart contracts – a huge hassle for decentralised projects.

As the Bitcoin Maximalist developer Jimmy Song explains, stablecoins suffer from a trinity problem. They need to lose their sovereignty in order to keep the price stable. However, by relinquishing control to a certain entity or single contract, there are increased risks.

ARE STABLECOINS THE SAFE FUTURE OF CRYPTOCURRENCY?

Volatile activity across the markets often leaves many investors looking away from crypto staples like Bitcoin and Ethereum. The search for a secure alternative is driving many towards stablecoins.

UK author and crypto expert Thomas Power says the shift towards pegging cryptocurrencies to something tangible **provides an attractive proposition.**

Freedom of choice

According to Thomas Powers:

"Stablecoins are certainly a future, but I wouldn't say they were the future, because I think freedom of choice has a huge role to play in how we treat our financial assets in the years to come. You want to see an environment where people have got a choice to use either or, rather than being dependent on one. We've seen Bitcoin fall dramatically from a high of nearly $20,000 this time last year to something currently around $3,400. Naturally, that sort of unpredictability makes it absolutely understandable that many users of cryptocurrency would want to look for something with more stability."

Stablecoins come with a warning

Dr Powers added:

"As a solution to short-term volatility, stablecoins are a very attractive option, as long as they are backed by something which will maintain a stable value such as gold, the US dollar, or even the British pound in the future. What it won't do, though, is fix confidence losses, particularly if the value of the reserve asset backing what is essentially a promissory note is questioned.
The price of that stablecoin is likely to fall if the ability to redeem the currency is at risk, which is why the whole premise of acceptance relies largely on one thing – trust."

THE TOP FIVE STABLECOINS

Although Bitcoin still holds the majority of the marketcap, different stablecoins are gaining popularity. Below, we take a look at each of the top five stablecoins.

1. Tether USDT

Tether USDT is a controversial cryptocurrency with tokens issued by Tether Limited, a company under the umbrella of Bitfinex. Each token issued is claimed to be backed by one United States dollar (USD).

Tether operates on the Omni protocol as a token issued on the blockchain. Every Omni transaction (Tether inclusive) is recorded in a Bitcoin transaction sharing the same transaction hash, boosting Tether's network security.

Tether is the world's most popular stablecoin. It even acts as a dollar replacement on popular exchanges such as Bitfinex and Binance.

Being backed by the USD means for every Tether issued **there is an equivalent amount of dollars kept in reserve.**

Why Tether

Tether brings a comparative advantage which its predecessors have failed to bring to the table – value for value conversion of fiat currencies into cryptocoins. This facilitates the ability to trade stablecoins.

There are some clear benefits for adopting Tether over other cryptocurrencies, some of which are:

1. **Secure transit cryptocurrency:** Tether facilitates the transfer of real cash into digital cash, considering the secured payments offered through the use of Bitcoin's blockchain.

2. **Cheaper and faster than USD:** it's also faster and more reliable to convert in-between cryptocurrencies than from regular fiat to crypto. Traders can keep digital fiat ready to purchase crypto when the right time comes.

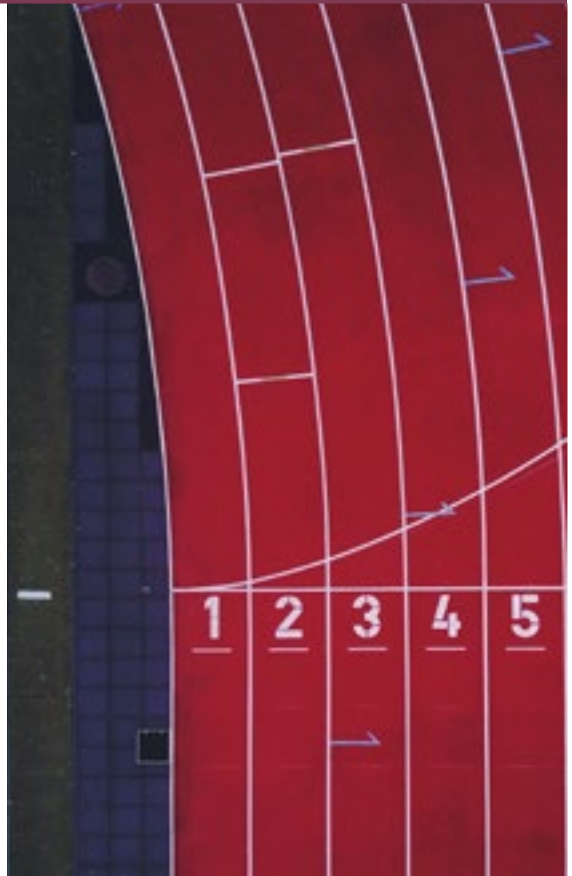
3. **Worldwide acceptance:** a good number of platforms working with cryptocurrencies enhanced their offerings after they adopted Tether. Platforms that initially lacked a withdrawal option to USD can now use Tether instead, allowing them to open up to new markets and possibilities.

Are there any issues with Tether?

Some problems with Tether are due to the centralised governance model used. Issues include:

1. **Lack of transparency:** the organisation responsible for USDT has yet to come forward explaining the connection between Bitfinex and Tether Limited founders.

2. **No audit trails:** because Tether Limited is a privately held company, it's under no obligation to provide bank audit trails.



3. **Reserve-banking is a possibility:** as there are no audit trails a serious possibility is one of reserve-banking behaviour. There is a chance Tether Limited does not hold a true 1:1 ratio, between USD and USDT, meaning a bank run would mean a significant price drop.

4. **Price-manipulation:** Tether has come under investigation for creating fake volumes, due to correlations found between Bitcoin's exponential price-raise in late 2017.

2. USD Coin

The USD Coin, launched in collaboration between Circle and Coinbase, allows crypto users to move their dollars across the globe. This can be done in a matter of minutes, rather than days.

The USD Coin is particularly attractive to users as it is part of the CENTRE stablecoin framework. Before the stablecoin can be used, USD has to be deposited with one of Circle's accredited bank partners. This adds an extra layer of security to using the coin, as users will need to be verified. This protects everyone making transactions from illicit activities.

The intention of the USD coin is not to act as an alternative to the dollar, but to make the fiat currency compatible with the world of cryptocurrency. Not only will this encourage greater levels of adoption, but users will benefit from being able to make transactions "globally, securely, and at lower costs".

Why USD Coin?

Coinbase and Circle claim to do much more than bring just another stablecoin to the market. In fact, they claim that they are starting a movement – one that will change the crypto ecosystem. As the underlying technology is open-source, developers from around the world are encouraged to contribute to its improvement.

Its work with reserve banks, service providers, and other organisations also helps the USD coin to stand out from the competition on the market

3. True USD

True USD, also pegged 1:1 with the US Dollar, attempts to resolve issues with low-volatility, dollar-pegged token. This stablecoin is legally protected and transparently verified by third-parties.

True USD looks to reduce counterparty risk and protect holders with protection from misuse. Unlike some of the other stablecoins, True USD is exchange-independent. This gives users extra reassurances that they are completely in control of their funds

Why True USD?

The underlying technology uses smart contracts to ensure the stablecoin is always pegged. Another differentiator for the token is that it USD exchanges can be done directly with an escrow account. An escrow account is where your funds are held in trust while the transaction is being completed. If the transaction fails on behalf of the seller, then the funds are returned to the buyer.

4. Paxos Standard (PAX)

Regulated by the New York State Department of Financial Service, Paxos Standard offers a great alternative – especially for those who are nervous about joining the cryptocurrency community.

It is the first digital asset to be issued by a financial institution and is frequently audited each month to ensure the coin is always pegged. Another attractive feature of this stablecoin is that there are no fees involved with the transactions. It eliminate conversion feeds, PAX transaction fees and redemption fees.

Why PAX?

Built on the Ethereum blockchain, PAX is available outside of traditional banking hours. Digital transactions and customer support is available 24/7. For a payment, PAX even offers a dedicated account manager to help manage your funds.

If you want to make international transactions at your convenience, with limited exposure to volatility, Pax could be the stablecoin for you.

5. Gemini dollar (GUSD)

The gemini dollar is issued by the Gemini Trust Company. Pegged 1:1 with the U.S. Dollar. It is the world's first regulated stablecoin. As a result, US regulators have oversight over GUSD – giving crypto users a more trustworthy option that other stablecoins on the market.

Why GUSD?

The supply is always kept equal to the USD in the Gemini reserves through monthly audits. The balance is examined by BPM, LLP, who make the reports public. This transparency is a huge benefit for the community – whether they are new or already experienced with stablecoins.

Gemini also has its own cryptocurrency exchange that lists U.S dollar trading pairs. U.S. dollars can be used to quickly buy cryptocurrency, making the market far more accessible to its users.

CONCLUSION

With so many alternative options to Bitcoin available on today's market, it's easier than ever to play a part in the cryptocurrency community.

Before investing in a stablecoin, we recommend that you carry out thorough research and due diligence, but don't be afraid to take a step forward.

Stablecoins look to address market volatility so often associated with cryptocurrency and minimise the risks involved. The popularity of stablecoins doesn't look like it will be slowing down any time soon, with some seeing stablecoin as the up and coming **blockchain star.**

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