

ARTICLE SERIES

INTRODUCTION TO STABLECOIN – THE STABLE CRYPTOASSET

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INTRODUCTION

Cryptocurrency has been the subject of many discussions and is presently taking the world by storm. It is a digital or virtual currency designed to operate as a medium of exchange. It is secured by cryptography [1], which makes it nearly impossible to counterfeit or double-spend. It is built on the blockchain, a decentralised technology spread across many computers that manages and records transactions.

Peculiar traits about cryptocurrency includes the fact that it is virtual and is not issued by a central authority or central banking system. It is therefore not subjected to government interference as it typical with fiat currency.

The first cryptocurrency, Bitcoin, was designed by the mysterious Satoshi Nakamoto in January 2009. It is built on a cryptography-based blockchain network that supports a peer-to-peer electronic payments system. As with other types of cryptocurrency, it is not under the control of any person, company or government and is run on a decentralised system.


THE RISE OF CRYPTOCURRENCY

Cryptocurrency has been on the rise over the last few months. Bitcoin in particular has seen an astronomical rise in its fortunes. As at March 2021, one Bitcoin was valued at over \$50,000.

The astronomic heights attained by Bitcoin has been attributed to a number of factors, including the cononavirus that ravaged the world in 2020 and still continues to spread in 2021.

Some identifiable factors contributing to the fluctuations seen in the price of Bitcoin and other cryptocurrencies include the following:

[1]a method of protecting information and communications through the use of codes, so that only those for whom the information is intended can read and process it.



1) Bitcoin has a limited number

Programmed into the underlying blockchain network for Bitcoin is a limitation on the number of Bitcoins that can be created.

Thus, unlike typical fiat currencies that are issued by the Central Banks of different countries without limits, only 21 million Bitcoins can ever be created. This means its price would be driven to a large extent by the laws of demand and supply. Since it is a “scarce” commodity, its price would be driven upward by the continuous demand of investors and speculators.

2) Speculation

Another factor that drives up the prices of cryptocurrency is speculation. Because majority of Bitcoin transactions are still investment based, investors transact with Bitcoins like they would any other investment. This buy-sell cycle usually makes the price of Bitcoin volatile.



3) Uncertainty about the technology

Unlike some other technological developments that have been embraced for many decades, cryptocurrency and the underlying blockchain technology only gained mainstream recognition about 12 years ago in Sakamoto’s Bitcoin whitepaper. Thus, a lot of people still do not understand the concepts behind cryptocurrency. As a result of this, there has been some negative publicity about how cryptocurrencies are created with some even describing it as a “ponzi scheme”.

Furthermore, because the workings behind digital currency requires a bit of technical knowledge to grasp, many investors and financiers who own Bitcoin remain unsure of how it gets its intrinsic value. For instance, most users of Bitcoin do not know that the design of its protocol has limited coin production to a fixed number of 21 million or that cryptocurrency mining technically builds a stronger and more trustworthy network.

This lack of understanding around cryptocurrencies and their operation leads to the continued volatility of the assets.




4) Most cryptocurrencies are digital and not backed by any assets or currency

Most cryptocurrencies are purely digital and are not backed by physical assets or any fiat currency and its usage is simply based on trust. This means that as indicated earlier, their prices are set entirely by the laws of supply and demand.

Consequently, if investors believe that the value of cryptocurrency will rise or fall due to factors such as Elon Musk's recent purchase of Bitcoin, they may sell their investment to make a profit. Such actions could affect the price and take it upwards. Conversely, actions can happen that could plunge the price downwards.

5) Government policies and regulations

Governments' acceptance or rejection of cryptocurrency can be a factor in the stability of cryptocurrency. Where governments legitimise and validate cryptocurrency, the prices could stay relatively stable.




It could mean that regulators understand the concepts and are working on policies aimed at gaining the most social benefit from digital money. Conversely, where government policies are unfavourable towards cryptocurrency, it affects its acceptance which could affect its market value.

Stablecoins = stable crypto

With the volatile nature of cryptocurrencies, there has been an increased focus on creating a digital asset that would possess the qualities of cryptocurrency but will have a level of stability that makes it a trustworthy asset.

This has led to the increasing adoption of the crypto assets known as "stablecoins", a range of cryptocurrencies that derive their market value from some external reference. It is pegged in value to fiat currency or other reserve assets.

The stablecoin is designed to avoid the volatility inherent in other cryptocurrencies whose prices are entirely market driven.



Thus, while the price fluctuations of other crypto assets make them more attractive for speculation, the relative stability of stablecoins offer the possibility of cryptocurrencies being adopted for use in everyday transactions and becoming a digital form of cash.

The introduction of stablecoins into the cryptocurrency ecosystem implies that it could receive wider acceptance in the market. Investors may be attracted to it as it would offer a bridge between the traditional financial markets and the emerging opportunities offered by cryptocurrency technology.

Indeed, it is estimated that the total addressable market for stablecoins is \$90 trillion, or essentially “all the money in the world and may mount a challenge for fiat money backed by weak governments around the world [2].

CATEGORISATION OF STABLECOINS

In order to achieve price stability, issuers of stablecoins usually peg the value of their

cryptocurrency using different mechanisms. There are two main classes of stablecoins with their respective categories and subcategories namely: **(1) backed** and **(2) algorithmic**.

Backed stablecoins are divided into fiat collateralised, commodity collateralised, and cryptocurrency collateralised. Algorithmic (non-collateralised) stablecoins do not have similar subdivisions.

We examine these categories below.

1) Fiat collateralised stablecoin

Fiat collateralised stablecoins are wholly or partly backed by a government issued fiat currency such as the Pound or US Dollar, often with a ratio, 1:1. A central entity, acting as an independent custodian, usually manages the process and ensures that the equivalent fiat currency is held in collateral for every token that is issued.

The challenge with fiat collateralised stablecoins is that they are vulnerable to fraud on the part of the centralised entity that serves as the custodian for the stablecoin. The holder of the stablecoin may therefore need to take steps to mitigate its risks.

[2] T. Koffman, (2019) Stablecoins: The Next Generation of Digital Money. Forbes. Available from: <https://www.forbes.com/sites/tatianakoffman/2019/03/08/stablecoins-the-next-generation-of-digital-money/?sh=3b71bac823f3>



2) Commodity collateralised stablecoin


Commodity backed stablecoin operate in a similar to fiat-collateralised coins. However, instead of being backed by fiat currency, this type uses other kinds of interchangeable assets and goods, such as gold, diamonds and valuable commodities, as collateral.

3) Crypto-collateralised

Under this category, the value of crypto-collateralised stablecoins is backed by cryptocurrencies, rather than by fiat or commodities.

The advantage that the crypto backed tokens have over fiat collateralised stablecoins is that there is the benefit of decentralisation, as the collateral is held in a smart contract which does not require trust in a central party/custodian.

However, this stablecoin possesses some risks as since the underlying assets are cryptocurrencies, it would be volatile. Consequently, a larger number of the underlying cryptocurrency assets will have to be held in collateral for every stablecoin.



This leads to what is referred to as “over-collateralisation” as a large amount of reserve cryptocurrencies will have to be issued for a small number of tokens in order to account for the price volatility of the collateral.

4) Non-collateralised (Algorithmic) stablecoins

These stablecoins are not backed by fiat, commodities or cryptocurrencies. Rather, they rely on supply adjustments or/and asset transfers in order to stabilise their prices. Their stability is derived from a working mechanism, such as that of a central bank, or through an algorithm.

They utilise smart contracts in managing the supply and demand scheme and guaranteeing price stability. The algorithmic system will generate new coins if the stablecoin is trading too high.

The operational model is similar to the way central banks maintain the value of fiat currencies, but this process can be done in a decentralised manner.



ADVANTAGES OF STABLECOINS

There are a few advantages that stablecoins have over other forms of cryptocurrencies. They include the following:

1) Price stability

A major advantage that stablecoins have over other forms of cryptocurrency is that they are designed to have a stable value and are not subject to fluctuations like other cryptocurrencies.

Thus, since there is a level of certainty regarding its value, it can be used for daily transactions and can also serve as a safe form of investment for investors with minimal risk of loss of value. Furthermore, in countries like Nigeria where the economy has been subject to monetary instability and hyperinflation, stablecoins can serve as an alternative to cash.

2) Distributed ledger technology

Like other cryptocurrencies, stablecoins operate with the distributed ledger technology

(DLT), the infrastructure that enables the secure functioning of a decentralized digital database. DLT eliminates the need for a central authority to keep a check against manipulation.

Using DLT, there is simultaneous access, validation, and record updating in an immutable manner across a network that could be spread over multiple jurisdictions.

The use of DLT can be a catalyst for speed and convenience in accessing other currencies and settling payments in a global market. Transferring funds using DLT can also provide more liquidity to markets, reduce credit risk and offer greater convenience to users, particularly in relation to cross-border transfers, through lower transaction fees and shorter transfer times [3].

For a jurisdiction like Nigeria, the use of DLT has the potential to increase financial inclusion by providing a universally accessible peer-to-peer payment system.

[3]Allen and Overly – Stablecoins



3. It is programmable with smart contracts

Stablecoins are fundamentally made up of codes built into smart contracts. This makes them programmable, and features can be added to them so they can be adapted to fit the users' needs. A popular way of implementing this is by building branded stablecoins into rewards or loyalty programs. By building loyalty programs on top of a company's "branded" stablecoin, loyalty becomes directly integrated into the user experience. Users could easily check their balances of their stablecoins and their loyalty rewards on a single app, doing away with inconvenient rewards cards.

4. Useful for remittances

There are a few challenges faced with cross-border payments and remittance such as the high fees that accompany such services. With blockchain technology already providing alternatives to remittance and cross-border issues, stablecoins provides a viable option with lower fees than traditional remittance services providers, and their inherent price stability, in comparison to other unstable cryptocurrencies.

CHALLENGES

Most of the challenges that plague cryptocurrencies, such as Bitcoin, which were highlighted earlier equally affect stablecoins. With blockchain technology and DLT yet to be adopted on a global scale, it would be some time before the world fully embraces decentralised cryptocurrency as opposed to fiat currency issued by a central bank.

With the uncertainty surrounding cryptocurrency and the level of distrust by governments and consumers, the widespread usage of stablecoins will be hampered. Additionally, the simplicity and security of traditional banking payment models will always serve as a contrast to the somewhat complex arrangements that surround stablecoins. This could serve as a further barrier to the adoption of stablecoins.





USE CASES FOR STABLECOINS

A number of private companies have issued their own stablecoins, although some are considered superior to others due to the level of acceptance they enjoy in the community.

Some popular stablecoins are listed below.

1. Coinbase - USD Coin (USDC)

Coinbase is the largest exchange holder and the world's biggest bitcoin broker. Its stablecoin is quite popular and is referred to as the "USD Coin".

2. Binance USD (BUSD)

Binance, another large cryptocurrency exchange, also issued its Binance USD stablecoin, which is pegged 1:1 to the U.S. dollar.

3. Tether (USDT)

Arguably the most popular stablecoin, it is renowned for its smooth integration with different platforms and for the security measures it has in place.

Tether is backed by gold, fiat currency, cash equivalents and "tethers" itself to the value of the USD.

4. True USD (TUSD)

True USD is pegged to the U.S. dollar and is one of the most liquid stablecoins. The coin offers lower transaction fees than wire transfers of fiat currency and higher interest rates on stored balances.

CENTRAL BANK DIGITAL CURRENCIES (CBDCS)

Central banks are increasingly investigating the possibility of creating digital versions of national currencies, recognising the potential of combining the opportunities offered by distributed ledger technology with the existing trust inherent in national fiat currencies.

The central bank would initially issue a central bank digital currency (CBDC), which would then circulate between banks, businesses and consumers without further central bank involvement.





CBDCs could be narrowly targeted, for example restricted to wholesale transactions between financial institutions, or opened up more widely to consumers as a general purpose currency. The advantages offered by a stable, digital form of cash are particularly evident in the central bank domain as an alternative to bank deposits. For example, a CBDC offers an alternative to the outdated and costly wholesale payment technology used by many central banks. It also has the potential to be used as a monetary policy tool to improve the transmission of policy rates to the real economy, allowing central banks to react more quickly and efficiently to economic challenges.

However, central banks may be limited in their ability to develop CBDCs due to concerns about the robustness of new payment systems and potential risks created by a CBDC circulating on a distributed ledger technology system; for example, in a crisis, bank depositors could turn to CBDC, if it is perceived as a lower risk form of money, which could in turn drain deposits from commercial banks, threatening commercial banks' lending activity.



REGULATORY CONSIDERATIONS FOR THE USE OF STABLECOINS IN NIGERIA

There are presently no regulations for stablecoins in Nigeria, although there have been some developments regarding the classification and regulation of cryptocurrencies in Nigeria over the last few years.

In 2017, the Securities and Exchange Commission (SEC) as the apex regulatory body for investments and securities in Nigeria, took the position that none of the persons promoting cryptocurrencies had been authorised or recognised by it to provide any investment in Nigeria and it warned the general public of the risk in investing in cryptocurrencies [4]

However, the SEC set up the Fintech Roadmap Committee to analyse the benefits and impacts of fintechs in the Nigerian Capital Market.



[4] Ugo Obi-chukwu, 'SEC Nigeria Issues Press Release Against Bitcoins and Other Cryptocurrencies' (Nairametrics, January 13, 2017). Available on <https://nairametrics.com/2017/01/13/sec-nigeria-issues-press-release-against-bitcoins-and-other-cryptocurrencies/>



The fintech Roadmap Committee of the SEC (“the Committee”) recently issued its report (accessible [here](#)) on ‘the Future of FinTech in Nigeria’ (“the Report”) recommending reforms for the development of the regulatory framework of the Nigerian capital market to better accommodate fintech innovations and solutions.

Part of the Report of the Committee was on the regulation of crypto currencies and virtual financial assets. Subsequently, on 14th September 2020, SEC released a “Statement on Digital Assets and their Classification and Treatment” (“the Statement”). In the Statement, SEC indicated that it was relying on Section 13 of the Investment and Securities Act (ISA) which grants it powers to regulate investments and securities business in Nigeria.

The Statement defines Crypto Asset as a digital representation of value that can be digitally traded and functions as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value but does not have legal tender status in any jurisdiction.



Based on the foregoing, SEC stated that it will regulate crypto-token or crypto-coin investments when the character of the investments qualifies as securities transactions. It also stated that SEC would consider crypto assets as securities, unless proven otherwise.

By laying this foundation, SEC places the burden of proving that the crypto assets proposed to be offered are not securities on the issuer or sponsor of the said assets.

Although the Statement did not serve as a regulation, it seemed to lay the foundation for what would eventually be a comprehensive framework for the regulation of cryptocurrencies that would be classified as securities and commodities, and not necessarily all forms of cryptocurrencies.

However, the Central Bank of Nigeria (CBN) took a different approach from SEC. Although it did not state that cryptocurrencies were illegal, it issued a warning to banks, via a circular dated January 12, 2017, regarding the use of virtual and cryptocurrency in Nigeria. The circular is accessible [here](#). This was later followed up in February 2021 by a letter to banks, financial institutions and





non-financial institutions, directing them to close the accounts of any person or entity transacting in or operating cryptocurrency exchanges.

Thus, while CBN did not ban cryptocurrency, the effect of CBN's directive is that customers will be unable to process any transaction on a crypto exchange using financial or non-financial institutions that are regulated by the CBN. In summary, while virtual currencies remain legal, trading them through an exchange in Nigeria may prove difficult.

There were a lot of reactions following CBN's directives and stakeholders, including the National Assembly and the Presidency, have had to wade into the matter. It is hoped that over the coming weeks, there would be clarity in due course on how crypto assets can be regulated in Nigeria as this could lead to a clearer pathway for stablecoins in the financial ecosystem.



CONCLUSION

It is evident that there are still a number of regulatory hurdles that need to be scaled before stablecoins can achieve its full potentials as a "safe haven" for investors.

However, with the rapid acceptance of cryptocurrency in different jurisdictions, it is projected that stablecoins would provide an alternative for investors who seek to enjoy both the relative stability of controlled currencies and the benefits of virtual currencies.



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