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Stablecoin growth favours TradFi entry

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It would be an understatement to say that crypto has become such a key focus for investors and regulators because of the meteoric rise of stablecoins, on the back of well above average returns being captured on Decentralised Finance (DeFi) protocols.

With a ballooning stablecoin treasury of US Dollar pegged tokens across multiple Layer 1 blockchains, the topic continues to be fairly hot as designs of various coins differ greatly, with pros and cons for each. In this In-Depth, Copper breaks extrapolates potential growth paths across the ecosystem. More likely than not, technical complexities regulators and central banks will face can only lead to the entrance of traditional banks into the now only semi-nascent sector.

An Executive Order out of the White House has opened the urgent need for digital assets to be studied, especially in the case of a US digital dollar, commonly referred to as a Central Bank Digital Currency (CBDC). And during a Morgan Stanley conference earlier this month, the Bank for International Settlements (BIS) broke down their research on the design of a retail CBDC.

Which highlights the key problem: regulators and their counterparts are seriously behind.

The reality is that central banks, regulators and organisations have been discussing the need for a CBDC seriously since 2017. While initially taking a position that such an endeavour would prove little benefit to settlement networks, Meta (formerly Facebook), who rolled out plans for a stablecoin to a now defunct project pushed regulators to take the risk seriously. But things are still slow moving. The BIS still far behind possible execution.

Meanwhile, stablecoins by private issuers exceed $180bn. Across all blockchains, Circle sits on over $52bn in deposits. Under a narrow banking charter, which seems inevitable, Circle would already rank in the Top 50 US Banks by deposits. The ecosystem as a whole would measure up in the Top 20 (see table 1).

Growth has slowed down this year, but with markets back in recovery, traders will continue to opt back into stablecoins as there is value to be captured across DeFi protocols. At current rates, Circle could be well over the $100bn mark by the end of the year, doubling where things stand today. Year-to-date, USDC has grown by 22%, while Tether has seen less than 2% growth.

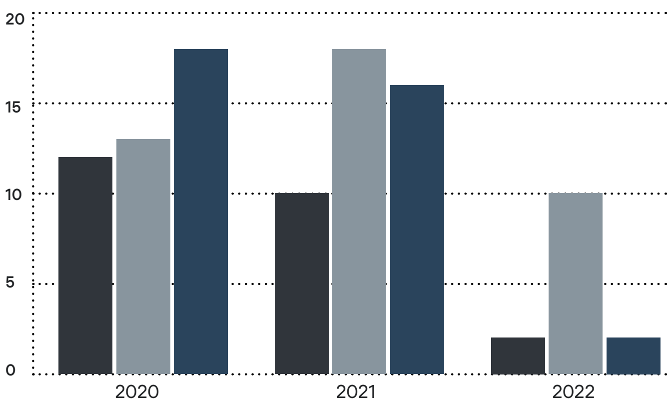
The liabilities on issuers is not small change by any means. But what is it that regulators can do to mitigate systemic risks?

Top 20 - Rankings by bank deposits

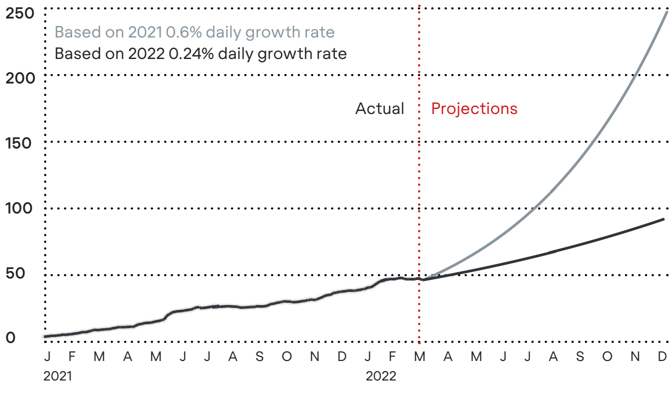
Bank	Deposits ($)
Jpmorgan Chase&Co	2,549,631,000
Bank Of America Corp	2,144,377,000
Wells Fargo&Company	1,524,535,000
Citigroup Inc	1,334,924,000
U S Bcorp	465,258,475
Pnc Finl Services Group Inc	463,881,572
Truist Financial Corp	428,138,000
Charles Schwab Corp The	392,695,000
Toronto-Dominion Bank The	370,804,425
Goldman Sachs Group Inc The	321,869,000
Capital One Financial Corp	316,873,931
Bank Of Ny Mellon Corp The	311,812,000
State Street Corp	260,805,000
Svb Financial Group	191,431,000
Public Blockchain Stablecoins	180,000,000
Fifth Third Bcorp	176,296,883
Morgan Stanley	164,020,000
Northern Trust Corp	161,727,482
Citizens Financial Group Inc	157,071,480

Source: FDIC, The Block *As of 29 March 2022

Average monthly stablecoin growth (%)



USDC: Growth into 2022 ($bn)



Bankers to the rescue?

While the benefits of a CBDC continue to be discussed, it's unlikely that regulators keep the status-quo and sidelining traditional banks from entering a seriously growing marketplace. More likely than not, banks will either issue a stablecoin, or partner with a technology provider to do so.

This measure, a temporary stop-gap, will reverse discussions once again by regulators as to the need for government to have such control in a retail environment. And it's not as if central banks are at the forefront of technology. The risks are simply too large for a major central bank to ramp up a CBDC in the coming years.

By some appearances, Bank of America (BofA) seems quietly eager to enter the market, albeit its potential approach into the ecosystem is not as clear. The major bank has set up its own digital assets arm that has been on point with their research, this team acknowledges.

Since spinning up its digital assets research division, BofA has developed insights into custody, digital asset transaction monitoring, and interestingly, discussions with Customers Bank, who itself has issued a stablecoin for their own B2B patrons to transact with offering real-time settlement round the clock.

BofA's most recent stock buy signal was Silvergate Bank, a well-known crypto-friendly outfit. "Stablecoin offering will likely position Silvergate as a one-stop-shop" the report said.

It's unclear, however, how regulators will treat tokenised liabilities which make for difficult earning projections on the back of a stablecoin offering alone.

Banking on an investment

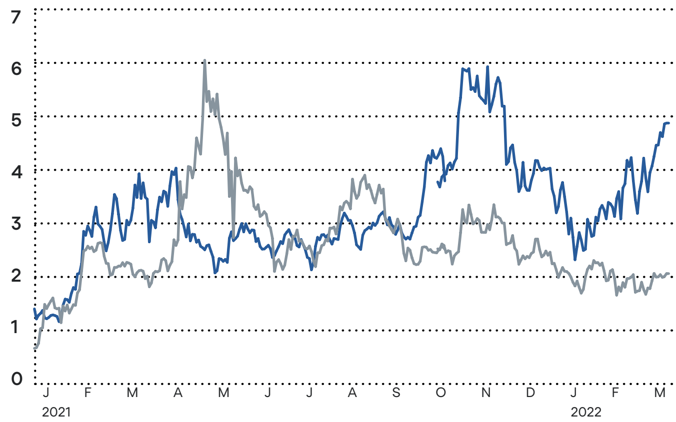
As stablecoin deposits and banking merge into what will be one of the most interesting narrow and fractional banking experiments since moving off the gold standard, valuations will become increasingly harder to assess.

Are there other opportunities within crypto? After all, there are other stablecoin options on the market outside of fiat-backed tokens. And importantly, the protocols that drive the issuance of decentralised stablecoins.

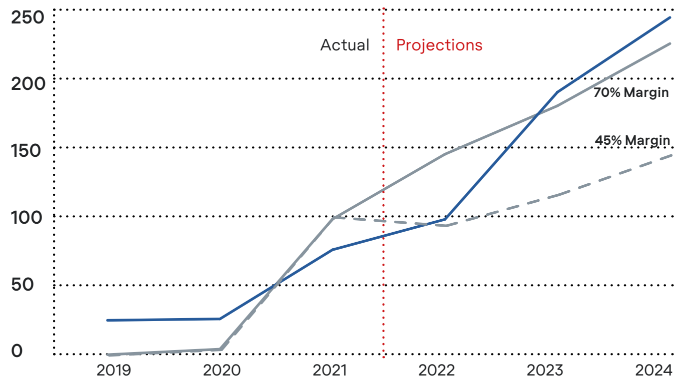
Although not apples-to-apples, there is room for comparison.

To start off, net income for Maker, the issuer of the Dai stablecoin, beat Silvergate bank by a whopping $23mn - a 27% difference in 2021. Market valuations, however, couldn't be further apart with

Silvergate vs Maker Market Cap ($bn)



Silvergate vs Maker Year-End Net Income projections ($mn)



Silvergate's market cap more than double that of Maker (see chart above). Is there greater risk on the crypto side? Of course. Is it double the risk? Unlikely. After all, regulatory guidelines for crypto operations and those servicing them are certainly not clear by any means. And volatility can be seen on both proposals.

Copper estimates that Maker, which will undoubtedly work at better margins, will continue to outpace Silvergate over the next several years. Projections have been based on 2022's very small daily growth rate of a mere 0.06% for outstanding Dai liabilities. For 1Q22, Maker has already netted $30mn even after recording its largest expenses to date. And markets have turned chipper.

While there are many considerations and Discounted cash flow (DCF) models projecting much larger figures, our conservative estimate shows that there is great room between the two candidates who could potentially corner stablecoin markets in their own right.

Of course, there are different considerations with either. Institutions gearing up can be a boon for Silvergate without question. But Maker's agility as a decentralised platform could see real world assets become part and parcel of the overall protocol operations much faster. But Maker isn't the only game in town.

New acronyms

While the BIS continues to figure things out, crypto developers continue to push product at fast pace.

Plenty of research and analysis has been done on stablecoins being able to maintain their peg. Some tokens do it better than others. On the overall, stablecoins have maintained close to parity as it's become a clearly understood arbitrage for those with patience.

And stablecoin models are plenty, with the latest entry coming from UXP built upon the Solana blockchain. The protocol shorts the collateral position immediately in order to maintain the total outstanding locked value on the platform and hence the peg. The delta is earned by governance token holders.

The execution of UXD stablecoin is novel. That of course is only until another project tries something else out. Currently, there are over 30 different stablecoin projects on various blockchains. Does the world need 30 different dollar pegged tokens?

Symbiotically speaking

DeFi is an extremely convoluted ecosystem with every project throwing out the phrase 'tokeneconomics'. And deep pockets are finding new innovative ways to create alluring protocols with high yields.

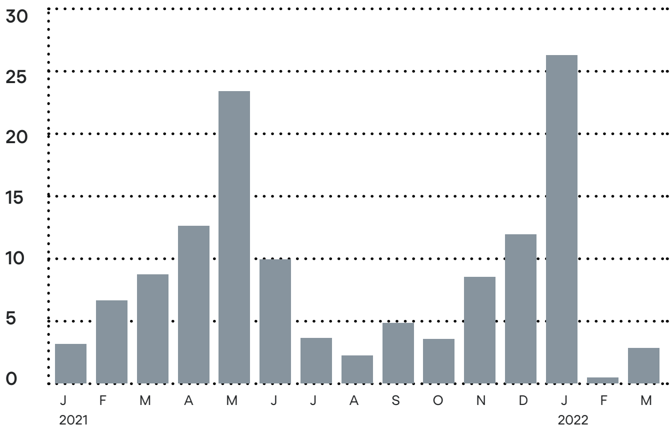
What things boil down to is demand. And should financial institutions get their foot in the door sooner rather than later, the reality is that onboarding will become a much simpler task than participating in a complicated space for the overwhelming majority of the population. Still, crypto can get creative very quickly. And user-experience has improved immensely.

But as worlds begin to slowly collide, it's important to realize that crypto projects should and will be held to the same valuation standards seen in the traditional world. Stablecoin protocols, regardless of design, will be subject to the very same scrutiny as when analysts rate equities.

Inevitably, the winner of this race will be the service that can create the most homogeneous experience and attracting the best yields in the utmost simple of forms.

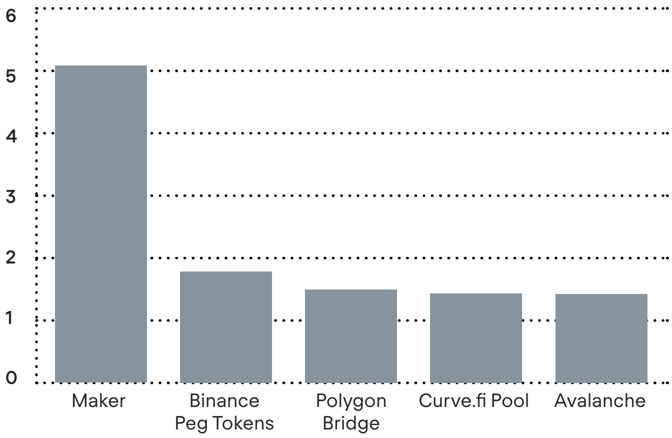
In essence, this will likely come down to the digital wallet provider or custodian, not the stablecoin protocol. We've already seen how yield farming can turn underlying protocols into a single large liquidity pool. And off-chain brokers have a clear yield advantage.

Maker net income ($mn)

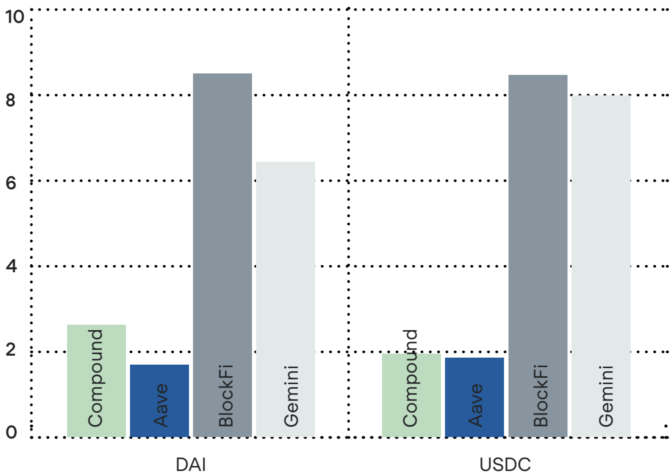


Stablecoin Type	Example	Risks
Fiat-Backed	USDC	Trust, Regulations, Censorship
Crypto-Collateral	DAI	Capital inefficient, Maintaining peg
Algorithmic	FRAX, UST*	Sustainability, Ecosystem growth
Hedge	UXD	Bear market cycles = Neg. fund rate

Stacked Peg - Top holders of USDC are stablecoin protocols ($bn)



2022: 30-Day avg lending rate - DeFi vs Centralized Exchanges (%)



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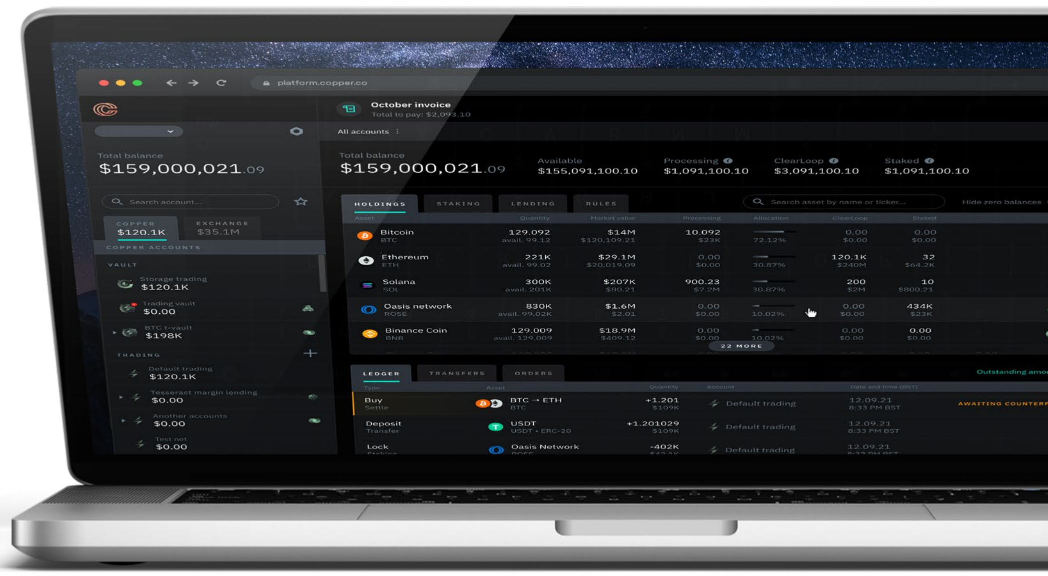

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