

What happened to Luna?

Initial UST depegging events

Within the crypto ecosystem there are several “stablecoins” whose value is usually pegged to a fiat currency. These are meant as an on-chain store of value, on-chain exchange of (mainly) dollars and are widely used in decentralized finance. Many stablecoins are backed by a basket of liquid assets and are supposed to have enough reserves to match the total value of all outstanding coins (e.g. USDC, USDT). UST, however, is an algorithmic stablecoin, whose value is mainly backed by the native token of the Terra network (now known as “Luna Classic”).

How it works:

1 UST can be swapped for 1 \$ worth of Luna tokens and vice versa. Consequently:

- when UST goes below 1 dollar it is profitable to swap 1 UST for 1 \$ worth of Luna tokens
- when UST goes above 1 dollar it is profitable to swap 1 \$ worth of Luna tokens for 1 UST

Unlike stablecoins like Dai (and USDC, USDT), UST is not backed by exogenous collateral (only recently a limited amount of BTC and AVAX was acquired as collateral).

It is not yet fully known what caused the initial depeg (deviation for the 1\$ value). While there are various circulating theories, one theory that is regularly referred to is the one concerning the Anchor lending protocol. Anchor offered a yield of 20% to users of its protocol. This high yield (especially considering it came without crypto volatility exposure) resulted in a situation where Anchor was home to 75% of UST’s circulating supply (14B vs 18B). The plan of reducing that yield might have caused the initial drain from Anchor this week (14B to 3B), with only limited other use for UST this might have resulted in the initial selling pressure.

A massive selling pressure on UST consequently led to a pressure on Luna (Classic) because of the swap mechanism described above; users were swapping their UST for Luna Classic (increasing Luna Classic supply) and were subsequently selling it on the market (creating sell pressure). Eventually the market cap of Luna Classic became lower than that of UST for the first time, and therefore there was no full collateral anymore “assuring” the UST peg. This caused some traders to fear the system to become insolvent (because UST holders would not have a way out in case of a “bank run”).

In order to support the UST price, the Luna Foundation Guard (LFG), which is Terra’s official peg defender, deployed its 2B reserve in Avalanche and Bitcoin. These (last resort) reserves were created in recent months after questions were raised regarding the peg dependency on Terra’s native token only.

While the rescue attempt did boost the UST price back to over 80 cents initially the peg never returned and volatility remained high with LFG scrambling for new investors to top up its reserves.

By the evening of the 12th of May (CET) the price of Luna Classic became so low that it became vulnerable to governance attacks at which point the chain was halted, to be restarted quickly after disabling delegations. The Terra chain was halted a second time on the 12th only to resume activity 9 hours later (around 4 AM on the 13th of May). In the meantime UST had fallen to 18.5 cents.

Halting message (13-05-2022)

In the past few days Luna has lost almost all of its value as a result of the efforts to defend the UST peg to the dollar. This low value caused issues and risks for the Terra network at which point Terra Validators decided to halt the network. At this point it is unclear when (and if) the network will be restarted. Due to that we are unable to conduct transactions in Luna and therefore unable to create the promised value that should be represented by the note. In order to protect investors we are therefore currently unable to accept new creations and redemptions.

Subsequent events

Luna Airdrop

When the chain was reactivated, with the UST swapping mechanism deactivated, the total Luna Classic supply had reached 6.9 Trillion and 1 Luna Classic was (and still is) worth less than 1 cent. In a plan to preserve the community a proposal was made to create a new chain with the same functionality as Terra but with UST left out, to be handed

out (airdropped) to current Luna Classic and UST holders. Older Luna Classic holders (from before the 7th of May) would get considerably more than Luna Classic/UST holders that bought their Luna Classic later. This proposal passed the vote (by Luna Classic holders) on the 27th of May and the coins of the new chain were dropped into the wallets on the 28th of May. At present the total value of the old chain moves around the 1 Billion USD mark and the value of the new chain around the 6 Billion USD mark. Considering the majority of holders agreed with the proposal, the Market Cap of the new chain is much higher and the main development teams on Luna seem to have adopted the new chain, Luna is now considered to be the dominant chain.