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Timeline of Terra Luna's Crash And the Origin of Luna Classic (LUNC)

In this article we'll break down the events that led to the crash of Terra Luna, Luna 2.0 revival plan and the origin of Luna Classic (LUNC).

The collapse of Terra Luna has been highly circulated for the last two months or so.

Luna's prices plunged from $87 on May 5, 2022, to $0.0005 on May 13. Terra's widely adopted stablecoin, UST, fell from the peg of 1:1 USD to a low of 0.03:1 USD.

For the uninitiated, Luna is the native cryptocurrency that powers Terra Ecosystem, a blockchain network focused on stablecoin creation.

The damage to the UST stablecoin also affected the other cryptocurrency markets, even triggering a sell-off of BTC and other stablecoins, bringing about systematic havoc that is still happening today.

So how did this all happen? We break down the events that took place surrounding the Terra Luna crash based on a new report by Huobi Research Institute (Huobi).

But first, understand how Terra blockchain actually works

Founded in 2018 by Do Kwon and Daniel Shin of Terraform Labs, the Terra protocol creates stablecoins pegged to the US dollar, South Korean won, and euro, amongst others.

Stablecoins exist to make cryptocurrency prices more predictable. In theory, Stablecoins are meant to have a fixed value of around the currency that they are pegged to so they can be a more reliable store of value for investors, in contrast to the extreme volatility of Ethereum, Bitcoin, etc.

Another benefit of stablecoins is that they exist on a blockchain that is accessible to global users, so users don’t need multiple international bank accounts to send crypto to their friends in other countries. With stablecoins, they just need one crypto wallet.

TerraUSD (UST) is Terra’s stablecoin. Unlike stablecoins backed by fiat currencies, UST is backed by its sister token, Luna, and relies on algorithms to maintain its US$1 peg.

To peg a TerraUSD (UST), a USD value of Luna is convertible at a 1:1 ratio with UST tokens. If UST’s price is, for example, at US$0.98, arbitrageurs swap 1 UST for $1 of USD and make a profit of US$0.02. This mechanism increases UST demand and also reduces its supply as the UST is burned. The stablecoin then returns to its peg.

When UST is above US$1, say at US$1.02, arbitrageurs convert US$1 worth of Luna into 1 UST and make US$0.02. The supply of UST increases, and demand for UST also decreases, bringing the price back to peg.

Hence, Luna is meant to serve as a kind of shock absorber for UST’s price. For this stabilising price mechanism to work, users can redeem 1 UST for US$1 worth of Luna, even if UST is worth less than US$1.

But this mechanism later led to one of the reasons for Luna’s crash.

The collapse of Terra Luna

1. TerraUSD joined the pool, then alleged attackers found vulnerabilities

Huobi's report outlined that the coordinated attack started with 3pool.

In the meantime, Terraform Labs prepared for the 4pool launch, and more UST liquidity was deposited into the curve. According to Forbes, this was followed by a US$350 million sale of UST for USDC on the curve, by a supposed attacker that caused a significant imbalance between the UST (85%) and 3CRV (15%) in the pool.

Subsequently, there was a bank run on Anchor, resulting in users rushing to pull out their funds and swap out of UST, as stated in the same Forbes article.

2. An arbitrage trading

As the defence liquidity pool played out, the alleged attacker kept threatening the sale of UST as an arbitrage trade, reported Huobi. Arbitrage is the practice of buying and selling assets in different markets.

With the knowledge that defences are down in guarding the peg, the attacker launched a full-scale swap on the curve.

This resulted in an imbalance of UST in the curve pool, despite the algorithm's attempts to restore balance.

Hence, this imbalance intensified the supply of Luna in the market.

3. The big short

The alleged attacker is now aware that the peg cannot be guarded quickly with an external liquidity pool. This opened up the execution phase for the attack plan, the Huobi report stated.

After the 4pool UST crashed, depositors quickly withdrew UST and swapped to Luna. The swap resulted in a selling pressure of Luna, which reduced Terra's liquidity as the primary source to buy back UST.

In response, the Luna Foundation Guard (LFG)—the organisation mandated to build reserves supporting the UST peg—sold assets like BTC and depleted all its reserve assets in an effort to further boost the value of UST.

However, the effort ultimately failed, resulting in the whole Terra chain suffering from a liquidity crisis where the entire value of Luna could not balance out the value of UST.

4. Luna's supply inflation

As UST is convertible at a 1:1 ratio to a dollar's worth of Luna. Arbitrageurs redeemed UST for Luna at discounted prices.

This resulted in more Luna being minted for each UST burnt, creating a hyper-inflationary loop in Luna's supply. Luna's value rapidly depreciated as arbitrageurs scooped up UST, burnt it, and minted Luna, then dumped that Luna on the market.

The benefit of the mechanism is that UST could re-peg if it worked, **but the risk here is that Luna could go to zero. In that case, UST would also go to zero.**

Eventually, the worst-case scenario played out. Both Luna and UST lost virtually all their value in a matter of days.

Do Kwon's Terra Luna 2.0 revival plan

Almost a week after the Terra Luna collapse, Terra's founder, Do Kwon announced a revival plan of the cryptocurrency on Twitter.

The new governance proposal suggests creating a whole new blockchain, with coins under the same name. Therefore, the depleted network will be renamed Terra Classic, and Luna to Luna Classic (LUNC), mitigating the need for the UST stablecoin altogether.

To incentivise investors, Terra airdropped new Luna tokens (otherwise called Luna 2.0) to Luna Classic stakers, holders, the remaining UST holders, and several app developers of Terra Classic.

The new Terra network went live during the last week of May, and traded on exchanges including Binance, Kucoin and Bybit.

On its first day, the cryptocurrency seemed to get off to a bright start,despite its high price volatility. It's worth noting that the prices vary widely from exchange to exchange, mainly attributed to trading volume.

In short, despite the undoing of Terra Luna in the past two months or so, reports indicate some optimism among investors and traders about the new Terra 2.0.

However, without UST as a unique selling point for Terra 2.0, questions surrounding the value and attractiveness of Luna remain up in the air at this time.

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