

INSIGHTS FROM CFA SOCIETY SINGAPORE

Crypto is the cure for, not the cause of, financial shocks



ROB PRICE

FTX is simultaneously the biggest fraud and the culmination of the largest banking crisis in the history of the crypto industry. But the FTX debacle has very little to do with crypto itself. It is merely another episode in global finance's long history of such catastrophes.

Despite extensive regulation and central bank activity, traditional finance is littered with shocks, panics, bank runs, and other disasters of which FTX is just the latest iteration.

But unlike traditional finance, crypto offers a pathway to a sounder financial system. If crypto is going to deliver on this, the principles of decentralisation, immutability and verifiability need to be adopted by more centralised institutions.

Financial crises: symptoms of opaque fractional reserve banking system

Fraud is as old as humanity, and banking crises are as old as banking itself.

But the ubiquity of such excesses has increased ever since banks evolved from depository institutions that held client deposits on

reserve to fractional reserve banks.

Fractional reserve banks only keep a small share of client deposits on hand. Hungry for returns, they prioritise profits over client safety, leveraging up their balance sheets by investing client capital in longer duration, less liquid and less creditworthy assets.

This dramatically boosts the sector's profitability, but it makes banks susceptible to runs and insolvency.

If clients seek to redeem their deposits en masse, the banks won't have the necessary capital available to meet the demand.

The FTX collapse is an outgrowth of this system. FTX chief executive Sam Bankman-Fried allegedly bailed out his own trading firm, Alameda Research, with FTX client capital, effectively turning FTX into a fractional reserve bank and executing the typical financial fraud.

Regulation and monetary policy don't fit with crypto

Traditional finance attempts to counteract the inevitable excesses of fractional reserve banking with regulation and monetary policy. Neither of these are likely to work effectively in crypto.

Let me explain. The FTX scandal highlights crypto's ongoing regulatory arbitrage potential. Bitcoin, Ethereum and other crypto assets are decentralised, Internet-based financial technologies.

They facilitate the movement of capital among various parties

throughout the globe, no matter their jurisdiction.

Exchanges are easy to set up in more far-flung jurisdictions as a means of evading restrictions and growing market share away from the hawkish eyes of developed market regulators. In fact, this is exactly the path FTX pursued, opting to conduct its operations in the Bahamas. Perversely, the stricter developed market regulators become in the wake of the FTX collapse, the greater the incentive among crypto operators to migrate to more permissive jurisdictions.

Enron, Barings Bank and Theranos all demonstrate that complex banking regulations solve neither banking crises nor frauds. In fact, FTX's Bankman-Fried cultivated close relationships with US regulators in the US Congress and the Securities and Exchange Commission in recent years. He was hiding in plain sight, and regulators didn't see a thing.

Thoughtful crypto regulations may help rein in crypto intermediaries in the future, but history shows regulation is no silver bullet. Central banking does lower the risk of bank runs in traditional financial markets. A central bank's status as lender of last resort reduces the incentive to flee insolvent institutions. But with crypto, monetary policy is both undesirable and not especially applicable.

Effective monetary policy requires supply elasticity. The US Federal Reserve can manipulate the US money supply, but nobody

can just print Bitcoin. An inelastic supply of the primary assets is a major constraint to any lender of last resort. Moreover, recent events demonstrate why central bank bailouts are both pernicious and undesirable.

FTX itself effectively acted as a lender of last resort in the crypto space in May and June. It bailed out troubled centralised lenders BlockFi and Voyager, as well as its trading arm Alameda. But these actions only hid the underlying risk in these institutions and led to a larger crisis down the road. Binance, crypto's largest exchange, looked like it might step in as FTX teetered on the edge, but wisely stayed on the sidelines.

Healthy economies reveal failure; they don't hide them

Bad business practices, poor risk taking, overly leveraged companies and outright frauds need to be uncovered and put out of business. That is how a healthy, functioning economy works. Central banks can help conceal these challenges in the short term and delay the final reckoning, but that creates economic inefficiency and damages productivity over the long term. So, where does crypto go from here?

Apply principles of verifiability and transparency to centralised finance

Like any nascent technology, Bitcoin is volatile, but it is robust. Bitcoin and Ethereum continue to

process transactions and smart contracts, delivering financial freedom to underserved people around the world.

They provide these services without the need for regulators and central banks.

Centralised institutions like FTX have failed to live up to the principles that make Bitcoin, Ethereum and other crypto assets valuable: transparency, openness, decentralisation, and more.

To take this industry to the next level, crypto advocates need to impose these principles on centralised financial institutions.

Crypto intermediaries like FTX cannot be allowed to succumb to the age-old shenanigans of traditional finance.

Self custody of assets and decentralised exchanges are two great solutions because they don't expose users to the vagaries of centralised custodians and their penchant for fractional reserve banking.

Proof of reserves can also make centralised institutions more transparent. After all, centralised intermediaries aren't going away. Not everyone has the wherewithal to fully transition into crypto's decentralised universe.

Traditional financial institutions need to integrate crypto's first principles into their operations.

A simple on-chain proof of reserves that allows the public to view company assets and liabilities would be a good first step. It

wouldn't prevent all malfeasance, but it would dramatically reduce risks by fostering accountability, openness and transparency.

Regulators wouldn't be required to audit exchange balance sheets. Instead, crypto can automate the audits through code and on-chain transparency.

That information could be disseminated in real time and be available to everyone.

Crypto isn't going anywhere

Bitcoin has declined 78 per cent since its October 2021 peak. It also fell 92 per cent in 2010 and 2011; 85 per cent in 2014 and 2015; and 83 per cent in 2018.

None of these crashes hampered its functionality or the rapid pace of adoption of the related technology.

In fact, crypto has advanced during each subsequent cycle, and its adoption rate is among the fastest of any technology.

So, while the FTX fiasco has shaken the industry, a return to first principles will see crypto re-emerge once more as a viable alternative to increasing global monetary disorder.

The question is – can the principles of decentralisation, resistance to censorship, immutability, transparency and verifiability expand beyond the protocols and into centralised intermediaries across the world?

The writer, CFA, is the founder and chief investment officer at Sound Money Capital in Los Angeles, a digital asset manager for high-net-worth individuals and family offices.