For release on delivery
1:00 p.m. EDT (7:00 p.m. local time)
June 3, 2022

Risk in the Crypto Markets

Remarks by

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at

SNB-CIF Conference on Cryptoassets and Financial Innovation

Zürich, Switzerland

June 3, 2022

Thank you for the chance to be part of this interesting discussion. It's a pleasure to speak with such a good mix of academic, industry, and official-sector experts about a topic with real importance to the future of the financial system. I know my remarks are coming after a long day, and I plan to keep them short. My goal tonight is not to weigh in on whether and how crypto-asset markets should be regulated. Instead, I want to make some observations that I hope will help focus discussion of that question in the right place. The main issue in crypto-asset regulation isn't how to protect sophisticated crypto-investors; it's how to protect the rest of us.

By any measure, the last five years have been a stretch of incredible growth in crypto-asset markets. Every aspect of them has expanded, from protocols and platforms, to instruments and intermediaries. Public awareness and government attention have increased. Above all, crypto itself has evolved from a limited set of coins meant to provide an alternative means of payment to decentralized finance, or "DeFi," arrangements, meant to provide alternatives to a range of financial products and services.[1] Innovation is happening fast, and many of the people and groups represented in this room have found new uses in finance for this technology.

By law or by practice, many crypto-related products and activities fall between the cracks of traditional legal and regulatory structures, outside the so-called "regulatory perimeter." In that environment, the normal backstops and safety nets of traditional finance do not necessarily or reliably apply. High volatility is the rule, not the exception; fraud and theft occur regularly, often at large scale. Your whole pot is always on the table; you take part at your own risk.

Some DeFi traders understand these dynamics well. If they don't embrace them, they still accept them as the natural state for a new, exciting, and still relatively unregulated

[1] International Organization of Securities Commissions, *IOSCO Decentralized Finance Report* (Madrid: OICV-IOSCO, March 2022), 3, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD699.pdf.

marketplace. And they have a point: Crypto and DeFi may be new, but these kinds of freewheeling markets aren't. They often emerge—to quote Professor Debora Spar—after:

> *"a sharp movement along the technological frontier—a moment in time when innovation leap[s] suddenly outward, creating new opportunities for commerce and tremendous enthusiasm among aspiring entrepreneurs. In each case…the technological leap also create[s] a political gap. Innovation, in other words, enable[s] firms to play in some new sphere of activity, free from the rules or regulations that might bind them in another, more established realm."*[2]

That was true with long-distance ocean trade in the 1400s; with the spread of railroad transportation in 19th century America and the explosive growth of banks to fund it; with "homebrew" computing in the '60s and '70s; and with the internet in the '90s. New technology—and a lack of clear rules—meant some new fortunes were made, even as others were lost.

There's a lot to like about these kinds of markets. Entry is often cheap, and exit is often swift. Competition can be fierce. And inefficiency can be fatal, so improvements can happen quickly. The ideas, practices, and technologies that survive in these rough waters can eventually disrupt and improve older and calmer markets. As I've said previously in the context of

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[2] Debora L. Spar, *Ruling the Waves: From the Compass to the Internet, a History of Business and Politics along the Technological Frontier* (New York: Harper Business, 2003), 9.

stablecoins, those positive spillovers can (under the right circumstances) make everyone better off.[3]

From the perspective of many market participants—the ones who survive and thrive in this rough and tumble—regulation isn't just unnecessary, it's counterproductive. It drives up costs, creates barriers to entry, and stifles innovation. From some crypto advocates, I have heard this argument as well as a related one: that these experienced investors know what they're getting into, and that they're not asking for protection because they believe they don't need it. Given all of that, the argument goes, why should anyone bring regulation into a space that's not asking for it?

Let's focus on crypto-asset users, who are a very different group than just a few years ago. The Federal Reserve's most recent *Survey of Household Economic Decisionmaking* found that 12 percent of adults used or held cryptocurrency in the past year, and more than 90 percent of these adults held them for investment purposes rather than payments.[4] The Pew Research Center put the number of users even higher at 16 percent, and other polls as high as 20 percent.[5] Some of these users are seasoned professional investors, but others, of course, are not—they're attracted to a new and complicated market by curiosity, by stories of newly minted crypto billionaires, or by promises of high and reliable returns on their life savings.[6]

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[3] Christopher J. Waller, "Reflections on Stablecoins and Payments Innovations" (remarks at the Financial Stability Conference, Cleveland, OH (via webcast), November 17, 2021), https://www.federalreserve.gov/newsevents/speech/waller20211117a.htm.

[4] Board of Governors of the Federal Reserve System, *Economic Well-Being of U.S. Households in 2021*, (Washington: Board of Governors, May 2022), https://www.federalreserve.gov/publications/files/2021-report-economic-well-being-us-households-202205.pdf.

[5] Thomas Franck, "One in five adults has invested in, traded or used cryptocurrency, NBC News poll shows," CNBC, March 31, 2022, https://www.cnbc.com/2022/03/31/cryptocurrency-news-21percent-of-adults-have-traded-or-used-crypto-nbc-poll-shows.html; Andrew Perrin, "16% of Americans say they have ever invested in, traded or used cryptocurrency," *Pew Research Center*, November 11, 2021, https://www.pewresearch.org/fact-tank/2021/11/11/16-of-americans-say-they-have-ever-invested-in-traded-or-used-cryptocurrency/.

[6] Anthony Cuthbertson, "'I lost my life savings': Terra Luna cryptocurrency collapses 98% overnight," Yahoo! News, May 11, 2022, https://news.yahoo.com/lost-life-savings-terra-luna-160848651.html; Muyao Shen, "DeFi App

New retail users, by definition, do not have crypto experience. They don't know how to independently buy a crypto asset, how to obtain and protect a private key, how to conduct trades on a DeFi protocol, or how to write a smart contract. They need help, and for a price, a range of fast-growing exchanges, wallet providers, and other intermediaries are willing to provide it. But while intermediaries can potentially help monitor and manage risk, they can't eliminate it. In such a volatile market, any user still has a meaningful chance of losing their money.

What happens in the aftermath of these losses? On an individual level, one possibility is a dispute between the intermediary and its customers over poor due diligence, poor financial advice, poor management practices, and so on. Resolving those disputes individually can be costly. So, it's no surprise that intermediaries would ask for some kind of protection from them—some standard rules of the road that, if followed, create at least some presumption of proper conduct. As a result, intermediaries can eventually demand regulation to protect themselves.

From a social perspective, there is another possible outcome when losses become widespread: Those losses become practically, politically, or morally intolerable. When everyday investors start losing their life savings, for no reason except wanting to participate in a hot market, demands for collective action can mount quickly. History shows that there will be demands to make individual investors "whole" by socializing their individual losses. We saw it just a few weeks ago after what can only be described as a run on the Terra ecosystem, when

Promising 20% Interest on Stablecoin Deposits Raises Concerns," Bloomberg, March 23, 2022, https://www.bloomberg.com/news/articles/2022-03-23/terra-s-promise-of-20-defi-return-raises-sustainability-concern.

everyday users were seeking restitution and even experienced DeFi players were discussing ways to compensate retail investors.[7]

This leads us to the main reason, in my view, that society wants to regulate new and poorly understood markets for financial products. It's not to protect high-net-worth investors but to protect society from the often-irresistible pressure to socialize the losses of investors with limited resources, and to limit the spread of financial stress.[8] The desire for a backstop can emerge even in an isolated failure—to say nothing of a systemwide event—when uncertainty or private information moves stress from one asset class to others. By definition, those financial externalities—which central banks, including the Fed, monitor closely—can create losses that innocent parties never signed up for and couldn't have controlled.[9] Those are the kinds of losses that the public often gets asked to cover—and when they do, very often, the public also asks for new oversight and regulations, so the same mistakes don't happen again.

In summary, financial regulation is typically demanded (1) by financial intermediaries as a form of liability protection and (2) by the taxpayer to prevent socialization of individual losses. It does not arise to protect sophisticated, experienced, well-informed investors. On the contrary: Large-scale losses can easily occur even if these investors are getting the information they need to make decisions and are otherwise following the rules. If we want to allow broad access to the crypto ecosystem, then the question isn't about what experienced users of that ecosystem want—it's about what the rest of the public needs to have confidence in the ecosystem's safety, and for

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[7] See, e.g., Alexander Osipovich and Caitlin Ostroff, "TerraUSD Crash Led to Vanished Savings, Shattered Dreams," Wall Street Journal, May 27, 2022, https://www.wsj.com/articles/terrausd-crash-led-to-vanished-savings-shattered-dreams-11653649201; Taylor Locke, "Ethereum co-founder says every 'average smallholder' impacted by Terra's stablecoin crash should be made whole, cites FDIC's $250,000 as 'precedent,'" Yahoo! News, May 15, 2022, https://www.yahoo.com/video/ethereum-co-founder-says-every-215033542.html.

[8] David Andolfatto makes this argument for other cases than crypto in his paper "A Theory of Inalienable Property Rights" *Journal of Political Economy*, vol. 110(2), (April 2002): 382-93.

[9] Board of Governors of the Federal Reserve System, *Financial Stability Report* (Washington: Board of Governors, May 2022), https://www.federalreserve.gov/publications/files/financial-stability-report-20220509.pdf.

better or worse, you can't program confidence. That question doesn't always have a clear answer, and it involves real and difficult tradeoffs. But it's a question that every new and fast-growing financial product must address if it wants to last very long.

Thank you.