6-2022

Is the crypto world having its own 2008 Lehman Brothers moment?

Eric LIM

Information Systems & Technology Management

Is the crypto world having its own 2008 Lehman Brothers moment?

30 Jun 2022

This article is republished with permission from BusinessThink at UNSW Business School. You can access the original article here.

Cryptocurrency markets have tumbled in recent times due to the age-old story of greed, arrogance and disregard for responsibility, writes UNSW Business School's Eric Lim

The crypto market is not divorced from the reality of global or macro events. We are seeing a macro environment where all financial assets are not having a good time. The US Federal Reserve (Fed) is doing its biggest and best impression of a hawkish dance without trying to induce a global recession by raising interest rate by 75 basis points.

The latest CPI figures again defied the Fed's expectations, that if it were to increase its balance sheet significantly over a short period to fund the government's largesse, the inflation it was seeing by the end of 2021 was never going to be "transitory". I remember being dismissed when I sounded the alarm as early as the end of 2020 that we will eventually have to pay the piper for this reckless quantitative easing, but I was shown some economic models and told to stay in my lane.

Perhaps like The Economist and the many economists the publication has spoken with, the Fed was "blindsided" by the inflation, or we could of course blame it on the war. Let's go two for two then. The economists are now saying "the cure for high prices is, high prices" and so the Fed is trying to dampen demand with a twist of a "soft landing".

I think we will have a better chance of a soft landing if engineers are building landing gears while the plane was flying. We could argue in another forum about whether this is a case of closing the barn door after the "bulls have bolted".

The last thing that any investors want to do is to fight the Fed. This means, in relation to the crux of the macro environment, investors are going de-leverage most financial assets and seek safety in the dollar. This means what we are seeing is selling pressure and general weakness in the crypto market, or financial markets in general.

A CRYPTO MARKET CREDIT CRUNCH EVENT?

Most detractors of crypto are focusing on the usual sound bites about the volatility of crypto and complaints about the degenerate behaviors we have witnessed in the space. As with any frontier technology, a market will always have trouble pricing its value. Sometimes there will be overexuberance and sometimes, there will be an overcorrection. That's inevitable and anyone who has an understanding of how the market works will know that time and education will buffer this volatility. Also, don't let anyone fool you into thinking that traditional stocks are any less volatile. Netflix was down almost 70 per cent.

There is no denial that crypto is having its own 2008 Lehman Brothers' moment due to the age-old human story of greed, arrogance, and disregard for the responsibility bestowed upon certain individuals. As Guy from Coinbureau correctly pointed out: "Crypto was meant to be the antidote… It was born out of the 2008 financial crisis – a crisis caused by reckless institutional leverage, illiquid assets and severe counterparty risk. A crisis that caused mass contagion and financial losses. We have come full circle."

I am not here to defend this behavior. It is abhorrent and disgusting. As it is impossible for me to possess all the information to be entirely certain of my arguments, I can only say that if all the rumors and bits of information are true, then the individuals who made these bad decisions without proper risk management on behalf of managing their clients' wealth, should be prosecuted to the full extent of the law.

Now, if one were to put aside their inherent biases against crypto, we can see clearly, this has nothing to do with the nature of crypto per se. Any financial markets are going to attract such actors who overleverage and overestimate their abilities to absorb risks, and are reckless with managing their clients' wealth. You can't throw the lack of regulation into this argument because we have seen these behaviors even in the heavily regulated US financial markets where the shadow banking system is unimaginably intertwined and leveraged, and are in close relationships with the Fed. It is all about incentives. As Charlie Munger said: "Show me the incentive, I'll show you the outcome."

CELSIUS AND 3AC

Celsius is a popular digital centralised platform for individuals and businesses to gain access to banking services using crypto instead of using fiat or traditional bank deposits. 3AC is short for Three Arrows Capital. It is quite a significant and renowned hedge fund (in the crypto space) that invests in crypto assets using the usual aggressive portfolio management techniques to earn returns for clients.

The former can be likened to money market mutual funds in the US (though less regulated) while 3AC is just like any other hedge funds in the world. Celsius arbitrages between the yields it receives from its loans to entities like 3AC and the yields it has to pay out for its liabilities like retail customers who deposit their cryptos with the platform. 3AC arbitrages between yields it receives from its portfolios and the yields it promises clients plus any service charges.

Sounds familiar? Of course! Because they are simply traditional financial institutions that are playing the same financial games in the crypto markets instead of the conventional financial markets. The long and short (pun?) of this is that, underlying such relationships, are collateralised assets like cryptos used for leverage. When such collateralised assets lose market value in a deleveraged market and hedge funds like 3AC can't meet the margin calls, panic is going to set in for any investors or other lending platforms that have exposure to 3AC.

Now, the most interesting part of this question is about the likely repercussions. Mainly, people will lose money. Of course, I have utmost sympathy for these individuals who have misplaced their trust in these actors. However structurally, the damage is contained within segments exposed to these entities, and we have not heard a pip from anyone calling for the Fed or the government to step in to bail out the market. No one is calling out to Satoshi Nakamoto to create more Bitcoins or any crypto assets to further devaluate the existing assets held by prudent and responsible investors. The general society cannot be extorted to foot the bill of a party that it wasn't invited to. This is the key difference between a financial market of a decentralised nature versus that of a centralised one.

IMPLICATIONS FOR GOVERNMENTS AND RETAIL INVESTORS

Without sounding glib, I would say that nothing fundamentally has changed for retail investors. I have always been an advocate for retail investors to educate themselves and hence the reason for why I started the UNSW Crypto Clinic. It is important to learn what this technology is about and what problems is it trying to solve. Not everything in the crypto space is a real cryptocurrency; some are just clones of financial services slapped on a blockchain where none is required.

If you wanted the same type of treatment you get from traditional financial institutions, then there is no need to veer too far from Wall Street. You won't get different treatments from using traditional financial services even if they are operating in the crypto space. Having said that, I can understand that there are always going to be individuals who would like exposure to crypto assets without the need to understand them. This brings me to the next point which is about the need for regulation.

Even before these events we are seeing unfurling with Celsius and 3AC, we already knew that regulations were coming. I have been saying all along that I welcome regulation because of the clarity it brings. The conversation has to start somewhere. Therefore, I was really happy when the Lummis-Gillibrand Responsible Financial Innovation Act was recently released. I would say that this represents a solid piece of legislative artifact from which a meaningful conversation can commence. The bill seems to possess the correct spirit with its understanding of the urgent necessity to protect retail and consumers in the crypto space from bad actors coupled with the understanding of the need to allow the innovation to strive without strangling it before it can even walk. I certainly hope this is a wake-up call to those opportunistic actors who think they could act with impunity in this space by preying on the uninformed.

Dr. Eric Lim is a Senior Lecturer in the School of Information Systems and Technology Management (ISTM) at UNSW Business School. His research interests focus on exploring the impact of digitalisation on individuals, organisations and the broader society, with a focus on the design and innovation of digital services across a variety of contexts such as crowd platforms, fintech and healthcare.