Crypto platforms say they're exchanges, but they're more like banks

August 12 2022, by William D. O'Connell

Credit: Ivan Babydov from Pexels

There is a well-known saying shared by both crypto experts and skeptics: "Not your keys, not your coins." The phrase, popularized by Bitcoin entrepreneur Andreas Antonopoulos, refers to how the contents of a crypto wallet are the property of whoever has access to that wallet's digital "keys."

This means that unless you personally have the keys to your crypto assets and store them offline, you are vulnerable to hacks, scams and bankruptcies. The endless stream of crypto scams has been well documented. So have the security breaches—and not to mention the eye-popping carbon emissions.

Of course, offline storage requires an extra level of understanding, technological sophistication and inconvenience. Enter crypto exchanges like Coinbase and Crypto.com, which offer simple, convenient platforms for users to buy and sell cryptocurrencies and NFTs.

However, the crypto crash has revealed that these firms are not just exchanges—they are more like banks. Except defunct crypto exchanges like Celsius Network and Voyager Digital were only banks if you read the fine print. Most customers, of course, did not.

Who needs deposit insurance?

Until very recently, crypto exchanges were all the rage. They had A-list celebrity spokespeople, stadium naming rights and public endorsements by major politicians.

Crypto exchange companies market themselves as platforms for users to buy and sell crypto. But they also function like stockbrokers and, more concerningly, their core business models quite closely resemble banking.

Traditional exchanges, like the New York Stock Exchange, rarely go bankrupt. And since they do not offer account services, if they do go bankrupt their clients are not on the hook for any losses. Brokerage firms, like Wealthsimple, do sometimes go bankrupt, but their clients' portfolios are held in the client's own name and, accordingly, may simply be transferred to a different broker. In the event of fraud, both Canada and the United States provide automatic insurance for lost assets.

Banks, like the Royal Bank of Canada, take on more risks and fail more often. Because banks use customer deposits to make loans, banks are vulnerable to runs. This is why most high-income countries—including Canada—have deposit insurance and regulate banking more than other financial services.

Herein lies the problem. Companies like Celsius and Voyager marketed themselves as both exchanges and brokers, so that is how their apps appeared. But if anyone were to read the terms and conditions, it would be clear that they were actually uninsured, quasi-banks.

Risks in crypto-banking

In companies like Celsius and Voyager, customers' accounts were not held separately in their own wallets, but rather held in a pool owned by the platform. The platform would use this pool of money to make loans (often to other crypto firms) or to engage in its own speculative investing (often in crypto assets). When depositors cashed out, they were paid from the pool, which was able to cover normal on-demand withdrawals, but did not have enough cash to handle everyone pulling out simultaneously.

Sound familiar?

When crypto prices collapsed, these firms' loans went belly up and some were forced to suspend withdrawals. When Celsius filed for Chapter 11 bankruptcy, their depositors learned their accounts were worthless, having been gambled away by the company.

These firms deliberately obscured this reality to their clients. In Voyager's case, they outright lied about being FDIC-insured. Snake-oil salesmen from these companies convinced their customers that regulated banks were the problem, only to learn exactly why those regulations exist in the first place.

To make matters worse, the lack of transparency in crypto markets makes it quite easy for executives and developers to dump their positions long before they suspend withdrawals. By the time customers realize their money is gone, those responsible have cashed out with a tidy profit.

The future of decentralized finance

So where do we go from here?

At the micro level, the answers are obvious. Crypto exchanges should be regulated in the same manner as brokers. Client assets must be held separately and securely, with clear rules on risk exposure in the firms' own trading.

Crypto assets themselves should be clearly designated as securities, and therefore subject to oversight. Exchange platforms should be required to hold sufficient cash in government-issued currency. If this sounds like it violates the ethos of decentralized finance, that's because it should.

The macro level is trickier. Post-2008, we have demonized the big banks and fetishized technology. Crypto enthusiasts claim Wall Street is only in it for itself, and they are right. But they've recreated the same system, only it's even riskier.

The late arrivals to the crypto party—the ones now holding the bag—are not the wealthy investing class. They are regular people, rightly distrustful of banks and, by extension, our institutions, and are desperately searching for ways to shield themselves from skyrocketing inflation.

Rebuilding that trust takes time and energy. It takes a willingness to deal with the inequities caused by a rising cost of living and an extractive financial system. And, crucially, it takes effective regulation. If it looks like a bank and behaves like a bank, it needs to be treated like a bank.

Provided by The Conversation