

# Crypto: What could more regulation mean for the future of digital currencies?

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Credit: AI-generated image ([disclaimer](#))

The founder of the world's largest cryptocurrency exchange, Binance CEO Changpeng Zhao, has called for more regulatory clarity after a week of crypto market chaos and a year in which investors are estimated to have lost [US\\$2 trillion](#) (£1.7 trillion).

"We do need to increase the clarity of regulations and the sophistication of regulations in the [crypto](#) space," Zhao said to [a gathering of G20 leaders](#) at a summit in Bali. But it is not only regulators that bear responsibility for protecting people, the industry should also look at new models that could help.

The recent collapse of FTX—which has filed for [bankruptcy protection](#) in the US, but was valued at [US\\$32 billion](#) earlier this year—has had significant repercussions for the entire cryptocurrency industry. Even the most established digital currency, Bitcoin, hit a [two-year low](#) following the FTX woes.

Cryptocurrencies allow traders or investors to buy and sell without the need for banks and brokerages. Blockchain technology enables peer-to-peer cryptocurrency transactions to happen on exchanges such as FTX and its rival Binance without these middlemen.

Instead, transactions are authenticated through consensus by a group of validators, typically called miners. Miners solve complex mathematical puzzles to do this, otherwise known as the [proof of work system](#) used by Bitcoin and most cryptocurrencies.

But when it comes to organizing these transactions, Binance and its peers use the same "limit order book" model as any traditional exchange such as the New York Stock Exchange. This means there is a centralized structure that matches buyers and sellers, with market makers supplying liquidity and charging traders for transactions.

This kind of structure has exacerbated recent events in the crypto space to some extent. FTX's centralized model allowed it to make [loans to distressed crypto firms](#) earlier this year. It also [used exchange-issued tokens \(FTT\)](#) to round out its sister company's books. This increases the risk of exposure to a market collapse.

But an emerging model, decentralized exchanges, operates under different rules for pricing cryptocurrencies and for governance that could reduce such risks. They allow investors to buy and sell tokens at an algorithmically determined price. This automated model does not rely on professional market makers, instead individual investors supply liquidity and collect a portion of fees from trades.

## **A different crypto exchange model**

Like many decentralized exchanges, [Uniswap](#), which launched in 2018, has a governance token called UNI that individual users of the exchange can use to cast votes in decisions about how the exchange operates. In principle, no centralized entity can manipulate system decisions voted through by owners of these coins.

This helps the users of the exchange to retain control over what's happening with their funds. [Estimates suggest](#) that up to 49,000 addresses on the Ethereum blockchain hold UNI tokens and 60% of tokens are held by investors.

Another issue that plagued FTX in its final days was that it is custodial, which means it had the right to suspend withdrawals of cryptocurrency by investors. FTX's decision to ban withdrawals by investors meant many [people have been refused access](#) to money they used to trade on the exchange.

Decentralized exchanges are non-custodial, so they allow individual investors full access to their crypto wallet balances and they can withdraw or deposit liquidity or stop trading at any time with no risk of their assets being frozen by the exchange.

One downside of decentralized exchanges versus centralized models such as FTX and Binance, however, is that they don't allow traders to

exchange fiat (traditional currencies issued by governments or countries) for crypto—they can only trade different cryptocurrencies on the exchange. The size of any trade will depend on the size of the liquidity pool, so if the latter is too small, a trader could find it difficult to make their desired transaction happen.

Which type of exchange is likely to dominate crypto trading in the future depends on several factors.

As some customers have withdrawn their crypto deposits from FTX over the past week, [approximately 60% of the outflows](#) reportedly went to FTX rival Binance. In the short term, the outflows of investors from FTX to Binance will increase its market share of crypto trading. This additional liquidity on Binance will help it to continue to dominate because it will be able to offer lower transaction costs.

But when activity is concentrated in fewer exchanges, more customers are exposed to the risk of any individual crypto provider or large trader failing. And the industry is only becoming more concentrated following recent market failures. Greater concentration means greater risk of contagion.

And over time, decentralized exchanges will be able to become more competitive and lower their transaction costs too. This is in part due to the development of "[scaling solutions](#)"—protocols (or sets of rules) that increase activity and transaction speeds without affecting decentralization. This will also help to bring down the amount investors must pay to validate their transactions on the blockchain, making it less costly to trade.

## **New rules**

And while traditional financial markets are heavily regulated, crypto is

not, something that looks likely to change following FTX's recent difficulties, as well as the events of this year. The importance of developing more official structures for the cryptocurrency market has become even more apparent.

Regulators have [already started to investigate](#) FTX lending products and management of customer funds after its collapse. But what else can they do?

## 1. Closer monitoring of crypto assets

As Binance's CEO has recently suggested on Twitter (above), one way to prevent a repeat of the FTX failure would be to monitor crypto exchange assets in real time rather than relying on [annual reports with \(in some cases\) gross inaccuracies](#).

This is already possible. An independent third party can provide "proof of reserves." This means the organization publishes [audit reports](#) to provide an independent review of the balance sheet of an exchange, tracking the flows of money in and out of investors' exchange wallets. This would flag up potential systemic failures due to unexpected activity, such as the use of exchange reserves to [make loans](#) to crypto firms, as described already with FTX.

## 2. Better crypto risk assessments

Financial regulators also need to adopt an appropriate risk assessment framework for [cryptocurrencies](#). This should include independent audits and stress-testing of on-chain data (information about [transactions](#) on a blockchain network).

Regulations could be imposed to restrict the use of an exchange's tokens

to make loans to crypto firms. More customer protection could also prevent exchanges from suspending withdrawals, leaving traders [unable to access money](#) held by an exchange that is in trouble.

Even amid the "[crypto winter](#)," all is not lost for crypto. Appropriate regulations and new models could help the industry to recover and strengthen, perhaps even encouraging further adoption of decentralized finance in mainstream financial markets.

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