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Remarks at the

DC Blockchain Summit 2022

"Crypto: A Call to Reset and Recalibrate"

Thank you for the kind introduction and for inviting me to speak today. I would like to provide a bank regulator's perspective on the recent events in crypto.

As many of your members know, I have been a crypto skeptic. In speaking to the Blockchain Association last year, I warned of risks in the crypto space, including unexplainable and unsustainably high yields and "innovation" for innovation's sake.[1]

What has become clearer to me since then is that these developments are indicative of the crypto economy's dependency on hype. Hype is needed to generate the interest and investment that are key to creating the "flywheel" of growth that crypto projects seem to need to get off the ground.

The recent collapse of the TerraUSD stablecoin and associated sell-off in crypto markets has shown that hype-driven growth can lead to bubbles, harm consumers, and crowd out productive innovation. I will say more on this in a bit.

Stepping back, though, I would like to share three high level observations from the perspective of a bank regulator.

[1] Acting Comptroller Discusses Innovation in Digital Assets | OCC

1.

First, the recent events of the past several months have revealed deep vulnerabilities in the crypto system. Three in particular stand out:

- *Crypto is highly fragmented and prone to hacks*. The crypto ecosystem has become increasingly fragmented with new blockchains being added daily. Cross-chain bridges have sprung up to mitigate interoperability challenges due to fragmentation, but these bridges are highly prone to being hacked.[2] It is as if instead of converging on a single standard railway gauge to connect the country, innovators are incentivized to build customized railcar systems from scratch. Then complex solutions are created on top to connect those systems, but they are, by design, easy targets for bandits.
- *Contagion risks are real*. The collapse of the algorithmic TerraUSD stablecoin sparked contagion to the largest stablecoin, Tether, and to the broader crypto ecosystem. This occurred despite the stabilization mechanisms for TerraUSD and Tether being quite different. And yet, Tether experienced a wave of redemptions and de-pegged after TerraUSD's collapse.[3] Such contagion is familiar to bank regulators and students of money-like instruments—prudential regulation can help.[4] Bigger picture, however, it appears that the hyper-focus on trading in crypto has created a highly interconnected

[2] Wormhole hack illustrates danger of DeFi cross-chain bridges | cointelegraph.com; Crypto-Bridge Hacks Reach Over $1 Billion in Little Over a Year | Bloomberg

[3] Stablecoin tether breaks its peg and drops to $0.95 as panic hits crypto markets after collapse of TerraUSD | businessinsider.com

[4] President's Working Group on Financial Markets Releases Report and Recommendations on Stablecoins | U.S. Department of the Treasury

ecosystem—something that became more clear after the collapse of the Terra ecosystem contributed to a massive sell-off in cryptocurrencies generally.

- *Custody and ownership rights are underdeveloped for the size, scope, and ambitions of the industry*. As TerraUSD was collapsing, the largest centralized exchange in the United States disclosed that, should it file for bankruptcy, its users would be at risk of becoming unsecured creditors.[5] This disclosure renewed questions about the nature of the "custody services" that centralized exchanges and other intermediaries provide.[6] For a technology and industry so focused on promoting an "ownership society," the lack of clarity on ownership rights, modes of ownership, and custody of digital assets seems like a fundamental problem that needs to be solved. When consumers buy crypto or NFTs through an exchange or app, what exactly do they own? How are the bundle of rights apportioned? Who must they rely on to exercise their ownership? Establishing clear standards for the ownership and custody of digital assets would protect consumers while enabling sustainable, long-term growth.[7]

2.

The second observation I would like to make is that recent events have shown the value of the OCC's "careful and cautious" approach to banks seeking to engage in crypto activities.[8] Despite significant volatility and the loss of one-half trillion dollars of market capitalization

[5] Coinbase warns customers they could lose their crypto if the company goes bankrupt | yahoo.com

[6] Not Your Keys, Not Your Coins: Unpriced Credit Risk in Cryptocurrency by Adam J. Levitin | SSRN

[7] Ibid. The article notes that crypto currency exchange user agreements often refer to the customer as having "title" to or being the "owner" of the cryptocurrency, while granting the exchange control over the private keys used to access the cryptocurrency and permitting the exchange to commingle customers' cryptocurrency holdings.

[8] Acting Comptroller Discusses Modernizing the Financial Regulatory Perimeter | OCC; OCC Interpretive Letter No. 1179 | OCC

following the collapse of TerraUSD, *there has been no contagion from cryptocurrencies to traditional banking and finance*. No banks are under stress or even rumored to be under stress due to crypto exposure. This absence of stress has allowed the traditional banking system to remain a source of strength to households and businesses through the recent financial market volatility.

The resilience of the traditional banking system to the recent events in crypto is not an accident. Rather, it is due, at least in part, to federal bank regulators' continued and intentional emphasis on safety and soundness and consumer protection. At the OCC, this emphasis was reflected in Interpretive Letter 1179, which was issued last year and reminds national banks that engagement in crypto activities that were addressed in prior interpretive letters is permissible only when banks have controls in place to do so in a safe and sound manner. This includes compliance with applicable consumer protection laws to ensure customers are treated fairly. With my encouragement and support, the FDIC followed the OCC's lead and sent a similar message via a letter to FDIC-regulated banks earlier this year.[9] I believe that these reminders have contributed to the safety and soundness of the banking system despite the heightened volatility and recent turmoil in the crypto markets.

3.

The third observation I would like to make is that hype is not harmless.

I noted at the outset that the crypto economy appears to be hype-based. (Indeed, it seems hype and yield are to crypto as user engagement is to social media.) Consider the arc of the TerraUSD stablecoin. It rose rapidly this year to become the third largest stablecoin from $3

[9] FDIC: FIL-16-2022: Notification of Engaging in Crypto-Related Activities

billion last November to over $18 billion at its peak in early May. How? By offering 20 percent returns to TerraUSD holders who deposited their tokens on the Anchor Protocol.

This "come-for-the-yield" approach is not unique to Terra. Offering outsized yields appears to be the primary mechanism of attracting interest and investment in many, if not most, crypto-assets, especially in the DeFi space. This mechanism is facilitated through so-called "yield farming." There seems to be growing acknowledgement that yield farming today may have more in common with Ponzi schemes than with productive innovation.[10]

A hype-driven economy presents real challenges for those interested in truly productive innovation and in protecting consumers. There is real potential for positive and transformative change with digital assets. And ensuring inclusion and access to anyone willing to invest the time and effort to learn about those opportunities could facilitate wealth building for those typically shut out from such opportunities. However, the hype and the associated vulnerabilities noted above make the crypto space very dangerous for investors of modest means. The TerraUSD holder stories are heartbreaking and a strong reminder that hype is not harmless. Given the massive inflow of venture capital dollars into the space, my fear is that the hype problem may get worse before it gets better.[11]

Getting the inclusion/protection balance right with crypto is going to take a lot of discussion and work. A paternalistic approach of prohibiting or discouraging investment is as problematic as a purely laissez faire approach. This is one reason I brought together Professor

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[10] Podcast: Sam Bankman-Fried Described Yield Farming and Left Matt Levine Stunned - Bloomberg

[11] State Of Blockchain 2021 Report | CB Insights Research. The report noted a 713 percent year-on-year increase in venture capital funding for blockchain companies.

Tonya Evans, a crypto expert, and entrepreneur and philanthropist John Hope Bryant, a crypto skeptic, to discuss cryptocurrencies and communities of color, as part of a financial health discussion series sponsored by the OCC.[12] It is also why I called on the Financial Literacy and Education Commission, which is chaired by the Treasury Department with the Consumer Financial Protection Bureau as its vice chair, to prioritize improving crypto literacy and education.[13]

In sum, although I remain a crypto skeptic, I have come to see its potential and understand why there is excitement around it. The industry has grown too fast, however, and suffers from a hype-based, "shoot, ready, aim" approach to innovation and value creation. The recent events in crypto should serve as a wake-up call and an opportunity to reset and to recalibrate the problems the industry is trying to solve. Until then, the OCC will continue to take a careful and cautious approach to crypto in order to ensure that the national banking system is safe, sound, and fair.

[12] OCC Launches Discussion Series on Financial Health | OCC

[13] Acting Comptroller Discusses Crypto Literacy | OCC