



2022

*25th Annual Japan - U.S. Symposium
on Building the Financial System of
the 21st Century*





The Future of Crypto Assets— Regulation, Cross-Border Issues and Role of Traditional Financial Institutions



Core Issues

- Principles for regulating crypto
 - Financial stability
 - Investor protection
 - Promoting innovation
 - Ensuring liquidity
 - Risk management
 - Usable liquidation regime
 - Clear jurisdictions
 - Full backing for stablecoins
- What needs to be regulated?
 - Disclosure!
 - Crypto assets? Probably not – buyer beware
 - Stablecoins? Definitely – contagion concerns, resemblance to unregulated MMFs
 - Exchanges (but maybe not DeFi)



FTX Failure

- Causes of FTX failure and investor losses
 - Lack of custodianship
 - Commingling + risk-taking = disaster
 - Bad corporate governance and internal controls
 - Lack of uniform regulation
 - Offshore exchanges skirt jurisdictional regulations
 - “Yield farming” as Ponzi scheme?
- Regulation can be effective
 - Japan FTX looks fine, while US and Bahamas units tanked
 - Bad actors thrive in unregulated spaces
 - Robust regulation may incentivize quality entrants and competition and deter investors from using less regulated entities

Regulating Crypto

- Regulating crypto exchanges
 - Key functions for capital markets
 - Exchange (matching orders)
 - Broker/market making
 - Payment/settlement
 - Lending
 - Custodianship
 - In traditional finance, separate entities and segregated assets
 - In crypto world, “exchanges” blur all the lines - nomenclature matters
- Can we adapt the existing regulatory toolkit to crypto?
 - Principles of segregation, KYC/AML may be sufficient in digital as in traditional if applied uniformly
 - Challenge in US of regulatory fragmentation
 - Crypto founders often from tech, not financial background



Regulating Crypto

- JFSA as global first mover
 - User protection: crypto asset exchange service providers (CESPS) must meet rules re segregation of users' assets, reporting, market integrity
 - AML/CFT: Implementing FATF recommendations, CESP's must monitor and report suspicious activities
 - Financial stability: stablecoin issuers set to be licensed as banks, fund transfer service providers, or trust companies
- Challenges to custodian model in crypto
 - BIS capital framework: 1250% risk weighting for crypto assets
 - U.S. banks barred from crypto custodianship by SEC accounting rules
 - Should regulators seek to increase connections with the formal financial system instead of seeking to isolate crypto?

Politics of Crypto

- Rise of crypto reflects mistrust of govt, big banks
 - Allure of “trustless” transactions ruled by algorithms
 - Reality is that much crypto is stored and traded on exchanges
 - Regulation is needed, but users seek to avoid
 - What do governments owe crypto investors?
 - Investor protection is about process, not about bailing out risky investments
 - Distinguish between unaware retail and institutional who should know better?
- Prospects for U.S. crypto legislation
 - Grounds for optimism
 - Bills currently in preparation are bipartisan
 - FTX and other failures raise urgency
 - But many crypto exchanges, issuers, and investors will continue to resist
 - First step likely to be stablecoins, seen as unregulated MMFs and main potential conduit for contagion to trad finance



The War in Ukraine, Financial Sanctions, and Consequences for International Finance



Effects of War

- Disruption
 - Challenge to international order, including global financial system
 - Massive humanitarian disaster and physical/economic damage
 - Knock-on economic effects– energy prices, supply chain, food insecurity
 - Debt implications for emerging market countries
 - Exacerbates already challenging environment of global inflation, monetary tightening, post-pandemic supply disruptions
 - Requires cooperation of creditors – G7, Paris Club, China
- Future implications
 - Does this make Chinese attack on Taiwan more or less likely?
 - MNCs and FIs must prepare for new contingencies
 - What effects on capital investments and risk premiums?



Sanctions

- Unprecedented range and strictness of sanctions
 - G7 appears unified in its response
 - Or is this just U.S. pushing its own agenda?
 - Import bans – but energy not fully covered
 - Export controls – especially tech and military use
 - Freezing of Russian USD reserves
 - Finance – removal of central bank and others from SWIFT and USD system
 - Targets – designated entities, countries, individuals (oligarchs)
- Leakages in sanctions regime
 - No global coordination via UN Security Council
 - Active circumvention by Iran, North Korea, China, etc.
 - Global South – willingness to trade with Russia
 - Can these be addressed by U.S., Japan, UK, Europe sanctions on companies that violate?
 - Will we resort to secondary sanctions to reduce leakages?



Sanction Effects

- What do sanctions accomplish?
 - Goals: degrading war capability, punishment, deterrence of future aggression, alternative to military response, symbolism
 - Effects: have degraded ability to wage war, but not determination or Putin's political position
 - History: don't expect regime change, but can hurt future growth
 - Oil price cap: Will it work as planned? Will it affect Russian war effort?
- Japan in sensitive position
 - Energy prices, curtailed access to supply
 - How to manage China relations, changing NE Asia geopolitics?
 - Challenge of keeping solidarity with U.S. and Europe



Unintended Consequences of Sanctions

- Short-term consequences
 - Burdens on MNCs – geographical and logistical shifts, regulatory compliance
 - Developing countries dealing with higher food and energy inflation
 - Seizing of individual assets a slippery slope
 - SWIFT cut off - future challenge to USD as a reserve currency?
 - Crypto as a tool to by-pass sanctions
- Long-term consequences
 - Shifting patterns of trade and finance
 - Efforts to insure against future sanctions
 - Stepped-up Chinese efforts to decouple
 - Will this accelerate creation of non-USD alternative financial system?



Long-Term Consequences for Japan, U.S., Europe

- New world order?
 - Will this make use of economic sanctions more common?
 - How to plan for counter-actions by China or others?
 - Possibility of deglobalization (or perhaps reregionalization) – friendshoring, industrial policy, reduced financial openness
- Effects on energy transition
 - Increased urgency for energy transition to preserve security
 - But inflation and fiscal consolidation reduce capacity to invest – may slow transition
 - Can governments speed the transition with carbon tax, feed-in tariffs, incentives for conservation?
- Are sanctions politically sustainable?
 - Popular frustration with inflation, food & energy volatility, aid to Ukraine
 - Cracks in the façade? European energy woes, new U.S. Congress



UPCOMING EVENTS

2023

Europe - U.S. Symposium

May 10-12, in-person

Frankfurt, Germany

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