After the Fall, What's Next for Crypto?

By INSEAD Knowledge

Amid the collapse of crypto exchange FTX, Lily Fang, Antonio Fatás, Peter Zemsky and Jason P. Davis unpack why it happened and where crypto could go from here.

The crypto universe has experienced numerous setbacks in the past year: from the **loss of over US$2 trillion** in total market value since its peak to the **breakdown of the Terra ecosystem**. But perhaps no event has been more shocking than the cataclysmic unravelling of crypto exchange FTX. Overnight, sovereign wealth funds, venture capital firms and retail traders saw their investments and deposits virtually wiped out as the beleaguered company filed for bankruptcy.

How did the fast-rising crypto star fall from grace? INSEAD Professors Lily Fang, Antonio Fatás, Peter Zemsky and Jason Davis weigh in on the FTX debacle, and how the crypto industry and regulations could evolve in order to install safeguards, restore trust and prevent a repeat incident.

The FTX collapse resembled a bank run

Lily Fang, *Dean of Research, Professor of Finance and the AXA Chaired Professor in Financial Market Risk*

The spectacular fashion in which FTX went down shows us what a bank run looks like. The firm suffered a sudden loss of confidence and the cascading withdrawal of capital, which can very quickly destroy even a healthy bank. But fundamentally, FTX brought this upon itself because it is not a bank – it is not supposed to be allegedly **“borrowing” customer funds** for its own betting. That revelation rightly triggered the run, which undid the firm.

Within the crypto world, there has been a contagion effect. People not only withdrew their assets from FTX, but other crypto exchanges as well. Even Binance’s coin, BNB, **lost more than 25 percent of its value** between 4 November and 21 November.

However, this is not affecting **mainstream financial markets** very much, because the crypto world operates largely in parallel to and independent of the latter. In fact, crypto is still relatively small in aggregate (US$1 trillion total market cap) compared to the financial system. For instance, the largest traditional asset manager BlackRock alone has US$10 trillion under management.

I think this incident will further drive away retail and institutional interest in crypto and will hinder the legitimacy of crypto as an asset class. This is bigger than previous crypto winters. We may enter a deep-freeze period for a while.

Regulators need to step in and protect consumers

Antonio Fatás, *Professor of Economics and the Portuguese Council Chaired Professor of European Studies*

These events show that some of those who were apparently trying to work with regulators (such as Sam Bankman-Fried) are not genuinely interested in regulation. They were merely lobbying and pretending so that they could continue running high-risk operations without any regard for proper finance tools.

This is not just one additional scandal; this is a reflection of a significant segment of crypto projects. They are overconfident, feel superior to the **rest of the world** and ignore the basic principles of financial markets. We are now talking about a good number of large exchanges getting caught running an unsound business, being fraudulent or both.

Regulators need to step in and protect consumers as they do everywhere else, but they have been slow in regulating crypto markets for two main reasons. First, it is not easy, as some of these projects (such as decentralised finance) are too different from traditional financial instruments. Second, regulators were hoping that some innovation would come out of these projects, and they did not want to constrain this with excessive regulation.

But regulators now realise that these markets are large and that there is significant fraud and limited innovation. Hence, we are seeing an acceleration of attempts to regulate the industry. However, while the regulation of domestic activities is possible, how to regulate offshore activities is not as obvious. We can therefore expect unregulated markets to continue operating in certain jurisdictions.

This is a massive wake-up call for a market that has developed without clear financial principles and has been driven by strong and unusual personalities who have been very good at attracting interest and funds but incapable of running a business. Yes, not everyone is the same in these markets, but sufficient companies have shown similar patterns – enough for investors to have serious doubts about the whole industry.

Crypto has failed to account for certain fundamentals

Peter Zemsky*, Deputy Dean and Dean of Innovation, Professor of Strategy and the Eli Lilly Chaired Professor of Strategy and Innovation*

Crypto seeks to **disrupt traditional financial institutions**. Unfortunately, it is clear now that the sector has failed to account for some of the fundamental principles and hard-earned learnings about the robust and reliable delivery of financial services. There are many issues here. The mismatch in timing of deposits and loans has resulted in susceptibility to bank runs, amplified by the lack of attention to internal controls and the risk of fraud.

Many investors are now reminded of the trade-off between risk and return. The high yields on many crypto deposits in a zero-interest rate environment came with massive downside risks. The implosion of the algorithmic stable coin Terra is complex but has elements of failed defences of exchange-rate pegs of the past. The possibility of massive, short-run wealth creation in financial markets unleashes “animal spirits” that risk obscuring these fundamentals, but they consistently seem to emerge in the long run.

I expect that recent events will heighten not only calls for regulation but also attempts to extend regulations in the traditional financial industry to the crypto sector. The winds were already blowing in the direction of greater regulation of tech companies. Post-pandemic, governments seem to be more assertive in general, and there is growing awareness that tech can benefit from regulation if done well. The massive impact on retail investors will also provide considerable pressure for heightened consumer protections.

Emerging technologies could help transform crypto for the better

Jason P. Davis*, Associate Professor of Entrepreneurship and Family Enterprise*

As a strategy and organisation scholar, I am guided by prior research on technology emergence and evolution, where the S-curve of adoption is usually our best framework. At the beginning of the S-curve, we expect experimentation, ambiguity, failure and even fraud until technologies become mature enough to accelerate adoption and shake out ineffective and fraudulent firms.

This is what we observed in the earliest examples of fintech based on Web2 technologies, and even in mainframe banking services based on Web1 technologies. It’s not surprising to me that we should see these features at the beginning of the Web3 and crypto-blockchain S-curve as well.

What is different here is that crypto networks exist in a borderless, 24/7 open market that regulation has, so far, not made much headway in slowing. Complementary technologies such as social media have no doubt also been accelerating adoption. This has attracted some of the most unscrupulous characters into the crypto world, alongside the most idealistic builders.

My observation is that the virtues of decentralisation – such as transparency, collusion resistance, disintermediation of middlemen and composability – are clearly features that some users are willing to pay for, as shown in the price of cryptocurrencies. No doubt wild speculation and the easy money of the past several years are reflected in the price as well.

But in this world of crypto networks, it is easy forget that value is a moving target. Cryptocurrencies aren't fixed assets. They reflect the activities of open-source developer communities who are each engaged in technological evolution. As I have **argued before**, emerging new technologies may transform crypto networks to better enable them to support human needs, including establishing identity, building reputation and preserving privacy. Along this argument, the future is bright.

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