Self Regulating Digital Finance

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Contents

I. Definition, Rationale of Self Regulation

Definition

- What is self regulation? defies simple definition (private regulation, soft law, self governance, voluntarism)
  - Firm level self regulation vs. Industry level self regulation
  - Voluntary self regulation (no direct government intervention) vs. sanctioned (government approves), vs. mandated self regulation (government requires)
  - Self regulation ≠ deregulation
- Drawing on concepts from academic debates:
  - **"Audited Self Regulation":** delegation of power by Congress or a federal agency, to implement federal laws or federal agency regulations by the federal government to a nongovernmental entity, with powers of review and independent actions retained by a federal agency (Michael, 1995).
  - **"Embedded self regulation"** (Omarova, 2011): a model of self regulation that would "embed" financial practices in broader social values and regulatory principals instead of "disembedding" them from public interest,
    - focused explicitly on preventing systemic failure
    - "embedded" within system of government regulation and oversight
- Building on these concepts, in this presentation, I advocate a "regulated self regulation" model for "financial consumer protection" in "digital finance"

Rationale and Criticism of Self Regulation

- Justification and Rationale for Self Regulation (Ogus, 1995; Black, 2002, Micheal, 1995)
  - Expertise and technical knowledge, context driven, flexible, fast, informed, responsive, shared values, stronger sense of participation, enhanced compliance
  - Cost reduction (monitoring, enforcement, establishing and amending standards) and Costs are internalized
  - Innovation as a driving force of self regulation (Stefanadis, 2003)
- Criticism (Black, 2002; Michael, 1995)
  - Conflicts of interest, self serving, self interested, lacking sanction, lack of , or inadequate enforcement, unreviewable discretion, free rider problems
  - from the legal perspective: modern "Corporatism", Lack democratic legitimacy, breach of separation of powers doctrine
  - from the antitrust perspective, self regulatory regimes, in effect, create entry barriers and protect anti competitive practices, and rent seeking behavior

Elements for an Effective Self Regulatory Regime

1. The Industry Factor

- Organized industry that are able to, and are willing to self regulate **(Michael, 1995)**
  - expertise, human and physical resources
  - Organic and preexisting professional groups or purposely designed by regulation (➔ "regulatory structure" factor)
- Regulated entities must have the incentives and motivation to comply. Motivation can come from economic self interest such as:
  - "Community of Fate" : Industry actors coming together in search of common self regulatory framework primarily to minimize or eliminate potentially negatives effects on the society, "either we stand to together or we fall together" (Omarova, 2011) (i.e., to contain systemic risk)
  - "Tragedy of Commons" situation: the benefits of exploiting resources accrue to individual market participants, whereas the costs of exploitation are widespread
  - Spotlight of public scrutiny from consumers, investors
    - Threat of government regulation (political transaction costs) (Maxwell et al, 2000): direct cumbersome government intervention may generate a willingness of the industry to comply (Michael, 1995)

Elements for an Effective Self Regulatory Regime

2. The Regulatory Structure Factor

- Existence of a formal framework or government regulation and enforcement
  - Government agencies must be able to oversee, "audit" the self regulatory bodies, and enforce (publicly or privately made) rules, and step in and enforce when needed (Omarova, 2011 at 445)
- Regulatory frameworks must effectively "internalize externalities" by efficiently transferring costs to the industry (Michael, 1995, at 171)
  - Requirements of the laws should be objectively stated, in terms of outcomes requirements or standards
- The regulator serves as the "auditing" or "regulating" agency that oversees the self regulation: The overseeing government agency primarily relies on information generated by the SRO, but also can examine accuracy, and review processes of the SRO (Michael, 1995, at 176)
  - Expertise of the overseeing government agency ("auditor")
  - Independence from industry (imperative to avoid capture)

Regulated Self Regulation for Financial Consumer Protection in Digital finance

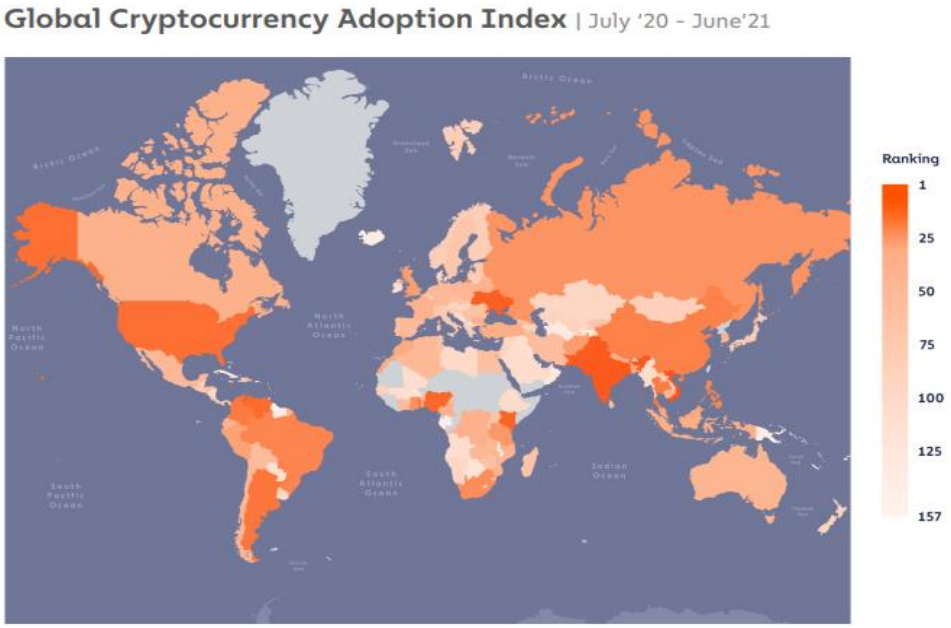
- Regulated self regulation
  - Government mandated and embedded within government regulatory framework
  - Oversight over self regulatory organizations (SROs)
- Goal of Self regulation: systemic risk vs. financial consumer protection
- Crypto asset trading and digital consumer lending are potentially good candidates for self regulation because government regulation is non existent or ineffective
  - Why self regulation might be better than direct government regulation?
    - Ability to collect vast amount of unreported data (i.e., digital consumer lending)
    - Globalization and cross border transactions (i.e.,crypto asset)

II. Self Regulating Crypto Assets

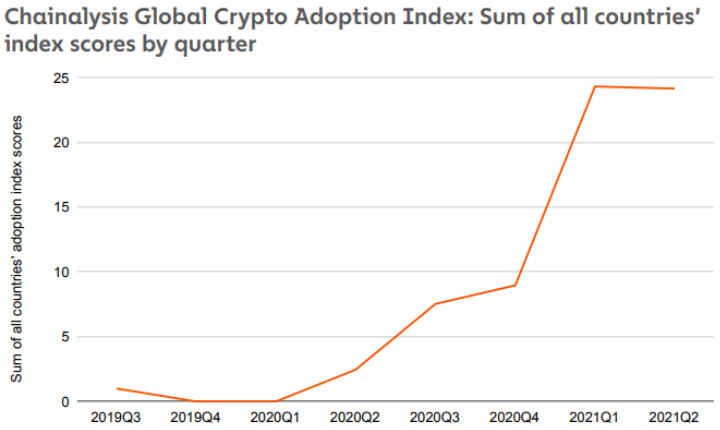
Crypto asset and self regulation

- Cryptocurrency is decentralized digital money that's based on blockchain technology.
- Can circulate without the need for a central monetary authority such as a government or bank
  - but in Korea, you need a bank account to open a crypto account at the exchanges
- Most common: Bitcoin and Ethereum …
  - more than 19,500 different cryptocurrencies are traded publicly (according to CoinMarketCap.com)
- The total value of all cryptocurrencies on May 26, 2022, was about $1.2 trillion, having fallen substantially from an all-time high above $2.9 trillion late in 2021.
- Source: https://www.nerdwallet.com/article/investing/cryptocurrency

Crypto Around the World



- Source: Chainalysis (2021) https://go.chainalysis.com/rs/503-FAP-074/images/Geography-of-Cryptocurrency-2021.pdf



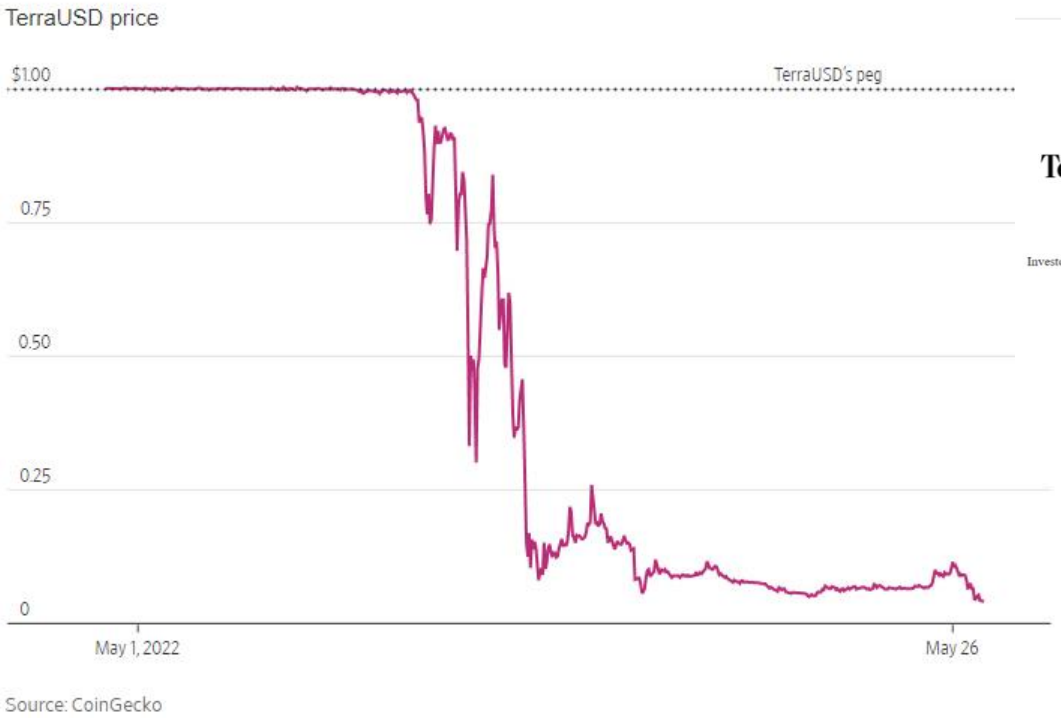
Risks of Crypto: Utterly Unregulated

- **Crypto is "Wild West"**
- **Volatility in market –** lack of entry barriers for high-risk investments
- **Fraud, scams**, market manipulation- government authorities lack legal mandate to investigate, enforce
  - lots of middlemen related scams, social media scams, pyramid/ponzi schemes
- **Lack of transparency**, classic information asymmetry issue – what is in crypto?
- **Customer agreements** – unfair terms and conditions
- **Accountability gap issues -** Who is accountable? The exchanges? P2P? Decentralisation makes it more difficult

Vulnerable "at risk" consumers: young, elderly, financially unsavvy, unbanked- those who can lease afford losses are invested in crypto

Luna Terra Crash -

"biggest crypto-Ponzi scheme"



THE WALL STREET JOURNAL.

MEMORIAL DAY SALE

MARKETS

TerraUSD Crash Led to Vanished Savings, Shattered Dreams

Investors swept up in the mania for the high-yielding stablecoin thought it would be safe

"The crash caught many investors off guard because TerraUSD was a stablecoin, designed to maintain its value of $1 per coin. Unlike bitcoin, which has crashed repeatedly in its short history, TerraUSD was pitched as a harbor from volatility. It slipped below $1 earlier this month and was trading around 3 cents on Friday."

Luna Terra crash brought wide spread ripple effect of suspended trading, paused or suspended withdrawals, and liquidation in a number of crypto firms

Calls for (Self) Regulation

- **Regulate it like a financial asset: Securities-like regulation**
  - **The duct test: If it looks like a duck, swims like a duck, and quacks like a duck, then it probably is a duck.**
  - If consumers treat crypto as an investment asset, and not a currency, or payment form, then regulate it like a financial investment.
  - Disclosure rules, regulate the exchanges, regulate market manipulation/insider trading
- **Regulate it like a consumer financial product**
  - Large presence of retail investors (compared to institutions)
  - Duty to explain, appropriateness rules, rules on advertising/marketing
- **Possibility of self-regulation and international coordination**
  - After Luna crisis, more governments (US, Korea) and international bodies like IOSCO, FSB are working towards regulation
  - Crypto industry insiders calls for crypto (self) regulation.
  - Crypto industry self regulatory organizations (or lobby groups) arise.
  - More than 19,500 different cryptocurrencies makes it difficult for a single regulator with limited resources to oversee entire industry- makes the case for self regulation
  - The ability of crypto to store and transfer data makes it easier for the crypto industry to oversee transactions
- US lawmakers' (Lummis and Gilibrand) crypto bill calls for a crypto SRO

How can we design an effective self regulatory regime for crypto assets?

- The Industry Factor:
  - Organized industry? Yes, crypto SROs exist in some jurisdictions, some outside of the US (i.e., Virtual Commodity Association, Association for Digital Asset Markets, Global DCA)
    - Crypto currency exchanges follow the development of US securities exchanges
  - Motivation to comply? Yes
    - “Tragedy of Commons” or “Community of Fate” type situation? Luna Terra crash shows that blockchain systems are interconnected and a small number of exploitive “bad players” can crash the entire system.
    - The industry has a vested long term interest in promoting mass adoption of crypto. Trust in crypto is imperative for more crypto growth.

How can we design an effective self regulatory regime for crypto assets?

- The Regulatory Structure:
  - Currently there is no regulation, so new regulation should internalize externalities from non-compliance
  - The requirements of the laws should be objective in terms of outcomes.
  - Which regulator would have the expertise of the “auditor” : in the US SEC and CFTC are running as crypto regulators and they would have the experience as a market regulator

- Difficulties to self regulate crypto:
  - U.S. securities laws achieve investor and market protections based on the assumption that there is and will always be a centralized entity
  - Decentralized nature of crypto might defy “centralized” self regulation

III. Self Regulating (Digital) Consumer Lending

Digital Consumer Lending

- Fintech platforms proliferate
- Non-bank lenders or alternative lenders, not subject to intrusive "bank like" regulation
- Heterogeneous in nature of products, business models
- Too many to regulate: regulators lack the resources to properly regulate. Lack of consumer protection at the fringes of the finance industry.
  - There are **approximately 23,000** payday lenders in the U.S., almost twice the number of McDonald's restaurants.
  - As of November 2021, there were **10,755 fintech** (financial technology) startups
  - In 2019, a total of **5,508 financial institutions**—banks, savings associations, credit unions, and nondepository mortgage lenders were in the mortgage lending business
- Issues
  - Short Term High Cost Lending: predatory lending, high interest rates, repetitive loans
  - Buy Now Pay Later (BNPL) industry (i.e., Affirm, Afterpay, Klarna, PayPal, and Zip)
  - P2P lending

How can we design an effective digital) lending self regulatory regime?

- The Industry Factor:
  - Organized industry? No.
  - Motivation to comply?
    - "Tragedy of Commons" or "Community of Fate" type situation? Maybe not.
    - Borrowers who in need of money will borrow no matter what, even from non-regulated loan sharks.
      - i.e. in states where payday lending is illegal, borrowers go to car title loans
    - Heterogenous industry: many different type of borrowers

- The Regulatory Structure:
  - Fragmented. Unlike the crypto case, consumer lending was regulated for decdades but lacks comprehensive regulatory scheme.
  - CFPB oversees consumer lending for compliance with federal consumer financial laws. But consumer lending laws (i.e., predatory lending, interest rate regulation) differ across the states.
  - Makes it more difficult to "reform" regulatory structure to incentivize self regulation

Some global examples:

- Indonesian Fintech Lenders Association is a self-regulatory organisation that works in tandem with the Indonesian regulator to regulate peer-to-peer or P2P lending apps.
- Australian financial technology (FinTech) sector's to self-regulate the disclosure requirements for small business lending
- Australian BNPL self regulation(lacks the force of law) (https://www.paymentsjournal.com/australian-bnpl-self-regulation-a-good-start-though-it-lacks-the-force-of-law/)

Thank you.

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