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Nov 9 • 20 tweets • fintechjunkie/status/1590476938753507333

Another day another meltdown in the crypto space. Smarter minds than mine are unpacking the details of what's happened and what comes next.

But I thought it would be worth explaining "the issue behind the issue" and when your money might not be safe!!!! 🧵 👇

To understand the meltdowns, you have to start with the functions of the entities that you entrust your money with.

Some entities focus on delivering a single product or service while other entities have a suite of products and services that they manage.

A full-service Financial Institution (FI) manages hundreds of products that can be bucketed into a few major categories:

👉Storage of money (deposits)
👉Movement of money (payments)
👉Lending of money (lending)
👉Asset management (investing)
👉Transference of risk (insurance)

Some products can be managed as independent business lines (manufacture a solution for $X and sell it for $Y) while others only work when bundled (i.e. – the output of one product is the input for another product).

Bundled products are complex beasts that require a diverse set of skills to manage well.

And bundled products that transform assets into yield producing liabilities are definitionally introducing risk to the system.

This is at the core of the "issue behind the issue".

The issue starts with most crypto consumers wanting two things at the same time:

👉Safe and freely accessible storage of money
👉Yield generation

These are two activities that people naively expect to be bundled because they're accustomed to Banks paying interest on deposits!

Technologists should be able to manage the first set of activities because they require technical solutions (a digital ledger).

But it's unclear whether these institutions have the skills to manage the transformation of short-duration assets into yield producing liabilities.

Banks understand how to transform short duration assets into yield producing liabilities.

Banks understand how to track and manage complex annuity-oriented businesses.

Banks understand how to assess and manage individual and counter-party risk.

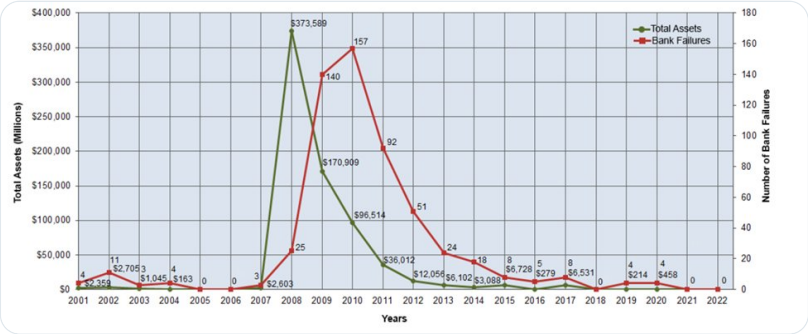
Banks understand lending.

But even with the right people and policies in place, Banks rely on safety nets to protect customers against exogenous events and sloppy execution.

The cost of these safety nets is baked into the system and they've been needed many times in the last hundred years of Banking.

For instance, Banks by their very nature are "risk balanced" or "low risk" entities and even then the safety net of FDIC insurance has come into play more frequently than one would think.

(561 Bank failures since 2001 ---- Wowsers!)



What about hedge funds?

Hedge funds invest money, but unlike Banks, they can walk away from poor decisions with impunity because the money being lost is wealthy people's money.

Wealthy people invest in hedge funds with a buyer beware mindset and sometimes they get burned.

One answer would be to separate the “storage” services from the “yield generation” services which would allow technologists to do the things they do best without putting their consumers’ deposit at risk.

Guess what? This concept already exists. It’s called a Custodian Bank!

A Custodian Bank is a specialized FI responsible for providing securities services. It safeguards assets and is not engaged in "traditional" commercial or consumer/retail banking.

Versions of Custodian Banks are emerging in the crypto world and it’s a healthy development.

These institutions can focus on storing and protecting digital assets without feeling the pressure to generate yield through lending activities.

And customers will almost certainly have to pay for these services because there’s no free lunch.

And in case you’re wondering (because who isn’t), the meltdowns are going to accelerate the Regulation of the crypto industry (at least in the US).

Regulation ALWAYS follows complaints and damages and it’s now easy to point to both.

On one end of the spectrum, crypto is fully transparent, auditable, and formulaic but difficult to onboard and understand (DeFi).

On the other end of the spectrum, crypto is centralized, opaque, and judgment based but very easy to onboard novices (CeFi).

There are risks that come with DeFi and CeFi solutions but what’s clear is that neither solution is bullet proofed nor ready for mass adoption.

Many hundreds of thousands of customers (possibly millions) have been hurt by crypto meltdowns and the lack of protection in the space.

The true unintended consequence of unclear regulation is that customers are taking on risk positions with little transparency and no oversight.

There are many bad actors, loads of incompetent decision makers and no safety net.

The system is broken for the mainstream consumer.

The “issue behind the issue” is clear. Its solution isn’t as straight forward.

Firms will have to “do less” or “do more with oversight”.

But what's clear is that being bad at managing complex financial products is the stuff that nightmares are made of.

Here's a quick link to the first tweet in case you want to like and share!

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