March 31, 2023

Edition No. 3

MARKET WRAP

by SPEX Analysts

Binance CEO Changpeng Zhao

The Crypto Crackdown

by Diya Patel

SBF and CZ. If there's one thing cryptocurrency enthusiasts love, it's a good abbreviation. Back in November of 2022, the FTX collapse left Sam Bankman-Fried in hot water, with Changpeng Zhao safe on dry land. But now tables have turned for CZ. On March 27th, the Commodity Futures Trading Commission (CFTC) filed a lawsuit against Binance and CZ for deliberately subverting US law. The suit claims Binance allowed customers to use VPNs to make illegal trades from within the US and notified "VIP" customers when regulators were investigating their assets.

As expected, CZ denied these claims, calling it an "incomplete recitation of facts." In 2022, Bianance handled $23 trillion of trades with 16% of their derivatives revenues coming from the US; an important number as the lawsuit comes with the threat of a potential ban on US derivative trading.

"Binance's reliance on a maze of corporate entities to operate the Binance platform is deliberate; it is designed to obscure the ownership, control, and location of the Binance platform."
– CFTC Complaint

After the fall of FTX, the crypto market has had major liquidity issues. However, while this lawsuit is many things, it does not seem to be a repeat of FTX.

For Binance, the filing has led to $1.6 billion worth of withdrawals within just a few days but most experts project that Binance's reserves are strong enough to withstand the pressure and a Silicon-Valley-Bank-level event seems unlikely. In fact, despite an initial dip, Bitcoin's price has stabilized this week.

However, the larger implications of the Binance lawsuit come with the fact that it is indicative of lawmakers' stronger antagonism towards crypto exchanges. Like a row of dominoes, lawmakers are naming more and more crypto exchanges as "next" on the regulatory hit-list. The SEC filed a lawsuit against Ripple Labs and Tron while also threatening action against Coinbase. Not even celebrities are safe, as Lindsay Lohan and Soulja Boy have been served with lawsuits for their promotion of crypto.

Many cite the sheer scale of the chaos left in the wake of FTXs collapse as the reasoning for lawmakers' recent emboldenment. The mass bankruptcies and bank runs have given justification for regulators to step in and tame the masses. Still, regulators must also regulate their own actions. Putting too much pressure on crypto operations in the US can push exchanges out of the US and at that point, the US would be left with no control over how the sector is run. The US's recent actions imply they are actively trying to suppress crypto. After all, what central bank would want an alternative to fiat currency?

Yet this sentiment leaves concerns that restrictions on crypto could subdue financial autonomy in an undemocratic way. In the past few months, crypto has demonstrated its usefulness by allowing $100 million in aid to reach Ukraine and promoting the de-concentration of digital power in an era of surveillance capitalism. So as regulators pursue action against Binance the question of cryptos costs and benefits loom over the trial.

In This Edition:

Law Makers Unite Against TikTok

Is TikTok selling American Data to the Chinese Government?

by Maryama Warsame

Photo of CEO Shou Zi Chew taken at the hearing

On Thursday, March 23, 2023, the House Committee on Energy and Commerce panel interrogated TikTok's CEO Shou Zi Chew for five hours. Both Democratic and Republican members of the committee perceived TikTok as a national security threat. Their concerns stem from Tiktok's Chinese parent company, ByteDance.

The hearing started with Chair Cathy Rogers (R-WA) accusing TikTok of collecting American user data that can potentially be used by the Chinese Government to "manipulate America". Chair Rogers was eager to call for a ban on TikTok because of its proximity to the Chinese Government.

Chew acknowledges the national security concerns pertaining to TikTok's parent company. He stated that ByteDance is not controlled by the Chinese government but that it's privately owned with five board members three of which are American. He adds that TikTok is headquartered in Los Angeles and Singapore and is even banned in China. Chew further defends TikTok by highlighting the Project Texas Initiative.

Although there is still legacy U.S. data stored outside of the country Chew tries to ensure that data is in the process of being deleted. Project Texas is the $1.5 billion plan to store American data in servers operated by Oracle, an Austin-based tech firm.

According to Chew, U.S. user data is stored automatically by an American-based company, Oracle, and overseen by TikTok U.S. Data Security. Towards the end of Chew's opening remarks, he establishes that the possible security threats, privacy concerns, and content manipulation are not specific to TikTok but can be applied to many tech firms.

During the hearing, some of the concerns lawmakers highlighted were not unique to TikTok. Representative Cammack (R-FL) presented a TikTok that shared threatening content toward Chair Rogers. While the video should have been flagged immediately, Chew points out that this is not an issue specific to TikTok. For example, Facebook has had its fair share of displaying harmful content.

Ban on TikTok would be unprecedented

In 2020, Trump's administration tried forcing TikTok's hands by urging ByteDance to divest its ownership of the company. This plan ultimately failed. And while it's important to be vigilant of potential threats to national security there is no evidence to conclude that TikTok is colluding with the Chinese government.

Another way to look at this issue is the U.S. Government's lack of regulation in data and privacy. TikTok is not the only social media outlet that collects, vast amounts of data. The European Union has the General Data Protection Regulation that can control what and how much data companies can collect on their consumers. Instead of proposing bans, Congress can enact stricter laws to regulate data harvesting that big corporations conduct like the EU.

Lastly, what would a ban on TikTok look like? TikTok has over 150 million American users. Many users have used their social media platforms to create content as a mainstream of income. TikTok has become one of the main sources and consumption for influencer marketing. A ban at this capacity could have detrimental economic impacts, especially for the influencer economy.

Undead Finance

by Sanidhya Bajoria

Jerome Powell; Chair of the Federal Reserve

The stability of the financial markets may give the impression that America's banking crisis is over. After March 12, there have been no further unsuccessful lenders. Stock prices for banks seem to be leveling off at a level that is around 25% lower than where they were at the end of February. Officials are now informing congressional hearings about the lessons to be learnt rather than putting out financial flames. President Joe Biden says the administration has done “a pretty damn good job”.

Yet, America has a long way to go before its small and midsize banks' issues are resolved. The fundamental reasons why the markets are calm are because the federal government is backing up the system. This implies that the economy may yet experience a crisis with a slower onset.

The fundamental issues are obvious. As of March 15th, banks outside of the top 25 institutions had lost $141 billion in deposits this year, which is almost 5% of the total amount of deposits not covered by government deposit insurance (which is restricted at $250,000 per customer). Unrealized losses for banks totaling roughly $4 trillion in combined assets are more than half their core equity safety buffers. Losses on commercial real estate loans might further reduce this buffer for smaller banks. Some lenders’ losses are probably far worse.

The banks have received considerable and indiscriminate support, which has kept things calm. Via facilities that provide loans worth more than the securities pledged as security, the Federal Reserve had lent $164 billion as of March 22. Additionally, the Fed and the Treasury have made strong suggestions that they will assist uninsured depositors if other banks collapse, as they did with the Silicon Valley Bank clients (SVB).

It appears that these efforts have been effective in curbing deposit flight. But, bailing out institutions with unrealized losses creates new issues of its own. The risk is that they turn into zombies, keeping money invested in unproductive legacy assets, an issue that most recently beset America in the 1980s, Japan in the 1990s, and Europe in the early 2010s. One risk is that zombies might reduce lending in an effort to boost their capital ratios. Another is that once rising interest rates starts to come into effect, they delay realizing losses that could yet occur on their loan portfolios. First Citizens Bank is now purchasing $72 billion of SVB’s loans at a discount of more than 20%, indicating that it anticipates further defaults. The consequences of ignoring losses these losses can be severe: in Japan it contributed to a “lost decade” of economic growth.

To avoid zombification, banks must quickly recognize losses and replenish their capital. Megabanks must mark to market a large portion of their securities portfolios when calculating their safety buffers; smaller banks should be required to do the same. Policymakers should conduct stress tests to determine what would happen to banks ’capital cushions if all their unrealized losses crystallized during a run and if interest rates continued to rise. Banks that appear to be too risky should be forced to recapitalize by suspending dividends and should be discouraged from attempting to improve their capital ratios by lending less.

A key test to check the Fed’s will to curb this zombification is whether it will close its emergency facility in March 2024 as planned. If it is extended, and Congress expands deposit insurance without addressing the underlying issues in the banks, zombies may proliferate. Worryingly, even with extended support, some banks may not be able to return to profitability and may take large risks in order to be resurrected, effectively gambling with taxpayer money. Banks are supposed to move trillions of dollars of capital around the country, but they may end up being a drag on the economy.

Silicon Valley Bank Headquarters