SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

"CRYPTOCURRENCIES: WHAT ARE THEY GOOD FOR?"

July 27, 2021 – 10:00AM

OVERVIEW

On Tuesday, July 27, the Senate Committee on Banking, Housing and Urban Affairs held a hearing entitled, "Cryptocurrencies: What Are They Good For?" During the hearing, Senators and witnesses discussed: cryptocurrencies relationship to the traditional financial system; intermediaries; decentralized finance; regulations; international standards; Filecoin; FedNow Service; and cryptocurrencies impact on climate change.

OPENING STATEMENTS

- Chair Sherrod Brown (D-OH)
- Ranking Member Pat Toomey (R-PA)

WITNESS PANEL

- Ms. Marta Belcher, Chair, Filecoin Foundation
- Mr. Jerry Brito, Executive Director, Coin Center
- Professor Angela Walch, Professor of Law, St. Mary's University School of Law

QUESTION AND ANSWER SUMMARY

Cryptocurrencies Relationship to the Traditional Financial System

Chair Sherrod Brown (D-OH) inquired if cryptocurrencies give "outsized power" to sophisticated investors. Professor Walch argued that decentralized finance can be "misleading." She asserted that software creators have concentrated "pockets of power" because they are responsible for operating the system, and cryptocurrency miners have the power to decide what order the transactions go onto the ledger. She argued "miner extractable value is seen as potentially a killer for the idea of cryptocurrencies."

Chair Brown asked about the risks cryptocurrencies pose to financial stability and if cryptocurrencies can run parallel to the traditional financial system or if they have to become integrated. Professor Walch stated there are already links between investments in cryptocurrency and the traditional financial system. She noted that if there is a malfunction in any cryptocurrencies' software, this could impact every single investor in cryptocurrency which could then spill over into the traditional financial system. She asserted the larger the cryptocurrency system becomes, the larger the associated risks will be.

Ranking Member Pat Toomey (R-PA) asked if Congress should be concerned about problems developing in the cryptocurrency space "cascading" into the traditional financial system. Mr. Brito pointed to experts who have argued the volatility in cryptocurrency does not impact the traditional economy. He asserted it is important to examine the linkages between the two and ensure they are supervised and regulated. He also emphasized the importance of creating adequate guardrails for hedge funds and other financial institutions to ensure malfunctions in cryptocurrencies do not decrease the value of the financial vehicles that invested in them.

Sen. Cynthia Lummis (R-WY) asked Mr. Brito if virtual currency and distributed ledger technology (DLT) can reduce the cost of financial transactions and create a more efficient financial system. Mr. Brito pointed to property registries and title insurance as an opportunity for DLT to improve efficiency in the chain of property titles. He explained with cryptocurrency ledgers the potential for corruption in the title insurance process could be greatly reduced and could eliminate the need for title insurance altogether. Sen. Lummis then inquired if the transparency of open-source finance can ensure a level playing field, promote financial inclusion, and create trust in the financial system. Mr. Brito emphasized "there is still work to be done in the open source finance space," but the transparency of the system can make it easier to address transaction issues.

Sen. Lummis then inquired if most virtual currencies are recorded on a publicly available ledger. Mr. Brito answered in the affirmative. Additionally, he highlighted that law enforcement finds this information useful because it creates a trail to find the criminals abusing the systems.

Sen. Bob Menendez (D-NJ) asked if retail businesses, like grocery stores and pharmacies, should only accept cryptocurrencies and not allow customers to pay with cash. Mr. Brito argued that cryptocurrencies should be accepted only in a physical store. Ms. Belcher noted that cryptocurrencies are not intended to be a competitor with the dollar, but instead used for specific purposes such as file storage. Professor Walch expressed concern with only permitting cryptocurrencies in a store because not everyone has access to digital financial services.

Sen. Steve Daines (R-MT) asked if cryptocurrencies will disrupt the Society for Worldwide Interbank Financial Telecommunication (SWIFT) payment network and if the two systems could coexist. Mr. Brito emphasized the SWIFT network would not be disrupted. He explained cryptocurrencies are "not just about moving money," rather they are open networks for verifying distributed ledgers and filing storage.

Sen. Elizabeth Warren (D-MA) asked if cryptocurrencies are safer and more secure than the traditional financial system. Professor Walch asserted that cryptocurrencies have characteristics that make it resistant to hacking, but it is a misnomer to argue that any system is "absolutely secure." She reiterated that cryptocurrency miners can use their power to reorganize the blockchain in certain circumstances. Sen. Warren then asked if cryptocurrencies are insulated from the risks that make the traditional financial system vulnerable to financial crises. Professor Walch argued the risk that occurs in the cryptocurrency space affects the cryptocurrency sector and the traditional financial system.

Sen. Jack Reed (D-RI) questioned how the financial system could be compromised by cryptocurrencies. Professor Walch explained one of the original motivations of developing cryptocurrencies was to create an alternative financial system and monetary system. She added this was due to a lack of confidence in the existing financial system being operated by the government. She argued cryptocurrency is seen as a "safety valve" for the collapse of the existing system.

Intermediaries

Sen. Reed asked how to authorize intermediaries in the cryptocurrency system. Professor Walch stated, "The middlemen between one person sending cryptocurrency are the miners." She explained a "transaction does not show up on the blockchain unless a miner puts it there." She expressed concern about the power miners have in choosing, ordering, and potentially delaying transactions. She also noted that China made it illegal for miners to participate in the cryptocurrency market, which resulted in many migrating to the United States. She also emphasized the importance of recognizing miners as intermediaries and ensuring their role is regulated in the system.

Ranking Member Toomey inquired about the power cryptocurrency miners have through controlling transactions on the blockchain and the role they play in the validation process. Mr. Brito explained “miners cannot redirect, steal, or initiate a user’s payment; however, they can affect the order in which payments are confirmed on the blockchain.” He also noted miners cannot block a transaction. He argued traditional trading in the financial market poses a similar problem. He stated, “This is why high-speed traders build propriety infrastructure to get their trades in quickly.” Ranking Member Toomey then inquired if miners should be thought of as intermediaries. Mr. Brito acknowledged that technically miners are intermediaries; however, he argued they are not considered traditional financial intermediaries.

Decentralized Finance
Ranking Member Toomey questioned if cryptocurrency is necessary to deliver decentralized storage. Ms. Belcher explained “cryptocurrency creates incentives for people to contribute their resources to maintain their network, or in this case contribute to file storage.” She added the same storage that enables individuals to transfer money or value instantly, without intermediaries, also verifys that files are being properly stored.

Sen. Warren inquired whether cryptocurrency is truly decentralized. Professor Walch explained that cryptocurrency does not have a central party, but there are “pockets of power” within these systems. Specifically, she highlighted the core software developers and miners that can “exploit their position of power to affect users.”

Regulations
Sen. Daines asked if overregulation of cryptocurrencies could hurt innovation. Ms. Belcher argued there are efficient and sensible existing regulations in the space, stating it is unnecessary to add additional laws that are only applicable to cryptocurrencies. She acknowledged concerns regarding fraud in the system but reassured the Committee that the Consumer Financial Protection Bureau (CFPB) and the Securities Exchange Commission (SEC) could adequately address fraud in the system. She also stated the existing CFPB and SEC regulations are efficient ways of ensuring the space is regulated without adding additional rules.

Sen. Jon Tester (D-MT) asked how cryptocurrencies should be regulated. Professor Walch stated Congress needs to pass additional regulations in the cryptocurrency space because it is meaningfully different from the existing financial system. She noted, during the past 10 years, “a lot of time has been spent debating about how cryptocurrency fits into an existing complex regulatory scheme.” Mr. Brito also highlighted that the U.S. does not regulate technologies, but rather activities and these risks should be regulated. Ms. Belcher emphasized that cryptocurrency is currently “heavily regulated” through on-ramps and argued the regulations should not be specific to cryptocurrency.

International Standards
Sen. Menendez asked how to avoid digital assets undermining the efficacy of the U.S. sanctions regime. Professor Walch argued that part of the vulnerability to ransomware in the United States comes from a lack of cybersecurity practices. She also stated the vulnerabilities might be tied to the liability framework around software development and recommended the creation of an accountability framework for software development to prevent ransomware attacks.

Sen. Menendez inquired what tools are available to financial institutions and regulators to prevent the use of mining to avoid sanctions. Mr. Brito asserted there is no action that prevents individuals from mining. He argued it is critical to have “on-ramps” that are regulated. He pointed to anti-money laundering regulations as an example of how to regulate cryptocurrency exchanges to follow the “Know Your Customer” (KYC) process and work with law enforcement. He also noted that overseas there are still exchanges that do not comply with U.S. regulations.

Sen. Tester asked about using cryptocurrencies for ransomware payments. Ms. Belcher argued that ransomware is not a cryptocurrency problem but a cybersecurity one. She noted many crimes have also been committed with cash, but the crimes committed with cryptocurrency can be tracked and recovered by law enforcement.

Sen. Mark Warner (D-VA) asked if there should be an international standard not only for digital currencies but also across the financial system. Professor Walch concurred with Sen. Warner's concerns regarding foreign compliance with money laundering laws. She emphasized the importance of developing a framework that sets a standard for cryptocurrencies and anti-money laundering laws in all countries. She added global bodies, such as the G20 and the Bank for International Settlement, have facilitated discussion surrounding international standards; however, no formal agreements have been made. Ms. Belcher also emphasized the importance of implementing measures to protect privacy around the issues of foreign countries issuing a central bank digital currency (CBDC) and digital surveillance.

Sen. Reed inquired about China's priorities in the cryptocurrency market. Professor Walch stated there is speculation that China and other nations feel threatened by cryptocurrency because it is an "alternative, non-sovereign financial system."

FedNow Service

Sen. Chris Van Hollen (D-MD) asked how to evaluate the relative benefits and risks associated with blockchain and cryptocurrency as a means to provide faster payments. Professor Walch stated, "Cryptocurrency can be fast, but typically because they are probabilistically settled there is no legal finality on blockchain." Mr. Brito added that cryptocurrencies are not going to compete with FedNow efforts. He also noted cryptocurrencies allow individuals to engage in "micro transactions," an action that is not economical in the traditional financial system.

Cryptocurrencies Impact on Climate Change

Sen. Tina Smith (D-MN) inquired how to stop cryptocurrencies from becoming a "significant contributor" to climate change. Ms. Belcher explained that different cryptocurrencies have different "proof systems that use different amounts of energy." She also highlighted that some major cryptocurrencies have switched over to less energy proof systems, such as Ethereum which is now using the "Proof of Stake" validation mechanism compared to the "Proof-of-Work."

Please click here for the archived hearing.