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FTX: The Lehman Brothers of 2022- Does it Count as a Lesson for the Indian Crypto Regime?

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ABSTRACT

2022 became a year of lessons for the Crypto world, it brought an end to the 'Cryptocurrency age of Innocence. It brought to light, the fallacies of the Crypto world, which shook the core of the global digital asset market. The sudden collapse of FTX unearthed multiple fundamental, regulatory, and0 policy-based flaws that have plagued the cryptocurrency industry at large. The following essay outlines the events that led to the Lehman moment of the crypto world- FTX collapse. The paper puts a focus on the history of the two most catastrophic economic events that shook the global economy, that is, the collapse of Lehman Brothers and FTX, bringing how these two events, though occurring in two different decades have become a lesson for investors all over the world. Research methodology along with an analytical study has been used to draw out the several risks as well as liquidity imbalances between the assets and liabilities of FTX, which manifested directly in the collapse of the exchange and subsequently led to contagion effects across a range of financial market products. It also, uses qualitative and quantitative analysis, to study the effects that the FTX collapse has had on the crypto regime in India and how India must come up with an effective regulatory framework.

Keywords: *Cryptocurrency, economic crisis, digital assets, regulatory framework.*

I. INTRODUCTION

As 2022, came to an end, the crypto-world came crashing down with the collapse of one of the largest "cryptocurrency exchange and crypto hedge funds -FTX". Though the crypto world is known to be a world full of twists and drama, with fortunes touching skyscrapers as well as disappearing within seconds, the FTX collapse sent shock waves through every blockchain that exists on the web. This collapse has now been given the term"the Lehamn moment of the crypto-world". The most serious domino fall which triggered the 2008 'financial crisis' in the last decade was the collapse of the fourth largest investment bank of that time "Lehman Brothers".

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It had $639 billion in assets and $613 billion in liabilities. [3]

It had, had very 'humble beginnings' with three brothers Henry, Emanuel, and Mayer Lehman starting a general store wherein, Farmers paid for their goods with cotton, which led the company into the cotton trade in Montgomery, Alabama, in 1844. Eventually, after Henry died, the rest started to expand their business by entering the world of 'commodities trading and brokerage services'. It became one of the most resilient investment banks in the USA, surviving the railroad bankruptcies of the 1800s, the Great Depression, two world wars, and a capital shortage when it was spun off by American Express (AXP) in 1994 in an initial public offering, and the Long Term Capital Management collapse and Russian debt default of 1998[4]

All seemed well with Lehman's estate business booming, enabling revenues in the capital market to even surge 56% between 2004-2006. The firm securitized $146 billion of mortgages in 2006—a 10% increase from 2005. Lehman reported record profits every year from 2005 to 2007. In 2007, it announced $4.2 billion in net income on $19.3 billion in revenue.[5]

Its stock price even reached a record high of $86.18 per share in February, 2007giving it a market capitalization of nearly 60 million dollars. However, Lehmans' headlong rush into the "sub-prime mortgage" market proved to bring the Bank to its knees when the cracks in the US housing market became apparent. Defaults on subprime mortgages began to rise to a seven-year high. On March 14, 2007, a day after the stock had its biggest one-day drop in five years on concerns that rising defaults would affect Lehman's profitability, the firm reported record revenues and profit for its fiscal first quarter. The slowdown in the housing market to defaults made mortgage loans grow. As a result, Bear Sterns- Lehman's competitor went down in flames. Lehman tried to save itself, by boosting market confidence through equity fundraising in the early summer of 2008. Yet, this turned out to be a lost cause as in September 2008, it reported "an anticipated third-quarter loss of nearly $4 billion. On top of this, it reported a $5.6 billion loss in toxic asset write-downs."[6]

The Lehman stocks then plunged to 77% in the first week of September 2008, amid the crashing equity markets worldwide. It now became a 'sinking ship' with the swelling of credit default

[3] https://www.investopedia.com/articles/economics/09/lehman-brothers-collapse.asp

[4] Yale School of Management. "The Lehman Brothers Bankruptcy A: Overview," Pages 3-5.

. With lots of hope, the 'Lehman Brothers' had made its way into the arena of mortgage-backed securities and collateral debt obligations, by acquiring five mortgage lenders along with BNC Mortgage and Aurora Loan Services, which specialized in Alt-A loans. These loans were made to borrowers without full documentation.

International Journal of Accounting Research. "What Caused the Failure of Lehman Brothers? Could it have been Prevented? How? Recommendations for Going Forward," Page 1.

[5] International Journal of Accounting Research. "What Caused the Failure of Lehman Brothers? Could it have been Prevented? How? Recommendations for Going Forward," Page 1.

[6] https://corporatefinanceinstitute.com/resources/capital-markets/lehman-brothers/

swaps on Lehman's debt, as well as with the backtracking of major hedge fund investors and when a final attempt fell through by attempting buyout deals by both Bank of America and Barclays, it had no other option, but to file for Bankruptcy on September 15, 2008. This set off the domino effect in the chain of events that led to the Global Financial crisis of 2008.

Now looking at the crypto world, FTX, once known as one of the "Blue-Chip companies", FTX was one of the most stabilized, well-capitalized companies which survived even when the rest of the crypto world was having a roller-coaster ride. It was the leading centralized cryptocurrency exchange that became the world's third largest by July 2021, dealing primarily with derivatives.[7]

It was founded in 2018 by MIT Graduate, Sam Bankman-Fried. It had even spent most of its early 2022, bailing out other crypto investors, and "was generally regarded by investors as a responsible, grown-up firm that didn't engage in risky, speculative trading or gamble with customers' funds."[8]

It was all calm before the storm hit up for FTX, when the leading news site specializing in bitcoin and cryptocurrencies, 'CoinDesk' came out with a report which highlighted potential leverage and solvency concerns associated with FTX-affiliated quant trading firm Alameda Research. It revealed that the latter held a position of $5 billion in FTT, which was the native token of FTX. In early November 2022, the exchange and the companies in its orbit began a steep fall from grace. However, problems arose, when Bahamas-based FTX and its FTX US affiliate had overlapping management teams but separate capital structures. It is to be noted that U.S. residents could only trade through FTX US. Taking into account the volatility, of the crypto world, FTX and FTX US crashed due to a lack of liquidity and mismanagement of funds, followed by large volumes of withdrawals by investors. The value of FTX nosedived, taking with it other cryptocurrencies like Ethereum and Bitcoin down to two years low by Nov 9, 2021. This led Binance, the world's biggest crypto exchange to sell its entire position in FTT tokens- roughly 23 million FTT tokens valued at about $529 million. Binance clarified that such a decision was made only because of assessing the risk management post the collapse of another crypto token, Terra in 2022. Consequently, FTX started facing a liquidity crisis. Even though Bankman-Fried tried to assure the FTX investors that its assets were stable, its customers demanded withdrawals worth $6 billion within days post the "CoinDesk" report. The value of FTT fell by more than 80% in two days.

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[7] a type of financial contract whose value is dependent on an underlying asset, group of assets, or benchmark. and leveraged products.

[8] https://www.nytimes.com/2022/11/09/technology/cryptocurrency-binance-ftx.html

Bankman-Fried even tried to save FTX by reaching a non-binding agreement, wherein Binance was supposed to buy the non-U.S FTX for an undisclosed sum. Unfortunately, FTX had to meet its end, when Binance backed off the deal when it canceled the deal after due diligence raised concerns regarding the mishandling of customer funds, among other issues. Eventually, it filed for bankruptcy on November 11, 2022, after a surge of customer withdrawals earlier in the month. Within hours of filing for bankruptcy, FTX alleged it was hacked. The exchange noted "unauthorized transactions" that may have stolen close to $500 million in assets, and which were spotted by Elliptic, a crypto compliance service. The hacker continued to drain wallets for several days using what analysts called "on-chain spoofing." The hacker reportedly then invested those funds in Ether (ETH).[9]

According to the bankruptcy filings, FTX had assets in the range of $10 billion to $50 billion and liabilities in the range of $10 billion and $50 billion.

As a result, 2022 became a game changer for the crypto market. This year became an eye-opener for all who swore by the digital asset market. The crypto market cap reversed in the final weeks of 2021 and 2022 after reaching an all-time high of $3,009 billion on November 10. On November 21, 2022, the bearish year drove the market capitalization of cryptocurrencies to a 2022 low of $727.58 billion[10].

The initial Terra Luna collapse changed the face of the crypto world, and when there was the "FTX-Alameda" fallout, the crypto came to the brink of a dangerous climax. It showcased the flaws of the industry, as well as the "enormous breach of ecosystem-wide trust".

Before the collapse of the FTX, in mid-November almost all assets were gearing themselves up for positive returns, however, the FTX collapse made 2022 one of the worst years for crypto investors. "The crypto market cap fell by 75.8% from its peak to its low. The market capitalization of crypto-currencies decreased by $1,429 billion (65.4%) to $756.15 billion at the end of 2022." [11]

The failure of FTX has sent the market into a 'nosedive', with the fraudulent activity which led to asset losses destroying crypto investors' confidence and attracting regulatory and legislative scrutiny.

"The FTX crash has hit many people. We estimate that 3-5 Lakh Indians would have had

[9] https://cointelegraph.com/news/ftx-hacker-is-now-the-35th-largest-holder-of-eth

[10] https://www.livemint.com/market/cryptocurrency/crypto-outlook-2023-what-are-the-emerging-themes-to-watch-out-for-11673796960788.html

[11] https://www.livemint.com/market/cryptocurrency/crypto-outlook-2023-what-are-the-emerging-themes-to-watch-out-for-11673796960788.html

exposure to the exchange and its token FTT. The investors who lost money in the FTX saga are in agony. It is unlikely that they will get all their investments back even if FTX receives extra funding via a takeover etc," Zee News, an Indian News Channel, quoted Giottus CEO Vikram Subburaj. [12]

When news like this hit the Indian Financial sector, it left the homegrown crypto investors pretty jittery. Indian crypto exchange platforms like CoinDCX and CoinSwitch Kuber had to reassure investors and traders about their reserves and exposure status. These exchanges claimed to hold sufficient reserves (in crypto and INR) to match their customers' funds and investments. Whether investors could solely rely on such assurances after the FTX fiasco became a matter of individual choice. After all, FTX founder and CEO Samuel Bankman-Fried continued to tweet till November 7 (which is now deleted) that everything was fine at FTX and it was just a competitor trying to malign the company.n India, 5 Million people have reportedly invested in FTT and lost their money.

The FTX collapse was just the final straw in bringing the Indian Crypto market to the dark ages, already many local incidents were leading to cracks in the foundation of the Indian Crypto regime, like, the GainBitcoin scam, which is one of the oldest and biggest crypto Ponzi schemes. A recent report by Inc42 estimates that the overall size of the scam could be around INR 90,000 Cr (based on the wallets operated by its key masterminds, the late Amit Bhardwaj and his associates). Earlier, the Pune police reported the scam size to be INR 2,000 Cr, and later, the ED estimated it to be INR 20,000 Cr.

For India, 2022, began with crypto scandals which dominated the Indian media throughout the year. The gloomy days for the Indian crypto regime began with the crypto trading platform WazirX knocking on the door of the Delhi High Court. The company filed a writ petition, seeking to set aside ED proceedings. In August, ED temporarily froze WazirX bank accounts with assets worth INR 65 Cr after raiding its parent company Zanmai Labs.

However, the probes were not limited to WazirX alone. The agency soon conducted search operations against 10 major exchanges, including WazirX, Binance, CoinSwitch Kuber, CoinDCX, Vauld, ZebPay, BuyUCoin, Bitbns, and Giottus, for Foreign Exchange Management Act (FEMA) or Prevention of Money Laundering Act (PMLA) violation. It also summoned crypto exchange founders to appear before the agency and submit certain details. This made all Indian investors nervous.

When Coinbase, a US-based crypto exchange, abruptly exited within a few days of its Indian

[12] https://inc42.com/buzz/ftx-collapse-has-impacted-nearly-5-lakh-indians-crypto-exchange-giottus/

launch and the Binance-WazirX merger-demerger led to the weakening of the once strong crypto base in India.

Looking at these catastrophic events, across the crypto markets, India's digital ecosystem needs a revamp and strengthening of the regulatory framework, to protect investors and maintain transparency. As of now, crypto entities don't need to disclose their 'proof-of-reserve data'. This is the reason why, investors have been demanding that all crypto exchanges must provide proof-of-reserve and periodic transparency reports. However, CoinDCX recently published its data, while WazirX said it would share the information soon. The latter publishes its transparency reports periodically. This is the reason why, Nomics, a leading cryptocurrency data company rated all Indian cryptocurrency exchange platforms a 'D', in terms of transparency.

"Regulations could have helped tackle situations like FTX collapse," Punit Agarwal, founder of the crypto tax platform KoinX, earlier told Inc42. "For example, proof of reserves and proof of liabilities must be provided by an exchange so that there's clear transparency between a CEX and its users."[13]

To make this framework successful, there needs to be strict adherence to user data reporting by all exchange platforms. Initially, the crypto industry did form an advocacy body called Blockchain and Crypto Assets Council (BACC) under the Internet and Mobile Association of India (IAMAI), to move towards self-regulation for better transparency and consumer awareness. However, in July 2022, the internet lobby disbanded BACC, citing an uncertain regulatory environment.

With the trio of Jandhan, Aadhar, and access to the Internet, Indian citizens have found themselves in this new era of digital assets, but, these developments give rise to questions, about whether can the Indian legal system keep up with the technological systems at a time where everyone needs consumer protection against such calamities of the crypto world. The speed of technological and digital advancement, if not matched with adequate safety aspects, could become a supervisory burden for global financial regulators.

When asked, how the FTX crash affected the Indian Crypto Regime Raj Karkara, COO of ZebPay crypto exchange, said, "The collapse of FTX and its native token, FTT, has been a shock for the entire crypto community. I am deeply sorry for those impacted by the subsequent fallout. We have seen significant industry players falter recently, and incidents like these reinforce the need for government regulation. It will ensure that all industry players follow a mandated code of conduct that safeguards investor interests. I will also urge investors to do due

[13] https://inc42.com/features/after-a-turbulent-year-2022-can-india-crypto-economy-make-a-comeback-in-2023/

diligence to select the right investment partners."[14]

All the existing laws need to be tweaked and incorporate crypto in such a manner, to come up with an effective regulatory framework suitable to be dynamic with changing times. However, this needs to be done with a deep understanding of the crypto industry, without plaguing the industry itself. There are many loopholes in the crypto world, which need to be addressed to avoid threatening the country's economic sovereignty. What India needs right now, is a decentralized manner of addressing the crypto regime rather than a centralized one. The framework needs to address the existing issues and should not become an issue in itself as and when it comes.

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[14] https://inc42.com/features/ftx-collapse-a-warning-bell-will-india-hurry-up-with-crypto-regulation-to-protect-its-investors/