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"Digital Assets and the Future of Finance: Understanding the Challenges and Benefits of Financial Innovation in the United States"

Testimony of Charles Cascarilla, CEO and Co-Founder of Paxos

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Introduction

Chairwoman Waters, Ranking Member McHenry and members of the Committee, thank you for this opportunity to appear before you today. My name is Charles Cascarilla, and I am the CEO and Co-Founder of Paxos. During my 22-year career in financial services as an analyst, investor and entrepreneur, I have witnessed the shortcomings and systemic risks of our financial market infrastructure firsthand -- and I've seen how digital assets, and the blockchain technologies they're based on, could solve many of those problems.

Paxos is a regulated financial institution and a blockchain infrastructure platform that offers a range of products primarily to institutional customers, including Bank of America, PayPal, MasterCard, Interactive Brokers, Credit Suisse, Mercado Libre, Societe Generale and many others.[1] In particular, we help large financial institutions provide their own clients with reliable, regulated access to digital assets.[2]

Paxos also offers a uniquely structured and regulated stablecoin, the Pax Dollar (USDP).[3] A true stablecoin is a type of digital token that is backed only by the assets held in reserve -- in this case, the U.S. dollar.[4] Because every one of our stablecoins is fully backed by one dollar, it is not volatile like other types of digital assets. However, it retains the same properties that have made this asset class so appealing: namely, it can be traded or transferred nearly instantly -- including overnight and on weekends and holidays -- with an extremely high degree of programmability, security and traceability. It is a "digital dollar."

Lastly, we recently completed a successful pilot program to offer same day securities settlement.[5] Earlier this year, the T+2 settlement cycle was thrust into the spotlight when Securities and Exchange Commission Chair Gensler testified before this Committee that "time equals risk." We at Paxos agree. The SEC is working to shorten the settlement cycle, and we're working to make that possible.

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[1] https://paxos.com/2021/09/09/how-paxos-powers-regulated-settlement-for-mastercards-new-payments-pilot-now-live-and-open-for-business/; https://paxos.com/2021/09/13/interactive-brokers-group-introduces-cryptocurrency-trading-through-paxos; https://paxos.com/2020/02/20/paxos-settlement-service-begins-settling-u-s-securities-trades-for-credit-suisse-and-instinet/;https://paxos.com/2021/12/02/mercadolibre-is-creating-the-biggest-crypto-market-in-latin-america-paxos-powers-the-experience/; https://paxos.com/2020/09/09/societe-generale-begins-settling-u-s-securities-trades-through-paxos-settlement-service/

[2] https://paxos.com/crypto-brokerage/

[3] https://paxos.com/usdp/

[4] https://insights.paxos.com/hubfs/USDP-whitepaper.pdf

[5] https://www.forbes.com/sites/ninabambysheva/2021/04/06/same-day-stock-settlements-are-here-using-paxos-blockchain-credit-suisse-and-nomura-instinet-hit-t--zero/?sh=8f70af838029; https://www.sec.gov/divisions/marketreg/mr-noaction/2019/paxos-trust-company-102819-17a.pdf

As you are well aware, there is an intense policymaking debate over how, or even whether, to regulate digital assets.

So let me be blunt. Regulation should establish a level playing field and safeguard consumers -- while still encouraging the innovation that helps ordinary people, especially those disadvantaged by the status quo. In fact, Paxos became the first regulated digital asset financial institution in the country when it was approved as a trust company by the New York State Department of Financial Services in 2015.[6]

With the right policy approach, digital assets and their related blockchain technologies can create a more efficient, secure and innovative financial system -- and by extension, a more inclusive and equitable global economy.

Our Current Financial System is Inadequate

The U.S. financial system is exceedingly slow. This is in part by accident and design. Virtually every other aspect of life has sped up. Computers make trading decisions in nanoseconds and yet moving the money can take days. It can take five days to transfer funds internationally.[7]

At any given time, there are trillions of dollars' worth of capital held up in transactions that have not yet settled.[8] Remittance recipients and other payees don't have access to their funds.[9] Money that could help others or be productively deployed is unnecessarily trapped in limbo. Whole industries have developed to take advantage of these delays, often to the detriment of those who can least afford it. How many overdraft fees could have been avoided if people received their money immediately after it was sent?

Our financial system has failed many groups, like minority families who have not been able to obtain mortgages and build generational wealth or have otherwise suffered from discrimination that prevented them from receiving loans they were qualified to receive.[10]

While other sectors speed into the future, the financial industry has been slow to adapt to changing technologies and shifts in consumer demand -- and remains vulnerable to some of the same dangers that caused the 2008 financial crisis. Simply put, our financial system is not ready to meet the needs of a digital-first society.

The global financial system suffers from unnecessary fragility and systemic structural problems that threaten major financial institutions and consumers alike. And it also blocks tens of millions of low- and middle-income Americans -- and billions of people worldwide -- from full participation and equitable inclusion.

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[6] https://www.dfs.ny.gov/reports_and_publications/press_releases/pr1505071
[7] https://www.inaa.org/how-long-does-a-wire-transfer-take/
[8] https://www.banking.senate.gov/imo/media/doc/Cascarilla%20Testimony%206-30-201.pdf
[9] https://www.pymnts.com/news/international/2021/remittances-remain-a-huge-business-psp-to-benefit-by-offering-blockchain-compatibility/
[10] https://lgbt-token.org/banks-lgbt-same-sex-mortgage-housing/

In the existing system, a person needs a bank account to get paid, safely store money, establish credit, earn interest and borrow. Yet according to the Federal Reserve, 18% of Americans are unbanked or underbanked.[11] That rate is much higher among historically marginalized groups. For example, 40% of Black adults and 50% of adults without a high school degree are unbanked or underbanked.[12]

Globally, about 1.7 billion adults lack a bank account.[13] More than half are women.[14]

The existing financial system is also expensive for users, with the burden falling disproportionately on those who can least afford it. In 2020, Americans spent $303 billion on credit card fees, subprime auto loan interest, money order fees, overdraft fees and other similar charges associated with everyday financial services primarily used by vulnerable households, according to a report from the Financial Health Network.[15] Among people who are unbanked, nearly half said they didn't have enough money to meet minimum balance requirements, according to an FDIC study.[16]

Perversely, our banking system is most expensive for the lowest-income consumers.

With Blockchain, We Can Replatform the Financial System

There is another path forward. Digital assets, and the blockchains they're built on, offer a better alternative.

Blockchains are distributed electronic databases for securely recording transactions. This is an oversimplification, but think of them almost like an Excel spreadsheet that anyone can join and can be viewed by everyone simultaneously. Each transaction -- whether it's a bank transferring digital assets to another bank, or a person using digital assets to purchase a cup of coffee[17] -- is documented in a "cell" of the spreadsheet through a series of complex math operations. Once a transaction is complete and a "cell" is locked, it can't be edited anymore. There's a clear, irreversible public record of the transaction.

Most importantly, these transactions don't need an intermediary -- like a clearing house or payment processor.

Blockchain technology will revolutionize the global financial system.

First, it is vastly more accessible to the unbanked, whether here in America or in developing countries. A person with a phone and an internet connection but no bank account can download a

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[11] https://www.federalreserve.gov/publications/2021-economic-well-being-of-us-households-in-2020-banking-and-credit.htm
[12] https://www.federalreserve.gov/publications/2021-economic-well-being-of-us-households-in-2020-banking-and-credit.htm
[13] https://globalfindex.worldbank.org/sites/globalfindex/files/chapters/2017%20Findex%20full%20report_chapter2.pdf
[14] https://www.weforum.org/agenda/2021/01/women-banking-digital-divide/
[15] https://finhealthnetwork.org/research/finhealth-spend-report-2021/
[16] https://www.fdic.gov/analysis/household-survey/2019execsum.pdf
[17] https://www.foodandwine.com/news/starbucks-bitcoin-frequent-flyer-miles-payment-gift-cards

digital asset wallet and use that to send and receive assets. Of the 1.7 billion unbanked adults around the world, the vast majority -- 1.1 billion -- own a mobile phone.[18]

Second, trading or transferring digital assets is instantaneous and available at any time. People can send or receive digital assets 24/7/365 -- there's no waiting around for wire transfers or money orders to arrive, or for banks and stock exchanges to open for business. Imagine how dramatically less productive our society would be if we could only email on weekdays between 9am and 5pm.

Third, transferring digital assets is often very inexpensive. In these early days, transaction fees can vary widely. However, they are often much less than the fees charged by conventional intermediaries, in some cases as little as a penny per transfer. This is partly because digital assets can move directly from user to user, rather than passing through an intermediary. And as more and more people and institutions embrace digital assets, transaction costs will keep dropping thanks to improving technology and network effects.[19]

Fourth, digital assets can help restore trust in financial services. In the FDIC study of unbanked Americans, 36% said they didn't trust banks.[20] Internationally, reports suggest that people in countries with less stable national currencies turn to digital assets at higher rates, seeing them as safer stores of value.[21]

Fifth, digital assets and blockchain platforms can reduce bias in finance. At its heart, blockchain is just a math equation -- it is totally agnostic to a user's identity. There's no collection of data on race, gender or proxies like geographic location. And no reliance on traditional credit scores. Instead, we have the opportunity to create platforms that strictly look at a user's assets and historical usage.[22]

This inherent neutrality appeals to groups that view their governments and financial systems with skepticism -- often with good cause. Digital assets are already more popular among marginalized communities. A Harris Poll conducted in June and July showed that 17% of Hispanic Americans and 23% of Black Americans said they owned digital currencies, compared to only 11% of White Americans. While only 13% of the general public own these assets, a quarter of LGBTQ people do.[23]

Sixth, in a world of increased cyber-security risks, the historical reliance on centralized ledgers creates fragility due to reliance on single points of failure.[24] The very nature of distributed ledgers increases redundancies, improves resiliency and largely eliminates the risk of systemically significant cyber security incidents.

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[18] http://www.brinknews.com/bridging-the-digital-divide-to-widen-financial-services-in-central-asia/

[19] https://www.federalreserve.gov/newsevents/speech/waller20211117a.htm

[20] https://www.fdic.gov/analysis/household-survey/2019execsum.pdf

[21] https://www.weforum.org/agenda/2021/02/how-common-is-cryptocurrency; https://www.afr.com/technology/bitcoin-s-growing-roots-in-unstable-economies-20210915-p58rxn

[22] https://blog.seagate.com/human/potential-effects-blockchain-credit-reporting-industry/

[23] https://finance.yahoo.com/news/black-latino-lgbtq-investors-see-100412051.html8

[24] https://www.reuters.com/article/us-usa-fed-fedwire/fedwire-resumes-operations-after-hourslong-disruption-idUSKBN2AO2I1

We Can Avoid More Financial Crises

Blockchain technologies have the potential to prevent or mitigate the kind of financial crises experienced over the last two decades. Consider how, during the Great Recession and its aftermath, mortgage foreclosures piled up, and a lack of documentation became a major problem.[25] Lenders and brokers failed to make sure fees and taxes were paid, failed to record deeds and failed to properly assign mortgage notes. This mess often caused lenders to wrongfully foreclose on consumers, kicking families out of their homes.[26]

Blockchain's ability to permanently and publicly record and track transactions would significantly reduce such failures.

Or consider how, during the buying frenzy for Gamestop shares earlier this year, the clearinghouse that settles stock trades forced retail brokers such as Robinhood to put up billions of additional dollars in margin overnight.[27] Robinhood, in turn, had to restrict trading in Gamestop and other "meme stocks" while it raised emergency capital -- a move that sparked outrage and created the perception that a cabal of financiers were colluding to harm retail investors.[28]

A blockchain-based financial architecture could settle trades on the same day, mitigate counterparty risk and eliminate the costly central clearinghouse.[29] This would enable market participants and regulators to monitor and correct settlement and margin shortfalls in real time.[30] We agree that shortening the trade settlement cycle should be a high priority for the SEC, and we are working aggressively to make that possible.

The Need to Update Rules and Regulatory Frameworks

At Paxos, one of our governing principles is that regulation is essential to maximize the potential of blockchain technology. This is why we sought oversight by a primary prudential regulator.

Just as we are regulated as a company, so are our products. There are only three regulated, dollar-backed stablecoins in the world -- and two of them are issued by Paxos.[31] These regulated stablecoins are fundamentally, economically and legally different from other stablecoin products in the marketplace. New York State regulation requires that each stablecoin token correspond to an existing U.S. dollar held in custody by Paxos. Our stablecoin reserves can only be held in the safest and most liquid forms -- cash and cash equivalents like short-term U.S. Treasury bills -- which protects stablecoin holders from liquidity and credit risks.[32]

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[25] https://thjf.org/2012/12/21/mortgage-assignments-as-evidence-of-fraud/
[26] https://www.chicagofed.org/publications/chicago-fed-letter/2016/370
[27] https://paxos.com/2021/02/05/what-lehman-brothers-gamestop-and-the-next-financial-crisis-have-in-common/
[28] https://www.cnbc.com/2021/01/28/robinhood-interactive-brokers-restrict-trading-in-gamestop-s.html
[29] https://paxos.com/2021/02/05/what-lehman-brothers-gamestop-and-the-next-financial-crisis-have-in-common/
[30] https://www.cnbc.com/2021/01/30/gamestop-reddit-and-robinhood-a-full-recap-of-the-historic-retail-trading-mania-on-wall-street.html
[31] https://www.dfs.ny.gov/reports_and_publications/press_releases/pr1809101
[32] https://paxos.com/2021/07/21/a-regulated-stablecoin-means-having-a-regulator/

We pursued oversight because we wanted to build trust within a clearly established regulatory framework that provides certainty as we structured our operations and developed new products. We also knew our customers would find the reassurance of this oversight valuable, especially since some of the most important financial infrastructure companies in the US are New York trusts.[33]

As a regulated trust company, we adhere to the same anti-money laundering and "know your customer" rules as banks. We are subject to regular examinations of our operations, procedures, capital levels and books and records. We are required to keep high capital reserves and to custody client assets bankruptcy remote and fully segregated from the corporate treasury that funds our business and operations.

Unfortunately, the uncertain state of digital asset regulation is hampering the industry's dynamism. The solution is not to shoehorn digital asset operations into a regulatory system designed for earlier generations of financial assets. Rather, we have an opportunity to learn from past failures and build something more efficient and effective.

For instance, if policymakers gave non-bank digital asset platforms direct access to the Federal Reserve's services[34] -- just as the Bank of England already grants access to non-bank payment service providers[35] -- it would enable these platforms to offer a wider array of products to consumers, without the cost and delay of depending on financial intermediaries.

We believe a primary prudential state or federal regulator should regulate both digital asset companies and their products. Anti-money laundering and know-your-customer rules need to be enforced, and regulation must ensure that customer assets are held fully segregated from the company's balance sheets. For stablecoins, independent auditors should regularly attest that assets backing the tokens are always held in reserve,[36] and those reserves should be held bankruptcy-remote and therefore not available to the issuer's general creditors.

By creating a clear set of standards for companies, the government can create the conditions that drive innovation -- which not only results in greater convenience and better products for consumers, but also helps ensure continued American primacy as the global reserve currency and center of global capital markets. The biggest financial institutions in the world, including JP Morgan, Bank of America and Credit Suisse, as well as some governments, like the European Union and China, are embracing blockchain technology.[37] A failure to embrace blockchain wouldn't just mean lost economic opportunities. It could actually threaten America's financial preeminence and economic security.[38]

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[33] https://www.dtcc.com/about/businesses-and-subsidiaries/dtc; https://www.theice.com/publicdocs/clear_us/ICE_Trust_Overview.pdf
[34] https://libertystreeteconomics.newyorkfed.org/2021/12/why-central-bank-digital-currencies/
[35] https://www.bankofengland.co.uk/-/media/boe/files/markets/other-market-operations/accessfornonbankpaymentserviceprovide
[36] https://paxos.com/attestations/
[37] https://www.eib.org/en/press/all/2021-141-european-investment-bank-eib-issues-its-first-ever-digital-bond-on-a-public-blockchain; https://www.wsj.com/articles/china-creates-its-own-digital-currency-a-first-for-major-economy-11617634118; https://www.jpmorgan.com/solutions/cib/news/digital-coin-payments; https://www.bloomberg.com/news/articles/2021-05-17/bank-of-america-joins-paxos-blockchain-stock-settlement-network?sref=lMCzuOUc; https://www.credit-suisse.com/about-us-news/en/articles/media-releases/paxos-settlement-service-202002.html
[38] https://www.federalreserve.gov/newsevents/speech/brainard20210524a.htm

If the federal government stifles the adoption of digital assets, then issuers, talent and capital will flee to more welcoming jurisdictions. The advantages of well-regulated stablecoins, in particular, are so great that it's only a matter of time before they become the primary means to transfer large amounts of funds between consumers, companies, financial institutions and even central banks. Without reputable, U.S.-dollar backed stablecoins or a central bank digital currency and the infrastructure to support them, it will become less viable for other countries and multinational companies to continue using the U.S. dollar as the global reserve currency.

Final Remarks

For our industry to succeed and benefit *all* Americans, we need clear standards and the government's support to create a new, more secure, more competitive financial system. The benefits of getting this right are enormous -- but so are the consequences of getting it wrong.

To the Committee, thank you for the opportunity to provide my testimony. I look forward to your questions.

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