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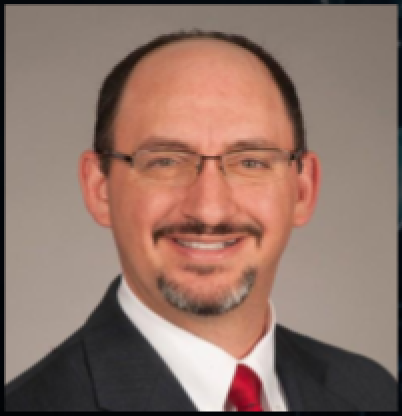
Virtual Event Series

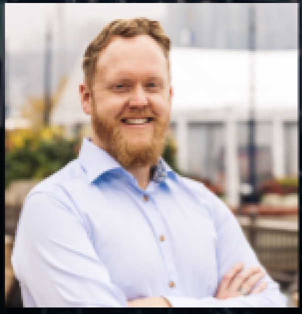
Centralized Lending Economics

Guest Speaker:



Howard Krieger
CEO at Residual Token, Inc. & Interim President at Aegis Trust Company

Hosts:



Kenny Estes
CEO & Founder
Diffuse

Ayla Kremb
COO & Co-Founder
Diffuse

DiffuseTap: Centralized Lending Economics

Last time on DiffuseTap, Howard Krieger, CEO of Residual Token Inc. and Interim President at Aegis Trust Company, talked to us about the problem with combining centralized lending and crypto, what needs to happen in the crypto space for lending to work as well as it does in TradFi, and the recent SEC crackdown on Kraken.

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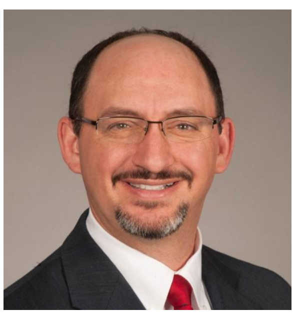
DiffuseTap

This networking session is part of our weekly virtual events series. Networking (you'll bump into at least a dozen high caliber fund managers) meets purposeful (you'll tap into brand-new sources of ideas)... straight from your armchair like a boss.

Meet the Speaker



HOWARD KRIEGER is a finance and digital asset professional with more than 20 years of experience in valuation, risk management, and project management in complex financial instruments. He models derivatives, structured credit, and debt and equity investments for tax, financial reporting, litigation, and due diligence purposes. He is currently CEO of Residual Token, and Interim President at Aegis Trust Company. LinkedIn: @howardjkrieger

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KENNY ESTES: Mr. Howard Krieger, would you mind telling the good folks a little bit about your background and what you're up to at Residual?

HOWARD KRIEGER: Sure. Thank you very much for having me. Welcome, everybody. This is my first time but it's great to see so many smiling faces on this lovely Wednesday. I wear two main hats. Currently, I am president of Aegis Trust Company. They are a South Dakota digital asset qualified custodian. I know the term qualified custodian has been in the news this week, but we are a legitimate custodian.

We have a license in Singapore and Hong Kong as well. That makes us the only custodian to have those three licenses stacked together. We're working with the New York DFS to open trust operations there as well. That's half of my day job. The other half is I'm the CEO of unFederalReserve.

unFederalReserve a Web3 DeFi infrastructure company. We currently have three products. We have a retail overcollateralized pool-to-peer lending platform. We have a crypto to TradFi product. And then, we also have an institutional self-custodial version of overcollateralized lending. That involves custody and all these other things. We're FINRA-registered, US-domiciled, and I always carry a copy of the United States Constitution and Satoshi's Bitcoin almanac on me at all times. Good to know where you come from, right?

AYLA KREMB: Wow, that's quite a commitment. Awesome. I will throw you right into the deep end with questions, and everybody feel free to pop yours into the chat as well. Centralized lending feels like a real thing if you think about people lending money and earning an interest. But other times, it also feels a lot like a Ponzi. What is your take on the economics of centralized lending? Why is it potentially not compatible with crypto markets in the first place?

HOWARD: Well, I'm not the first to say this, but centralized lending and crypto does not work anywhere. We started down the path a couple of years ago wanting to just lend crypto, or lend fiat against crypto. Prior to being in this space, I spent 10 years as the head of pricing for consumer lending at HSBC, and then eventually, everything consumer lending except mortgage at Wells Fargo. And so, I intimately understand the makeup of all interest rates.

Interest rates have two main components to them. One, interest rates measure risk and loss expectations and act as a way to advance repayment to lenders. But the other aspect of interest rates that is important is that they have to cover the cost of originating the loan, as well as those losses. And so, I got the brightest minds together in Orange County, California, home of risky consumer lending products, and we laid out the economics of lending fiat against crypto.

We found that it's impossible to do unless you put your thumb on the scale or cheat. What we mean by that is this. If you think about the use case for using your crypto as collateral, the average crypto holder in the US is 18 to 50 years old and about $65,000 in debt, most of which is college debt at a low interest rate.

The idea of borrowing an asset to consolidate debt doesn't really doesn't really pan out. In fact, the only reason to use your crypto to borrow is to buy more crypto, and that's exactly what we've seen.

You have a couple of challenges. One is the acquisition funnel, or the cost to find worthwhile people who have $65,000 to $75,000 in crypto to make a loan against. That is a small population. And then, the amount of that population that you would convert into funded loans is so small that your acquisition costs are going to be through the roof on average. We found it to be between 5 and 8% of whatever the principal amount borrowed is. So right there, you have to charge more than 5 to 8% on secured lending in order to make that loan.

Second, you have to fund it. You don't use your own money because your own money is more expensive than borrowing. So even if you tried to say “hey, I got scale. I have a nice and secure book. I'm going to secure some funding”, the cost of that capital, even two and three years ago, was still 7, 8, or 9%.

Between your cost of acquisition and your cost of capital, it is impossible to make a loan that is going to be at a competitive rate versus just walking into a Wells Fargo and taking out a personal loan. So, how did they do it? Well, the way they did it was by gambling the collateral. And unfortunately, that's the only way to make the economics of crypto for fiat lending from a centralized entity make sense.

KENNY: That's a strong statement you made. Let's learn more details. There certainly are companies like FalconX that do a lot of this and seem to be arguably doing well throughout this whole process. Is it something inherent in crypto? Is it capital inefficiency? What is it that makes this not a viable business model? Because clearly, in traditional finance, lending is a real thing. So what is it about crypto that doesn’t work?

HOWARD: I would say that the hallmark of a healthy economy is a robust, decent structured finance existence. One of the challenges with crypto is that everything tends to be all spot and short term. And you really want the safety of both contrarian products and time-based products to really create a robust economy. That’s why crypto inherently can't be used as collateral to make loans.

Nothing is wrong with the crypto itself, but it has to do with the de minimis use case, the small population of qualified borrowers, and the cost of capital to actually make the loan. Over collateralized loan is still a very good thing, but considering the overhead from a centralized lending perspective to make that loan, it's impossible to make money unless you gamble the collateral. I would hazard a guess that the entities that are doing it today have either hypothecated the collateral in the agreement, or they're taking it as a loss in order to gain in another business.

AYLA: That's fascinating. So they have a few other pits. Say you want to get into this space and you want to lend your crypto out or borrow some. What do you need to look for in the loan documents to make a better assessment on the risk profile of that borrower?

HOWARD: I remember when we first started our investigation, the first thing we did was we applied for a loan from BlockFi just to gather the documents as you go "dialing for dollars". We would download the documents and we would scan through them. I remember section three in particular had this really cute phrase that said the lender is under no obligation to hold your collateral. The lender is under no obligation to hold any asset that is equal to the value of the collateral you're providing them.

And then, the third statement was something like, "No asset of ours should ever be confused as being your collateral." In essence, they are broadcasting that they were going to gamble it, and they had to. They used Gemini. Gemini gave them free custody at one point and then started paying for the security interest or collateral and it allowed BlockFi to offer some very competitive rates.

If you are going to use your crypto as collateral to make a loan, then do your homework. Make sure that the lender you're working with isn't going to hypothecate your collateral, and that the liquidity of that lender is in good enough shape that you don't have to wonder whether the money is going to be there when you come back and get it.

What we prescribe is self custodial, overcollateralized lending and borrowing. Find the platforms that are forks of compound, or whatever is your favorite protocol that offers pool-to-peer lending. Look for depth and liquidity pools, make sure the issuer isn't using their own token anywhere as collateral, and stay away from anything that looks too good to be true. If they're dropping tokens on you for using their platform, odds are they're not in it to be the highest and best actor in this space.

KENNY: Fascinating. You've talked a little bit about the economics being upside down for that 75k loan size. Let's call that retail, or at least the higher end of retail. Does that change with institutions where there are bigger dollar amounts? Is there actually a viable business in that? As a corollary to you mentioning the compounds of the world, I would argue that those are not usable by an institution because you cannot have the risk of being liquidated immediately without a margin call notice. There's just no way somebody is going to be monitoring that. So, is there a bifurcation between the retail market for lending and the institutional market?

HOWARD: Those are really great points. One of the things that I'll add is to make Compound institutional-friendly. That's the basis of our infrastructure. I'm a little biased, full disclosure. But there are two things. One, having a qualified custodian as an admin address in the core wallet and only whitelisting approved entities. In our case, we partnered with a bank. Only the bank's customers can apply to be whitelisted.

The idea is that a traditional U.S. Treasury chartered bank isn't going to mess around with its clientele. Only whitelisting customers of the bank and only giving control over changes to the contract to a qualified custodian to act in an escrow role is enough to raise the security for institutions. But the usability is still an issue.

The second piece is can traditional lending be done at larger scales for institutions? Yes, absolutely. I think that if you start talking about ticket sizes in the seven figures or higher, then the economics start to change. But then it gets back to the lender's cost of capital. And if you are secured borrowing, you really shouldn't be paying more than a couple of points.

AYLA: Just asking another question about regulation. A lot of this lending is now being looked at as security in one way, shape, or form. All the programs are being shut down. Companies are leaving the US because it doesn't seem like it's a favorable environment. Is crypto lending going to come back or are the regulators going to kill it entirely? What do you think is the future of this environment and ecosystem?

HOWARD: Sure. Obviously, I'm a little bit biased. If people have questions, I'm on LinkedIn. Hit me up or email me at howard@unfederalreserve.com. From a regulatory perspective, I remember that I sat down with Mike Cagney, the founder of Figure, a few years back and we talked about what needs to happen, and what needs to happen is we need years of court cases.

One of the most beautiful things that came out of the Payward settlement last week (I do a quick take on it to be released next week) is that you have a judge. Or rather, not so much in the Kraken case, but in the settlement. I'm trying to think of what the settlement was. It was a Coinbase settlement, where they dismissed the case. If you read the dismissal, you have a jurist writing in legalese bringing together these analogies and concepts from other assets in other industries.

That's what's critical here. We need years and years of court cases actually enforcing the terms and conditions of the contracts being entered into these lending and loan agreements. I don't know if I feel like most of the regulation we need for digital assets is already in place in the U.S.

It's really a question of enforcement and a question of the number of court cases that actually get settled, where the smart contract terms are enforced. There needs to be more recourse perspective. I feel like that is the next evolution. Enforcing recourse based on smart contract terms. And then secondarily, enforcing the regulations that are already on the books. That to me is the future of lending.

KENNY: Okay, let's expand on that. With Gensler, obviously there's a lot of backlash over the SEC stance with Kraken, and saying this is a security. He's demanding everybody now to, for lack of a better term, kiss the ring. That's kind of what's happening here. But then, you have Hester Pierce, and she's arguing that actually there is no clarity whatsoever, and Gensler's being capricious and arbitrary in how he's trying to put these laws down. What's your take on that? Would you agree with that stance? Or is that something that's just a matter of time while the court cases work through the system?

HOWARD: I think the three-legged stool here is actually interesting. The Custodia decision by the Fed to unanimously deny them of their application to the Fed charter, and to not have one ally among the existing governors to move forward with their application, is super interesting. And then meanwhile, they're likely looking to somehow lever anchorage out of that OCC umbrella, calling it like a Brian Brooks lame duck last Hail Mary. I think we need to watch that space because that's going to tell you a lot about expectations around custody.

They already said you can't have cryptos or principal assets, where you can only really have fiat and real estate anyway. I think it is going to be interesting to see how that space evolves. I think with Gensler in the SEC trying to settle the nature of the asset type, and the SEC cracking down on crypto more so that "hey, you have to line up and get our blessing that you're not failing the Howey Test", it challenges the use of crypto as collateral in the US, except in instances of private blockchains. Or something like what Centrifuge might be doing where you have asset-backed securitizations tokenized. It's publicly traded so it will be an issue with the SEC.

But if Centrifuge uses their technology to create private blockchain securitizations, I could see where again, institutions or RIAs or regulated entities use that crypto as collateral for lending and avoid any crypto that's listed on any DEX. I think that's the angle there. Look at the SEC to see how well crypto performs as collateral, but watch the Fed and the OCC to see how crypto will work itself into banking products. Those are my two cents, but I'm no expert. I'm just a guy with a tie on.

AYLA: Fascinating. I'll give you another quick question here. In terms of the commercial terms that people will be agreeing on in the future, how do you see that developing? Is there going to be some kind of standardized, regulated structure of these products in the future? How do you see the actual nuts and bolts of these loans happening?

HOWARD: I think it makes sense to look at blockchain technology as a more efficient messaging system. Even though it's an asset, I think we all know that their aim is really a messaging system. The challenge is that right now, and I know Kenny mentioned one of the challenges of Compound in particular, is instant liquidation.

How did Aave solve it? If you look at the platform, there's actually a point where you can go into technical default without instantly being liquidated. That is just one element of crypto borrowing and lending and crypto products that is a total greenfield, and I'm looking forward to seeing what comes of it. When you think about how debt is structured today, it's either secured, unsecured, secured by a lien on a property, maybe some forward contract elements, maybe even some institutional or commercial debt, comes with warrants, or some other callable political convertible provision.

We will see in the next decade our more evolved blockchain-based lending contracts that consider and capture the features of traditional structured finance. It has to go that way. I don't know what's going to be the first element that gets put on-chain. Perhaps a convertibility feature gets baked into a contract that's looking at some reference asset. It all depends.

The reality is that we're going to see the features and terms, variable rate, index rate, etc. Even swaps. I'm talking with ISDA about putting together a mapping of a smart chain with solidity and the typical ISDA so that they can start putting swaps on-chain. Couple a swap with a variable rate commercial loan and you have one of the most popular banking products in the world.

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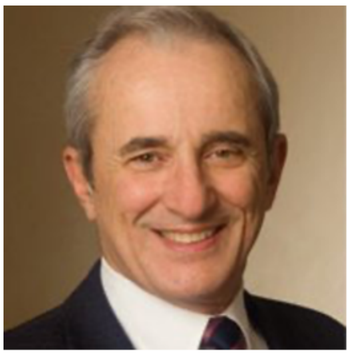
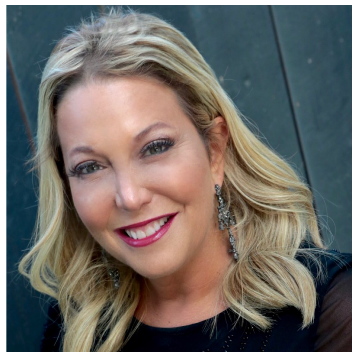


Dennis Chookaszian

Corporate Director, CME Group

DiffuseTap: Institutional Grade Governance

Sharing his decades-long expertise on corporate governance, Dennis talked about how to avoid a co-partnership going sour, the problem with overly idealistic CEOs, and the importance of keeping your board in check. Read on

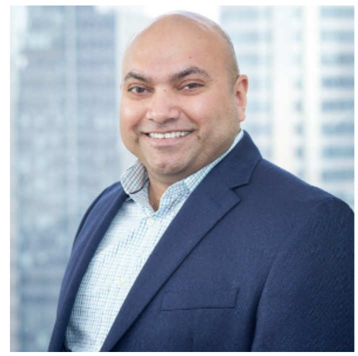


Susan Brazer

CEO & Founder, LionShare Media

DiffuseTap: Media Metaverse 2022

Susan described the 2020 digital media landscape; the evolution of media distribution; how converging, emerging technology points to the metaverse; and the prospect of having an open, decentralized, and free Web 3.0 marketplace. Read on



Raj Mukherjee J.D.

VP/Global Head of Tax, Binance.US

DiffuseTap: Crypto Taxes Decoded with Binance.US

Raj explained the complexities of the US crypto tax landscape, how he built a dynamic tax information system for Coinbase and Binance from scratch, and how investors can profit from crypto without getting caught in a taxation mess. Read on

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