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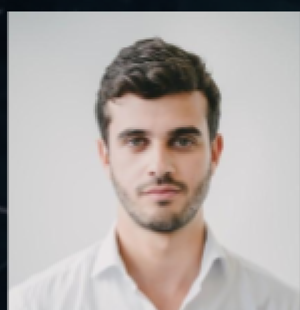
Virtual Event Series

Can Crypto Lending Be Safe?

Guest Speakers:

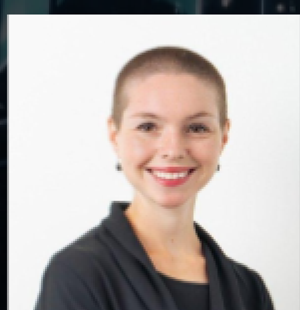
Aya Kantorovich
Co-Founder & Co-CEO
Fractal



Alexandre Elkrief
Co-Founder & Co-CEO
Fractal

Hosts:

Kenny Estes
CEO & Founder
Diffuse



Ayla Kremb
COO & Co-Founder
Diffuse

DiffuseTap: Can Crypto Lending Be Safe?

Last time on DiffuseTap, Aya Kantorovich and Alexandre Elkrief, Co-Founders and Co-CEOs of Fractal, talked to us about the biggest issues that make crypto lending a risky venture, why most auditors fail to make an accurate assessment of crypto lending platforms, and red flags that foreshadowed the demise of major crypto lending platforms.

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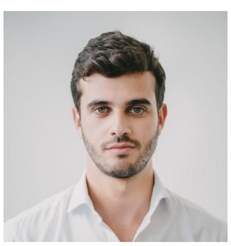
DiffuseTap

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 Speakers

AYA KANTOROVICH is a digital asset markets expert who has worked in top crypto companies like hedge fund Pantera Capital and FalconX, where she was able to scale the company's revenue through an $8B valuation. Aya is Co-Founder and co-CEO of Fractal, the first cross-collateralized margin account for institutional investors.
Linkedin: @ayakantorovich



ALEXANDRE ELKRIEF, also a Co-Founder and Co-CEO of Fractal, is a capital markets veteran with both TradFi and DeFi experience. He led DeFi at LedgerPrime, a multi-strategy digital asset investments firm, and co-founded Knowhere, a San Francisco-based startup that developed machine learning and text understanding models for the media industry.
Linkedin: @alexandreelkrief

About Diffuse

We are an alternative fund platform offering differentiated investment products. From digital assets, to VC funds, and beyond, we identify green field investment opportunities we feel will have market beating returns and turn them into professionally managed funds. For more information visit www.diffusefunds.com.

KENNY ESTES: Now we're going to hear from the speakers of the hour, Aya and Alexandre. Aya, maybe we'll start with you. Would you mind telling the folks a little bit about your background and what you're up to over at Fractal?

AYA KANTOROVICH: Sure. For my quick background, I started my career off as a banking and capital markets consultant before joining my first startup, which was focused on equity research. And then, I joined crypto full time. I was at Pantera Capital on the venture side of the business, before joining as part of the founding team of Falcon X.

I built out their sales and trading arm and led them through the recent series D of last year before transitioning over to Fractal. On a high level, at Fractal we are building an institutional on-chain collateral management tool which helps institutions settle and manage their collateral, all in one place.

KENNY: That was concise and to the point. There's a reason this is not your first time on Diffuse Tap. Alexandre, do you want to tell the folks a little bit about your background and how you came to join Aya on this journey?

ALEXANDRE ELKRIEF: Sure, absolutely. Prior to Fractal, I was running the DeFi portfolio at a crypto hedge fund. Prior to that, I started my first company, which was a machine learning company in the media space. We incubated Fractal to face a number of frustrations around operating and deploying capital in DeFi in a capital efficient way, trying to fix the capital markets for the industry.

AYLA KREMB: Beautiful. We will dig right into questions right up front here, and I'll pop this one to Aya as a starting point. What made crypto lending unsafe in the first place? Why was a safer solution required?

AYA: Sure. I would summarize it in four different ways. The four main reasons for why crypto lending was unsafe are not unlike traditional markets, either. I would say the first is lending against illiquid assets. You saw a lot of this during the bull market. You were seeing loans made against some questionable things which did not have a liquid market to trade in and out of.

Sometimes, it was also physical mining rigs or physical infrastructure that did not have a liquid market to sell in and out of. You are currently seeing a lot of lenders with those funny rates now stuck on the balance sheet.

The second is just a lack of transparency. You are seeing a huge lack of proper due diligence, where collateral, for example, was posted across multiple desks. You had the unfortunate example of Three Arrows, who would send an email stating how much collateral or balance sheet they had, but there was no proof of balance sheet or any audited financial statements that were requested from the respected lenders.

And then, the third is rehypothecation. You had a lot of collateral, where lenders would stick it into a pool of risky assets. Whether it was incredibly risky DeFi pools, sometimes it was rehypothecated as venture investments, and sometimes just rehypothecated and lent out to, again, not diligenced counterparties.

And then, the last and I think most important one was the people in operational issues. This is an issue you see time and time again coming from TradFi that has not been fixed. There were manual mistakes and decisions being made across the different counterparties.

Whether it's Luna and the centralization there, or Three Arrows, or BlockFi, there were a lot of decisions that were made operationally that were bad. Genesis, FTX, Floyd, or Celsius too. You can consistently see that there were operational issues that I think led to their demise.

KENNY: Awesome, Alexandre, anything you want to add to that?

ALEXANDRE: No, I will just echo what Aya was saying. I think that in general, the lending ecosystem and infrastructure, and the whole lifecycle was just full of asymmetry of information. There was always something that the borrower could withhold, and the lenders did not really have the tools or the transparency to get the full picture to properly assess counterparty risk.

KENNY: Okay. So, what is the solution? How are you guys trying to solve this asymmetry of information problem?

ALEXANDRE: Sure. I mean, we're using technology. We are using the blockchain for what it is actually supposed to be. This is what I mean by that. Just to circle back to some previous experiences, at my previous fund, which used to be a large options market maker, the process was very manual.

The back office process was fairly manual. You look at your risk, and then you realize that a certain counterparty owes you $100,000 of margin, and that you owe $100,000 of margin to another counterparty. And then, you have an ops person making manual transfers back and forth.

Now, this is what the blockchain should actually be used for. This is what most of the centralized finance players of the last cycle did. If you look at how they were set up, they could have been trading crypto, but also just regular commodities or any other type of underlying asset. They were not necessarily leveraging the blockchain for what it actually enables you to do, which is enabling the software to perform automatic collateral management, automatic liquidations, automatic monitoring, instant settlement, etc.

The tools we are building are enforcing just that. In Fractal subaccounts, you deposit your funds and you can get a loan against the collateral that is in your account. But there are very, very clear access controls around what you can do with that collateral. The lender has full transparency on the risk levels, the loan-to-value, and the underlying exposure that their loan proceeds are exposed to. Then, we move collateral around automatically.

And by that, I mean the protocol will just enforce a set of rules that have been agreed upon at inception. And finally, everything is fully automated on the liquidation side. There is not really an option of not being liquidated, or avoiding your position from being seized because it's underwater.

KENNY: Okay. Aya, maybe you want to add on there. Does this actually make the problem go away? Because at the end of the day, even with transparency, you have the underlying crypto exposure on loans.

AYA: I would say in terms of a risk perspective, what we are really doing is not necessarily removing the risk of crypto. But what we are doing is removing the risk of counterparty by creating more transparency. We are giving the lender the ability to fully be able to underwrite their counterparty risk. The same thing goes for the borrower too.

Let's say a borrower or client is facing the market maker. Sometimes, those market makers will not post margin in a tri-party escrow account, or in an escrow account, or anywhere for the borrower to see. You don't even know whether your market maker is potentially going to go under. That happened when the market imploded.

And so, what we're doing is trying to limit the counterparty risk by creating more and more transparency. We are allowing each of these users within the institutional user journey to calculate what that risk is. The way I think about it is when you are engaging with a C-Fi provider today, or even when you leave assets on an exchange, you will have no idea where those assets are being held, how those assets are being used, or whether those assets are being rehypothecated.

It's not that you are able to trace it on the blockchain and see exactly how many hops the money has gone through, where the money sits, and how it's being used. And really, I think that is the future of lending and the future of crypto at large. But to your point, it is not going to remove the risk of crypto. But the lender gets to decide what kind of risk they are comfortable with, and will actually be able to underwrite the full amount of risk.

AYLA: Fascinating. That is a very good point. When we are looking at this lending environment, even though transparency might remove some of the risks and add some more safety, is demand coming back for this, and is it coming back with a vengeance? Or is it going to just trickle back until people get more comfortable? What does that look like now, and who are the borrowers today?

AYA: I would be lying if I said that demand is coming back full force. I think you can see just by looking at market prices that the market has gone sideways for quite some time. That is what we are seeing on the demand side. Because the risk free rate is around 5%, it's much harder on-chain to get that level of yield.

Realistically, the reason you had the DeFi summer is because you could not find that kind of yield anywhere in the market. Obviously, that has changed due to the market ecosystem. However, with the clients that we have today, all of them are comfortable with DeFi and OTC bilateral agreements, and they are running some form of delta neutral strategies.

That could be, let's say, a basis trade. They are buying the underlying or staking it, and they want to earn the yield but they do not want to have exposure to the underlying, so they are shorting on the other side. They're just collecting yield on the asset. We are seeing lots of iterations of that.

Or, for example, they're lending. And again, they're comfortable with default, but they're lending on Aave or Compound and trying to hedge some form of risk there too. Other forms of trades that we have seen across our client base are anything like swaps, where you have clients who are trying to get some synthetic exposure to, let's say, an exchange or a certain position, or in DeFi where they cannot touch it directly themselves.

AYLA: Alex, do you want to add anything to that one?

ALEXANDRE: I think leverage is a loaded word. But if we start with the origins of leverage, you learn to take the commodity pool operator test. If you are a farmer and you grow wheat, and you want to hedge your exposure to the price of wheat, you short a future on the commodities exchange with leverage because you do not have the wheat to sell. You are going to sell it when you harvest it.

And so, it's very important to be able to operate in a capital efficient way. The same thing applies to financial institutions. When you are long on the S&P 500 and short on the S&P 500 future, the two assets cross-collateralize each other such that you do not have to fully margin the short leg, and you can use the long leg to collateralize the short leg.

Before we talk about operating on 10x leverage to directionally bet on Bitcoin going up, I think some of the basic piping and infrastructure needs to be built to enable market makers and financial players to operate in crypto with the same level of capital efficiency as they do on traditional finance assets.

AYA: Yeah. I would add one last thing. We talked about the crypto native, and Alex started talking about the traditional assets we are seeing. Because of where markets are today, we are seeing a number of tokenized real world assets come on-chain. One of our investors today is Avalanche Ava Labs. They have made it their mission to bring tokenized real world assets on-chain.

For example, if you sit in America and you have access to an American bank, getting treasuries is not very difficult. But for folks offshore, that is very difficult. We have seen that to be one of the largest drivers of tokenized real world assets. People are trying to find ways to get capital efficiency on that by using tokenized treasuries as collateral.

Other things that we have seen are even as dry as some insurance products, in which you have regulated entities purchasing insurance, tokenizing that, and again, wanting to use that as collateral for another position. Those are just some examples outside of the altcoin craze.

KENNY: So basically, try and take everything that banks do and do it on-chain in a more efficient manner. I think that is the end ideal of DeFi overall. It's to just do what financial services does, but better, faster, and easier. We are not necessarily faster, but certainly cheaper. So yes, I think there are tons of use cases there.

On the topic of safety and transparency, I have a question here from Scotty. Maybe we will start with you, Aya. If audits for crypto staking and lending companies is, in some sense, an alternative way to get a little bit more comfort with on-chain lending solutions, was that something that you see taking off and the regulators actually getting behind? How do you see that market evolving?

AYA: Great question. We have gone through three audits. What I can say with audits is, it is an unnecessary evil. I say it is an evil because these auditors are so backed up that there are only a few very good, well-tested auditors. However, their incentives do not necessarily align. They are paid an upfront fee. They are not paid over time relative to whether or not, let's say, the application gets hacked down the line.

And so, you can say that the auditors do not always have the incentive to dig deep other than reputational risks. We have seen that some auditors just process and audit a number of companies out there quickly, as opposed to thoroughly. When done properly, these audits will sometimes take six months to schedule before you even get audited as a company. And so, you will start to schedule your audits far before the products are even built in expectation of wanting to get that audited in time.

That said, an interesting color would also be that traditional insurance providers in the US and globally are in the process of becoming auditors themselves. Insurance providers have structured or braced themselves and set aside budgets to go into crypto at large.

What will happen is these insurance providers are not going to trust these third party auditors to do the audit for themselves. They are going to read the audit internally so that they further understand the risks that they are insuring against. That is going to be the next iteration of auditors, and it's definitely something we are most excited for. In that way, we would be able to sell insurance on top of these structured products to hedge against smart contract risks, and we would feel much more comfortable with an insurance provider auditing our smart contracts.

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Corporate Director, CME Group

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CEO & Founder, LionShare Media

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VP/Global Head of Tax, Binance.US

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