The Emerging Crypto Lending Landscape

lending cryptocurrencies

Summary: As adoption of cryptocurrencies grows, cryptofinance and crypto lending are extending their reach and proving alluring to some borrowers and lenders alike. We give you an overview of this developing trend — certainly one for community financial institutions to watch.

Did you know that the first evidence of lending dates back to 2000 BCE in Mesopotamia, where farmers started borrowing seeds against later payment? By 1754 BCE, the very first large-scale system of loans and credit had developed. The Code of Hammurabidefined the price of silver and how the interest charged on silver loans was to be regulated. Four millennia later, we are now contemplating a very different type of finance: crypto lending.

Cryptocurrencies have boomed in the US. and around the world, with market capitalization reaching a high of $3T in November 2021 (although it has since fallen to $1.65T this April). According to an NBC News poll, one in five Americans has invested in, traded or used cryptocurrency. Meanwhile, a survey conducted by Investopedia found that nearly 60% of millennial investors own cryptocurrency.

As crypto adoption grows, cryptofinance is expanding into the traditional banking sector, across products such as interest-bearing accounts, cryptocurrency-backed loans and credit cards. Indeed, the demand for crypto lending is rising steadily. This type of loan offers borrowers an alternative route to finance and can potentially provide lenders with much higher yields than traditional deposits.

Although still in its infancy, community financial institutions (CFIs) may want to stay abreast of crypto lending developments — starting with this overview.

The basics of crypto lending

Crypto lending — a cryptocurrency-backed loan — occurs both on centralized finance platforms and decentralized finance (DeFi) platforms. These platforms pool crypto deposits to provide loans and pay interest to depositors. While they are not designed for traditional low-risk investors, they can provide an alternative for savvy investors seeking higher yields.

Central exchange in centralized finance (CeFi) platforms, such as BlockFi and Celsius, act as a central exchange, taking custody of a depositor’s assets and paying interest in return. They are typically used by institutional players, such as hedge funds.

By contrast, lending on DeFi platforms, such as Aave, MakerDao and Compound, is done through smart contracts (programs that run when predetermined conditions are met) on open-source blockchains. Any individual user can become a borrower or a lender without having to provide personal information, or undergo KYC procedure. This can potentially make financial services more accessible and drawing greater liquidity into the market. In the last six months, the amount deposited on DeFi platforms alone has oscillated between $160B and $250B.

Just as traditional financial institutions offer secured fiat currency loans against a car or a house, crypto loans are secured using cryptocurrencies as the underlying collateral. The value of the loan needs to exceed the underlying collateral, in order to compensate for the high volatility of cryptocurrencies.

The pros and cons of crypto lending

Savvy crypto customers are turning to crypto lending for three main reasons:

1. **Attractive rates.** Annual percentage yields for lenders range from 3% to 7% on cryptos and up to 17% for more stable crypto assets, such as stablecoins. These rates are substantially higher than yields offered by traditional bank accounts. On the flipside, interest rates for borrowers are lower than typical personal loans or credit cards.
2. **Ease and speed.** Assets can be lent and borrowed in a matter of hours, without intermediaries or lots of paperwork and administration.
3. **Flexibility.** Long-term crypto investors may need short-term liquidity to avoid missing out on potential investment opportunities, without the need to sell existing crypto assets and the tax liabilities this can create. They might also want to short a cryptocurrency, engage in sophisticated trading, hedging strategies or arbitrage. Crypto loans could offer such investors this flexibility.

However, crypto lending has substantial risks for borrowers and lenders. Because of the high volatility of crypto, borrowers are at risk of margin calls — when the value of the collateral drops below a certain loan-to-value and the lender requires an increase in holdings to maintain the loan. Also, assets are generally hard to access in the short term, which can be problematic if there is a sudden drop in value.

Lenders, on the other hand, have little visibility into what the platforms are doing with the underlying crypto assets. What's more, the assets are not FDIC-insured as they are with traditional deposits, while the smart contracts of DeFi platforms can have bugs, faulty protocols or act as a target for hackers.

Going mainstream?

Globally, there are signs that cryptocurrency is starting to go more mainstream. Mastercard recently announced a partnership with three Asia-based crypto companies to offer crypto-funded payment cards. In April, Goldman Sachs offered its first bitcoin-backed loan through a partnership with Coinbase. Others are also dipping their toes in this market, although a lack of comprehensive guidelines has created an uncertain operating environment.

For example, in February this year, a subsidiary of BlockFi was fined by the SEC for selling its product — deemed a security under applicable law — without registering it or securing an exemption. The Director of the SEC's Division of Enforcement stated: "*Adherence to our registration and disclosure requirements is critical to providing investors with the information and transparency they need to make well-informed investment decisions in the crypto asset space.*"

This is the first step in what promises to develop into a regulatory framework that makes crypto lending more accessible to traditional financial institutions.

As reported in previous BID article, several CFIs have started offering crypto services, while others are still weighing the risks. While crypto lending may be further in the future for your institution, keep an eye on this dynamic market as regulatory guidance becomes more solidified and could turn into a rewarding opportunity.

LOOKING TO GROW YOUR LOAN PORTFOLIO?

Financial institutions are looking for ways to boost their loan portfolio. Depending on your portfolio concentration, you may need C&I loans or choose a hedging solution to satisfy the long-term, fixed-rate needs of your customers. Check out our Lending Services to find the right solution for your institution.

ECONOMY & RATES

Rates As Of: 06/09/2022 05:31AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	1.28	0.12	1.22
6M	1.77	0.13	1.58
1Y	2.28	0.20	1.90
2Y	2.81	0.25	2.07
5Y	3.06	0.24	1.79
10Y	3.04	0.19	1.52
30Y	3.17	0.12	1.27

FF Market	FF Disc	IORB
0.83	1.00	0.90
SOFR	**Prime**	**OBFR**
0.76	4.00	0.82