

Digital Asset Lending Snapshot
 2019 | Q3 Insights
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Genesis continues to see sustained growth in its digital asset lending business. In the third quarter of 2019, Genesis added \$870M in new originations, breaking our record of \$746M set in the previous quarter. As of September 30, 2019, active loans outstanding stood at \$450M, roughly flat from the previous quarter despite a significant decrease in Bitcoin’s price.

Originations increased 38.1% QoQ marking a sixth consecutive quarter of strong growth and bringing total originations to \$3.1B since we launched the lending business in March 2018. Our loan portfolio largely sustained its value through increased cash (USD and stablecoin) loan issuance, offset by a decrease in the notional value of crypto loans outstanding.

In this report, we’ll take a closer look at the continued growth in cash lending markets globally and the opportunity this presents for larger financial institutions to earn outsized returns relative to risk in credit markets.

Figure 1



Figure 2

(\$ in millions, except BTC Price)	6/30/2019	9/30/2019	QoQ Growth
Cumulative Originations	\$2,285	\$3,155	38.1%
Cumulative Loans	\$1,362	\$2,001	46.9%
Cumulative Borrows	\$922	\$1,154	25.1%
Active Loans	\$452	\$450	-0.4%
BTC Price	\$11,227.01	\$8,284.00	-26.2%

Quarterly Asset Composition

For a second consecutive quarter, cash loans as the percentage of loans outstanding increased significantly. At the end of Q3, cash loans represented 31.2% of our active loan portfolio, up from 23.5% at the end of Q2 and 14.0% at the end of last year. As we mentioned in our Q2 report, there has been and continues to be strong demand internationally to borrow USD. Due to traditional banking frictions, a large portion of this cash demand translates to stablecoins like USDC and PAX. This trend has significantly impacted our portfolio composition as well as our counterparty composition.

The new USD issuance in Q3 mostly took share away from active BTC loans as altcoin demand increased slightly.

Figure 3

Asset	12/31/2018	3/31/2019	6/30/2019	9/30/2019
BTC	63.4%	68.1%	62.5%	50.2%
BCH	0.3%	0.3%	0.5%	0.3%
ETH	6.9%	3.6%	3.9%	7.5%
ETC	4.1%	2.3%	0.9%	3.0%
XRP	7.3%	6.7%	2.5%	3.6%
LTC	1.1%	3.6%	3.7%	2.0%
USD and Equivalents	14.3%	9.6%	23.5%	31.2%
Other	2.6%	5.9%	2.5%	2.2%

International Demand for BTC-Backed Cash Loans

Figure 4 below shows total cash loans outstanding YTD. We started the year at approximately \$20M outstanding and after seeing moderate growth to \$40M towards the end of Q2, Q3 saw nearly a 4x increase in cash loans outstanding, reaching a high of \$160M in mid-September. Currently our cash loan book sits at \$140M – the recent reduction in outstanding loans can be attributed to deleveraging after the spot selloff from \$10,000 to \$8,000 as well as a flattening of forward curves which were formerly in steep contango for the majority of Q3.

Figure 4



When taking a closer look at those counterparties borrowing cash, we find strong growth in international demand, with demand in Asia growing steadily.

The following figure show cash loans to international counterparties as a percentage of total cash loans outstanding YTD as well as cash loans to Asian counterparties as a percentage of international cash loans outstanding YTD.

Figure 5



Q1 and Q2 saw large, discrete step-like movements in the percentages - since there were only about \$30M of cash loans outstanding on average through the period, returns and new loans shifted the book composition meaningfully. However, in Q3 the time series became more continuous as the number of cash originations and outstanding loans increased substantially. Currently, international counterparties comprise 45% of outstanding cash loans, with nearly 70% originating from Asia.

China has been experiencing currency “flight” for a number of years, and the government has been attempting to restrict Yuan transfers out of the country [1]. Although the Chinese government has attempted to restrict transfers of Yuan directly into Bitcoin, there are still many liquid on-ramps for Yuan into the digital currency ecosystem, through pairs such as Yuan/USDT, localbitcoins (a peer to peer bitcoin transaction site) and transacting directly with miners. Once in the digital currency, getting to USD or another stablecoin is straightforward and we believe this flow of funds is one of the larger drivers of cash demand out of Asia. Additionally, Asia is home to some of the largest bitcoin mining firms in the world. As mining companies become more sophisticated, they can optimize their balance sheets by leveraging BTC holdings for cash financing to pay costs such as electricity.

From a macro perspective, every time a dollar is borrowed against BTC collateral, the cash is largely used in one of two use cases: speculation or working capital. Speculation is the simplest, where the cash is borrowed to purchase more BTC and leverage long. An example of a working capital use case is a miner who is generally BTC-rich while cash-strapped and electing to pay for electricity contracts by leveraging cash financing against his BTC holdings. Ultimately, both use cases are facilitating sell pressure on USD and foreign currencies, increased velocity on USD, and increased liquidity on the bid for BTC.

Asset-Based Lending in Digital Asset Markets

As cash demand grows amongst miners, hedge funds, trading firms and individuals, it spawns the question “who will service this demand?” BTC investors generally have limited ways to earn yield on their assets, so rates remain relatively low as current supply outsizes demand (especially in bullish markets). Investors and holders of cash, however, have numerous ways to generate returns on their assets. These cash holders, despite being participants in the digital asset ecosystem, can easily invest in other asset classes such as equities, traditional debt, real-estate etc. Given these other yielding opportunities, cash lenders in digital asset markets can demand much higher rates than their BTC lending peers.

Another key consideration for cash lenders in digital asset markets is the level of risk assumed by taking collateral assets such as BTC and if that return/risk profile is better than traditional return streams. Because these questions don’t have obvious answers and given the fact that many large cash holders such as banks, asset managers, and private lenders haven’t fully entered the crypto economy, the supply of cash is generally constrained relative to the supply of BTC and other large-cap digital assets like ETH.

For cash supply to scale with the increase in demand, we’ll need to see more willing lenders enter the space. That means they’ll need to conclude that the risk-adjusted returns of BTC-backed lending are greater than traditional lending.

Below, we highlight some common credit structures that lenders will assess relative to lending against BTC [2]

Figure 6 [2]

	BTC-Backed Loans	Asset -Based Loans (A/R)	Asset -Based Loans (real assets)	Securities -Based Loans	Bank Loans
Description	• Cash loans against bitcoin	• Cash loans against future cash flows from sales	• Cash loans against assets such as property, equipment and inventory	• Cash loans against liquid securities such as equities or notes	• Cash loans against the credit and balance sheet of a company
Return on Cash	• LIBOR + 5 -8%	• LIBOR + 3 -6%	• LIBOR + 7 -9%	• LIBOR + 2 -4%	• LIBOR + 6 -10%
Usability of Collateral Asset	• Usable	• Unusable	• Unusable	• Usable	• N/A
Return on Collateral	• 3-5%	• N/A	• N/A	• LIBOR + 2 -4%	• N/A
LTV (Advance Rate)	• 50-80%	• *75-85%	• *50-75%	• *50-95%	• N/A
Volatility of Collateral	• High	• Low-Med (Variable)	• Low	• Med-High	• N/A
Liquidity of Collateral	• Highly Liquid	• Generally Illiquid	• Moderately liquid	• Highly Liquid	• Illiquid
Repossession Costs	• Low Costs	• Moderate costs	• High costs	• Low Costs	• High costs
Duration	• 0-2 years	• 1-5 years	• 1-5 years	• 0-5 years	• 0-5 years

There are numerous credit structures and opportunities in capital markets and Figure 6 only highlights some of the more common ones. We chose these structures because they compare to a BTC-backed loan when evaluating expected return and risk on capital.

Though BTC is quite different from the assets that back traditional loans, it shares some of the same properties that make it a viable collateral against when managed properly.

Return Profile

When looking at the range of rates lenders charge on cash, BTC-backed loans fall on the higher end of the spectrum, most similar to loans against real assets like inventory, equipment, or real estate. The difference with BTC-backed loans, however, is that the collateral is generally sent directly to the lender where the lender bears direct control of the asset. Traditional real asset collateral is usually pledged to the lender via a legal agreement, where the lender cannot actually control the collateral unless the borrower defaults. Given this unique ability to control the collateral asset during the lifecycle of the loan, the lender can generate additional return if there is an interest rate market for that asset. In BTC markets, there is natural bid for BTC borrow among various institutional participants. Genesis, for instance, has roughly 30,000 BTC on loan earning yield.

In summary, given lenders can utilize BTC collateral over the duration of the loan to earn additional interest, the returns of BTC-backed cash lending can be substantially higher than traditional asset-based lending. This concept becomes magnified as the average LTV on BTC-based lending is often somewhere between 50-80%, giving the lender more value in BTC to deploy than the cash lent to the borrower.

Risk Profile

Traditional lenders likely assume there is more risk in holding bitcoin as collateral compared to other assets. Bitcoin has volatility, bearer custody, and headline risk, but there are also properties that decrease collateral risk if managed well. Because bitcoin is still highly volatile relative to traditional assets, a lender has to be quite proactive in monitoring the LTV (advance rate) over time.

The attractiveness of bitcoin as collateral relies heavily on the lender's competency with both holding bitcoin and managing margin calls and forced liquidations. If the price of bitcoin decreases rapidly, the lender needs to ensure the borrower adds more bitcoin collateral to back the loan or have a systematic selling solution in place if the price continues to fall. With that being said, bitcoin is highly liquid. One can sell millions of dollars of BTC on exchange or OTC within seconds at relatively low costs. When comparing these costs to the repossession costs of other forms of collateral in traditional lending, bitcoin liquidation is much more economical.

Take for example the inventory of a manufacturing company. If the manufacturing company defaulted, the lender is protected by the cash value of the equipment collateral. To actually realize that value, the lender would have to work with another company that specializes in the sale of the equipment or its parts. There would be costs associated with that partnership along with depreciation costs on the sale of that equipment. On top of that, the value of that equipment is a lot less transparent than the value of bitcoin. The liquidation of bitcoin collateral is a simpler process that ultimately is more economical if the lender has the necessary procedures in place, and there are several tested, reliable custody solutions to hold the collateral.

Summarizing BTC-Based Lending Opportunities

BTC-based lending is in its early stages and there aren't many large institutional lenders actively participating. Demand for cash in digital asset markets is high and seems to be increasing over time. Because of this imbalance, cash lending rates will likely remain reasonably high until there is more supply, and yield opportunities may be more attractive than credit opportunities in traditional markets. Lenders that choose to participate will ultimately need to familiarize themselves with bitcoin's infrastructure to properly manage the volatility and custody risks present in the space.

Closing Thoughts

- We continue to see strong growth in both digital asset and cash lending through Q3 2019
- Cash lending, especially to international counterparties, particularly Asia, has grown the most of any asset in our portfolio YTD
- There is real demand to sell certain global currencies into USD and BTC
- Bitcoin is one of the most liquid forms of collateral available for asset-based lending and presents a unique opportunity for lenders to earn yield on cash where many traditional firms are not looking

Sources

[1] - <https://www.bloomberg.com/news/articles/2019-08-05/fears-of-china-capital-flight-hang-over-a-newly-sliding-yuan>

[2] - <https://www.yieldstreet.com/resources/article/advantages-of-asset-based-lending>

<https://www.occ.treas.gov/publications-and-resources/publications/comptrollers-handbook/files/asset-based-lending/index-asset-based-lending.html>

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