DIGITAL ASSET MARKET NOTE: THE BLOW-UP OF 3AC: LTCM WITHOUT THE NOBEL ECONOMISTS

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A process of deleveraging is underway in the digital asset industry. The events of recent months serve as a useful demonstration of how digital assets (or "crypto") are merging with traditional finance—for better or for worse. The liquidation of Three Arrows Capital (3AC),[1] alongside the increasingly apparent exposures of its lending counterparties, have thrown a spotlight on the relatively new crypto lending industry.

At the same time, these events have demonstrated the strengths of decentralized finance (DeFi) applications, which are still running smoothly, and provide transparency and auditability as all transactions on 'defi' platforms are conducted via open source software code and stored on distributed databases that can be checked 24/7.

DeFi vs. CeFi

To start with, it is important to establish what DeFi is. The following is a succinct definition: "Decentralized finance (DeFi) offers financial instruments without relying on financial intermediaries as brokerages, exchanges or banks by using smart contracts on a blockchain."[2]

According to the WisdomTree Digital Asset Taxonomy, [3] the DeFi segment of the digital asset ecosystem is less than 1% of the overall ecosystem's market capitalization.[4] The segment comprises a set of decentralized applications (dApps) that operate on smart contract networks (e.g., Ethereum, Polygon). These dApps provide financial instruments or services such as trading, lending or derivatives. Examples include Aave, Compound and SushiSwap.

The key part of the DeFi definition lies at the end. The implication of using smart contracts on a blockchain is that one can audit the holdings at any point, owing to the transparent nature of distributed ledgers (blockchains) and open source smart contract code. The rules of the contract are very clear. Those who use DeFi apps do so with their public/private key pair[5], which means that they self-custody their assets and decide when and how those assets are used.

DeFi stands in contrast to what some term centralized finance (CeFi). Historically these two domains were separate in the sense that digital asset networks, like the Bitcoin network, were created outside of the traditional financial system (indeed – Bitcoin was created at least in part as a response to loose monetary policy over prior decades). In recent years, however, the lines have been blurring.

The emergence of the centralized crypto lending industry is one such example. The industry can be broadly divided into crypto lending companies (e.g., BlockFi, Celsius, Babel Finance), intermediaries connecting the lenders with borrowers (e.g., Genesis) and the borrowers themselves. These borrowers were often hedge funds who in some cases took leveraged positions on various digital assets. 3AC is one such hedge fund. If not taking leveraged long positions on digital assets, borrowers could also invest their holdings in DeFi apps so as to take advantage of the sometimes high yields offered.[6] Much of this lending activity involved U.S. dollar pegged tokens (stablecoins), which is another example of the blurring of the crypto and traditional financial rails.

With these concepts in mind, it is possible to better understand what is currently transpiring.

Let the deleveraging begin

To understand present events, it helps to start with the collapse of Terraform Lab's TerraUST (UST) and the associated LUNA cryptocurrency. At the beginning of April 2022, the LUNA cryptocurrency was valued at the equivalent of around $41 billion. By mid-May it was worth less than $300 million.[7] The peak amount of outstanding UST was over $18 billion on May 7, 2022. By July 1, 2022, one UST was trading at ¢4 on the dollar.[8]

Think of the collapse of UST/LUNA as a depth charge. Now those who were exposed to the explosion are floating to the water's surface.

The first to show public signs of shakiness was crypto lender Celsius, when it suspended withdrawals citing, "extreme market conditions."[9] The next was crypto lender BlockFi, which began to cut headcount[10] before revealing it was one of a number of companies involved in the liquidation of positions belonging to hedge fund 3AC.[11] It is at this point that the interconnectedness of the various crypto lenders with 3AC (and one another) becomes apparent.

So far it is thought that 3AC had over $200 million in exposure to LUNA[12] —and that is the start. Crypto broker Voyager Digital has revealed in public filings that 3AC was unable to meet payments on a loan of 15,250 BTC, worth about $305 million, and $350 million of USD Coin (USDC).[13] Market maker and lender Genesis is thought to have hundreds of millions of dollars of exposure to 3AC.[14]

At this time, a number of takeover and bailout efforts have been initiated but not concluded. Crypto exchange FTX is one of the main parties.[15] Crypto investment firm Morgan Creek Digital is another.[16] Time will tell how this will play out.

If this story sounds familiar it is because you are thinking about Long-Term Capital Management (LTCM)—minus the Nobel Prize winning economists (or government bailout). The outcome of taking large, leveraged, long positions in markets that are as volatile as digital assets is hardly surprising. It is worth noting that the lack of transparency around the leveraged positions of hedge funds, like 3AC, and the level of collateralization of the positions of lenders such as BlockFi or Celsius, stand in contrast to the transparency and auditability that, as we noted above, are characteristics of DeFi.

In the coming months, expect digital asset prices to remain subdued. The forced liquidation of digital asset positions puts additional supply into markets that have been characterized by a risk-off sentiment since January 2022. Even networks or dApps that have nothing to do with the liquidated positions and insolvencies, and continue to operate smoothly, are likely to end up collateral damage. Also expect more insolvent parties to emerge, particularly as trading volume dries up on small crypto exchanges.

The path to responsible DeFi

The good news is that the liquidation and bankruptcy of these entities has not yet had material impacts via contagion on the traditional financial system.[17] However, as lines between the crypto and traditional finance systems continue to blur, it is hard to imagine regulators not taking an even closer look at activities in and around the digital asset ecosystem. What is likely to emerge will be a more 'responsible DeFi,' spurred on by a more stringent set of regulatory requirements and oversight in industrialized economies. This trend was already apparent with the Executive Order on Ensuring the Responsible Development of Digital Assets[18] in the U.S. and with the soon-to-be-passed Markets in Crypto Assets (MiCA)[19] in the EU. It will continue to gain pace in the near future.[20]

[1] https://blockworks.co/three-arrows-capital-ordered-into-liquidation-by-bvi-court-report/

[2] https://en.wikipedia.org/wiki/Decentralized_finance

[3] For a copy of 'A New Asset Class: Investing in the Digital Asset Ecosystem' please contact digitalassets@wisdomtree.com

[4] https://www.coingecko.com/en/categories/decentralized-finance-defi

[5] Public key cryptography underpins digital signatures. There is a public key, which is revealed to all. Then there is a private key, which one must keep secret. This is the technological means by which one can 'self-custody' one's digital assets i.e. keep the private key secret, and sign transactions using the public/private key pair when adding new entries on a distributed database (i.e. 'blockchain').

[6] https://defirate.com/lend/

[7] https://www.coingecko.com/en/coins/terra-luna

[8] https://www.coingecko.com/en/coins/terra-usd

[9] https://blog.celsius.network/a-memo-to-the-celsius-community-59532a06ecc6

[10] https://www.reuters.com/business/finance/crypto-firm-blockfi-cut-headcount-by-20-2022-06-13/

[11] https://www.ft.com/content/126d8b02-f06a-4fd9-a57b-9f4ceab3de71

[12] https://www.wsj.com/articles/battered-crypto-hedge-fund-three-arrows-capital-considers-asset-sales-bailout-1165546

9932?mod=latest_headlines

[13] https://www.prnewswire.com/news-releases/voyager-digital-provides-market-update-301575492.html

[14] https://www.coindesk.com/business/2022/06/29/genesis-faces-hundreds-of-millions-in-losses-as-3ac-exposure-swamps-crypto-lenders-sources/

[15] https://www.bloomberg.com/news/articles/2022-06-30/ftx-nears-deal-to-buy-crypto-lender-blockfi-in-likely-fire-sale

[16] https://ca.news.yahoo.com/exclusive-morgan-creek-tries-counter-153133748.html?

[17] https://www.ft.com/content/03bb9296-b645-4311-abb2-14bc3ab66443

[18] https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/

[19] https://coingeek.com/ecb-head-christine-lagarde-calls-for-regulation-of-staking-and-decentralized-finance-lending/

[20] https://www.wisdomtree.eu/en-gb/blog/2022-05-19/digital-assets-the-government-is-not-going-to-ban-them

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DEFINITIONS

Cryptocurrency : a digital or virtual currency that is secured by cryptography, which makes it nearly impossible to counterfeit or double-spend.

Decentralized Finance (DeFi) : A system by which financial products become available on a public decentralized blockchain network.

Open Source : Open source refers to a software program or platform with source code that is readily accessible and which can be modified or enhanced by anyone. Open source access grants users of an application permission to fix broken links, enhance the design, or improve the original code.

Blockchain : a distributed ledger system in which a record of transactions made in cryptocurrencies are maintained across computers linked in a peer-to-peer network

Centralized Finance (CeFi) : A type of financial practice within the cryptocurrency sphere where users can earn interest and get loans on their digital assets through a centralized platform.

Stablecoin : Stablecoins are cryptocurrencies the value of which is pegged, or tied, to that of another currency, commodity or financial instrument.

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.