Alex Svanevik: ... to some extent, meaning if they default, the co-signer will pay back at least some portion of the amount that was borrowed and then the co-signer will pursue the person borrowing and that's typically local companies that are basically, what do you call them? Debt collectors.

Tim Tam: Interesting. I think to demonstrate and to demonstrate to the audience how this works, Alex we should go back to the office, I'm going to take out a big loan on Ripio and you should co-sign it.

Nate Tsang: Welcome to the CoinFi Podcast. We have a lot of random conversations about crypto in the office and we thought it would be interesting just hit the record button and riff off of whatever topics come to mind. The idea is that you get to be a fly on the wall in the CoinFi office, giving you an inside perspective on how the team members of a fast growing crypto startup look at this crazy new industry. The CoinFi team has an interesting mix of backgrounds. From co-founding a hedge fund, to launching a Bitcoin exchange in Shanghai back in 2013, to heading algo development for major banks, to managing data science for online brands with hundreds of millions of pages a month and on each episode, we pull in different team members to talk about areas where they have professional expertise, or maybe even just a strong opinion.

What's up CoinFi fans? Welcome back to another episode of the CoinFi Podcast. Thanks so much for joining us. Today, we're talking about crypto-backed loans. You'll learn how you can increase your return by lending out your crypto, the risk of lending your crypto, why lending USD on a crypto exchange might actually be lower risk than lending out Bitcoin and an explanation of how margin lending works. With us today are three CoinFi team members who have personally increased their returns by lending out crypto. First off, we have Tim, CoinFi confounder slash CEO and a former hedge fund trader. Jonney, our head of crypto research and formerly the senior portfolio manager at a volatility arbitrage hedge fund, and Alex, our chief data scientists, and of course as always, I'm your host, Nate Tsang.

Hey Tim, what are you doing with all your idle crypto?

Tim Tam: I'm buying CoinFi, what else am I going to do? Jokes aside, besides the large exposure in CoinFi, the additional Bitcoin and Ethereum that I own personally because I am structurally think that crypto's in a bull market long term, I actually put it on exchanges and lend it out to earn interest because if I'm HODLing Bitcoin, we can get additional return by lending it out.

Jonney Liu: The interest, like, that's interesting, I guess. No pun intended.

But basically I mean, I think people don't realize that you can actually earn some sort of interest on your crypto. Right, unlike in traditional markets, I think a lot of people who, since you're not in- the amount of interest you get is actually very low. But, for the older generation, people might know that at one point in time in the 80's, you were getting 10% interest.

Tim Tam: Yeah.

Jonney Liu: And actually that actually adds up very very fast and compounds very very fast. So getting interest is something that is maybe unique to some people in the market.

Tim Tam: Yeah, but I think for me, regardless of what the return is, I feel that, I'm all about optimizing returns. So, I feel like if you are holding Bitcoin and Ethereum, you should be deploying it somewhere to get interest because there's really no downside. You set it up and it's kind of done automatically and the interest rate for Bitcoin varies between 3-5% per annum, which obviously when compared to traditional crypto returns is not a large amount but compared to interest rate returns in U.S. dollars or Euro or Yen at the moment, it's reasonable and the argument I always make is, it's really no additional work to do. You just set it up and it's earning interest and the way you actually earn interest is you put the money on an exchange where there's a margin lending function. You lend it out at the current market rates and you'll effectively get that additional return.

Jonney Liu: So let's just talk a little bit about, maybe some people want to ... we'll just add some numbers. So what is the interest rate in the U.S. right now? I think in ten years, like 3%, right?

Tim Tam: Ten year bond is like 2.9.

Jonney Liu: I think it might have been past 3.

Tim Tam: Caught me off guard there, I haven't looked for a month. Last time I looked it was 2.9.

Jonney Liu: Yeah, actually last time I looked was probably before I joined the Bitcoin, it was actually when I was working in finance. And how about that for the Yen.

Tim Tam: Yen, I actually don't know that. It's low though. I think it's negative interest rate, isn't it?

Jonney Liu: I don't think it's negative but its pretty much zero.

Tim Tam: Okay. I just know if I put my money in a bank account, it earns like nothing.

Jonney Liu: Yeah, you pretty much, actually I think it might be negative at some points short term. So actually for the audience members, you talked about marginal lending. Can you explain maybe some of the ways that you guys earn interest on the crypto?

Tim Tam: Yeah, so I think Alex and I both lend personally the crypto we have on the exchange and Alex's point is a hundred percent, I think it's not risk free. The difference between keeping Bitcoin in your Trezor or keeping it in your own Ethereum in MyEtherWallet Ether with your own private key is obviously, whenever you put money on an exchange, there is an exchange risk. So, to me, the way I factor it in- I don't put all my Bitcoin on there. I put a substantial amount on the exchanges that I think are legitimate and to me that additional 5% return, that is compounding, actually compensates for that risk that the exchange can bow down. I think, Alex, you do a lot of lending as well, what are the exchanges that are currently available for lending on Bitcoin and Ethereum and other coins and what coins can you actually lend on?

Alex Svanevik: Yeah, so I think Bitfinex is probably the big one. There are a couple other exchanges as well. Coin is one Poloniex I believe is the third one. There's actually a very nice service called CoinLend where you can automate a lot of your lending across these three different platforms. That's one that people can check out.

Tim Tam: Interesting, can you walk us through that- first I imagine it's a bot or something like that, right?

Alex Svanevik: Yeah, that's right. So, essentially what you do is you set up accounts on these different exchanges or it could be just one of them and then you give API keys to CoinLend which gives them access to essentially control your margin lending. So it doesn't control your trading, it can't do anything like that, it can't withdraw any of your funds but it can automate the lending of course as itself. Because these loans that you give out are typically quite short term. So, 2 to thirty days, which means that you need to basically have some kind of mechanism to renew the loans.

Jonney Liu: That's interesting. Can you guys talk about margin lending. I obviously know what it is, but maybe a lot of people don't. What is margin lending and who are you lending to?

Tim Tam: Margin lending is when you put crypto on an exchange and I'm lending that out to another trader to trade. So let's do it by example. I lend out my Bitcoin to the exchange, I'm getting paid roughly 5% per annum, and what happens is the other side of the trade. So let's say Alex is probably taking that Bitcoin-

Jonney Liu: So he's borrowing.

Tim Tam: He's borrowing it and that's how effectively you can short Bitcoin. So Alex is paying 5% interest per year to short Bitcoin. Now, obviously the danger is, it's done on what's called margin. So, it's leverage. So let's take Bitfinex as a specific example. What they actually do is they require from memory, twenty, I think it's 30% margin? Or is it twenty?

Jonney Liu: I think it would actually be twenty off the top of my head.

Tim Tam: I think it's twenty. I think it's twenty percent margin, we'll crosscheck and put it in the show notes. But effectively, what happens is you put 20% of the capital down, so if you want to short one Bitcoin, you actually have to put 0.2 Bitcoin with Bitfinex.

Jonney Liu: And then you borrow from you to ten?

Tim Tam: Yeah. And then, you effectively are able to short one Bitcoin. But if the position runs against you and your profit and loss is minus 0.2, they immediately liquidate your position and return the Bitcoin back to the borrower.

Jonney Liu: I see. And I guess, the person who lends gets paid an interest rate in order to assist this function.

Tim Tam: Correct.

Jonney Liu: And just so people know, there's actually a whole market and we spent a lot of time speaking about Bitfinex so far because they've actually been ... correct me if I'm wrong but they dominate pretty much the lending market.

Tim Tam: Yeah.

Jonney Liu: At least on exchanges, right?

Tim Tam: Absolutely. And I think, if people are interested, they can go to Bitfinex.com/stats and they can actually see the annualized and daily interest rates of all the different coins that are available for lending. What's actually interesting is they actually show the U.S., sorry, the amount on the lending book. Which means, what is the total amount that is being lent out and when I checked the figures earlier, it's 400 million USD a year, I'm sorry, that's 400 million USD that has been lent out currently as of today. And about 400 million worth of Bitcoin being lent out as well so it's about 60 thousand Bitcoin.

Jonney Liu: So it's actually kind of a large market with people trading and I guess people going short at the same time as well.

Alex Svanevik: Correct. So, actually I think one thing that might be a bit counterintuitive to people is that you can also lend out fiat on these exchanges.

Oh, yeah so in theory you could get interest on your fiat on a crypto-exchange without having any exposure yourself to crypto if you have a position that's purely in U.S.D. for instance.

Jonney Liu: Yeah, it's good that you brought this up because I remember last year when I kinda started dipping my toes into the crypto market and actually that was the first thing I looked at, that it had a skyrocketing USD lending rate. So, in order to borrow USD on Bitfinex, you had to pay northwards of 100%, you know, 50 to 100% per annum, right? Maybe, one of you guys can explain why that was the case or-

Tim Tam: Yeah, I remember those rates. The rates completely dropped now, I think you're looking at about 3-4% per annum, now. But last year I actually did this trade and when I looked at the profit in parts by average, it ended up being about 65% return last year and yeah-

Jonney Liu: What do you think has happened? Why do you think it's the long that happened?

Tim Tam: Well, I personally think and I don't think anyone knows 100%, but the way you look at it, what drives the lending rate up drives demand or borrowing that particular asset. So, in this case last year, the U.S. Dollar lending rate was going up, so why are people borrowing U.S. dollars on Bitfinex but borrowing U.S. dollars to trade on margin to buy crypto? So, in a bull market, like last year, people think, oh I don't care about paying 50 to 100% interest a year on borrowing U.S. dollar because Bitcoin is going to 3x and I'm going to make like 3 or 400%. So that's the bet people are making. So, I guess ... another interesting point; what is the correlation or is there any correlation when you see high funding rates and the state of the market, I mean, what do you take away from it, Jonney, as a financial trader?

Jonney Liu: Yeah so the funding market like any other market, like crypto or even equities or whatever, it's driven by supply and demand, right? So you brought up a point, where there's a huge demand for USD but at the same time, there was actually a lack of supply. People don't forget about it but then Bitfinex actually stopped their USD deposits so it's really hard to get USD into a system. So people are willing to pay exorbitant amounts just to get in there and just try to buy in this mixed money, right? So, that's what they're trying to pay.

Alex Svanevik: And in those situations, I think it's fair to say, if you happen to have that asset available on the exchange, if there's a lot of demand for it, you're probably getting pretty good return if you were to consider given the risks as well, compared to most other investments.

Tim Tam: And I think, to that point, if you have the cash and you believe in the exchange and the return is high, you know, it's a good risk-reward trade. The other thing, I think is clearly with the benefit of hindsight, it will work out so not saying you guys should do this, but last year when the rates were 50-60%, upwards to 100%, some people potentially, if you can borrow U.S. dollars at a cheaper rate, even again, full disclosure I'm not saying you should do this. This is purely academic. But, you can even arbitrage where you could borrow a personal loan at like 10% or something like that. Put it on a two day return and get annualized like

50-100% a year. Now, clearly there is risk involved in that. The exchange could go down, the rates can drop and things like that, but just explaining it kind of as a financial mechanism, people can ...

Alex Svanevik: Maybe we should explain a bit, the actual risks that we see in this process of lending out money, so the exchange can get hacked. That's not very likely, I think it's happened once with Bitfinex in 2016-

Jonney Liu: And I think, I'm not trying to endorse them, but I think they've been around long enough that I think they've gotten most of their security down. Although, these things are always changing all the time, right?

Tim Tam: And I think, sorry go ahead.

Alex Svanevik: No, I think, the other thing is, it might not be clear to people what kind of security you have as you lend out on this platform, but actually what happens is that when someone does leverage a trade, they get liquidated, right? It's the price of losing the wrong direction, which means there's kind of a safety net for you as a lender so that you won't lose your money.

Tim Tam: So let's break down those points because it's really interesting that you mentioned that, because I did this trade last year and my wife thought I was crazy. So I looked at all the risks to kind of explain why I thought it was a good risk assessment return so we go down point by point. I think the first one, you're right. The exchange can actually get hacked but if you do the U.S. dollar lending trade, when the exchanges get hacked, they just hacked on their crypto and if you look at Bitfinex's previous policies more or less, or talk generically about all exchanges, they do like socialize losses, so if you lend Bitcoin out, I think it's higher risk than lending U.S. dollar because Bitcoin can get hacked and then they socialize the losses but it is, I think, pretty difficult to get your U.S. dollar hacked. It's stored in a bank account at the end of the day, so there is the hacking risk and of course there it ... so I feel it's lower for U.S. dollars. There still is a risk that you need to trust the exchange that they're not going to run away with your money. But, again, if you look at exchanges that have been around longer, I think you can assess comfortably the risk. And then the last risk you have is liquidation, maybe Jonney you can explain this way better than me.

Jonney Liu: Yeah so actually we call this also debt risk as well in the financial terminology but just imagine the person that you lent it to, the leverage they put down 20%, right? That 20% is supposed to protect your capital. It's basically collateral for you to know that your money will get returned. So what happens with your shorts? Just imagine a price ... he borrows one Bitcoin from you and he shorts. And he puts down 0.2 Bitcoin. Right?

Tim Tam: Is he borrowing 0.8 or one?

Jonney Liu: He's borrowing one Bitcoin and putting down 0.2 Bitcoin, 20% in this case. So now just imagine the price of Bitcoin goes up. Goes up 10%, so it goes to ... the person now is losing 0.1 Bitcoin. The 0.2 still covers that loss. Now let's say it goes up another 0.1 Bitcoin and so therefor you lose another 10% so you lose this 0.2 Bitcoin, so at that point, the mechanism of the exchange is to unwind.

Tim Tam: What do you mean unwind?

Jonney Liu: So basically they auto-liquidate his position. Therefore he was short, he was forced to buy back. The exchange automatically does it for him and therefore you get your money back without ... you get your whole Bitcoin back and that 0.2 loss is something that he bears by totally by himself.

Tim Tam: Right.

Jonney Liu: But the problem is that, if you can imagine if it a market is very very fast moving, instead of going ... drastically upward, the exchange can liquidate it very easily. Suddenly the exchange ... let's say it shoots up to the roof, it might actually not be able to liquidate with enough cushion such that the 0.2 actually put down as collateral is enough and that becomes a loss and that actually might get socialized as well. If too many people do it, then this number can actually get very very large. So, the risk of shortskies is very large and you can almost imagine like if there is a gap risk. Gap risk is basically, you're unable to trade at increments and suddenly ... the whole price of Bitcoin drops like 50% when you only have a 20% buffer, then actually there's a 20 to 30% loss. Just imagine suddenly there's a massive attack and price of Bitcoin drops 50%. All these people that only put down 20% is suddenly at a loss of 30%. And the exchange has to foot that bill now. They're not going to be able to foot that bill, you're going to foot that bill.

Tim Tam: I mean, that sounds very scary, Jonney. I mean- well I was gonna ask Alex, we both do this. Should we not do it? Is it like really that risky? What do you think?

Alex Svanevik: I think if you believe that they have good systems in place, when you look at the actually returns you get, in many cases, it's going to be worth it, I think. I mean, so, I guess there's another risk there of movement ... in the price of the asset you're lending out. So, for instance, right now you can, or very recently you can lend out NEO at something like 800%. So if you're lending that out at a 30 day loan and now the price moves dramatically in the wrong direction for you, you can't really sell your position ...

Jonney Liu: Yes.

Alex Svanevik: Of your assets. Whereas, maybe you could say that a third risk, put some over here and when you see an interest of 800%, there might be something strange going on.

Nate Tsang: Yes.

Alex Svanevik: So it might be worth investigating that before you start lending out the money or you could just, you know, go for it and hope for the best.

Jonney Liu: So before I go to fourth risk, I actually want to go back to-

Tim Tam: Wow, so many risks guys-- hang on, hang on I gotta stop this podcast and then cancel my lending.

Jonney Liu: I mean a lot of these risks are not likely but, you know, we're talking about the mechanism of unwinding should something happen. Right? In general, if it's done correctly and it should be like 20% market is a lot or even 30% I think may be the case is actually a lot to do any sort of trading, you know like in equities, do like a future in S&P, I think you can put 5% down or even less in some cases, depending on how large an institution you are. But, you talk about the mechanism, recently OKEx was all over the news, they had a ... it's not to do with lending but they had a mechanism for unwinding and that didn't go down so well, right?

Tim Tam: That's true, that's true.

Jonney Liu: So that's why I bring up the risks. I'm not saying it's going to happen every single time.

It's not risk free, so therefore you do need to take that into account.

Tim Tam: Absolutely and I think Alex, you had a really interesting point about Neo being 800% and, if you put a 30 day loan in, it could drop a lot and then you can't do anything about it because you've lent out Neo to earn interest. I think the mean, looking at it very ... breaking it down in terms of what risks you're taking ... these trades already work if you're already long Neo. Making your taking a long term view on Neo here and you're trying to earn interest on it. If you're switching USD to buying Neo to lend out or you're switching Bitcoin to Neo to lend out because of a high rate, that's a different kind of trading risk.

Jonney Liu: You would need to find a way to short Neo, if you have to borrow Neo, that wouldn't be simple.

Tim Tam: It's too complicated.

Alex Svanevik: But also I think you have to look at it in a portfolio perspective.

Tim Tam: Yeah.

Alex Svanevik: If you're already long, say and that's what Alex was saying, why not get interest on that.

Tim Tam: Exactly. So I think a lot of these funds or personal investors that are Neo, EOS, Bitcoin or whatever crypto you are, there is small optimization you could do is, whatever amount you're comfortable lending, putting on an exchange which is obviously more at risk than a cold wallet especially if the return's high, there's some threshold, right, so if you're not comfortable with exchange risk at Bitcoin being 5% interest, well what happens if it jumps to 50, what happens if it jumps to 100. These rates jump around all the time, at some point, I think the risk justifies the reward. I think, also, not to jump back and forth, but I feel, compared to financial markets, maybe because I'm a true crypto believer, I think the gap risks and the margin liquidation risks is extremely low in Bitcoin because it's what we call a very liquid market. It trades billions of dollars a day.

And I'll say, if you contrast it with the equities market, if you're trying to short something like Tesla and you lend Tesla out to someone else to short. Because you can do stock lending in equities market. You hold Tesla and you can, well as a hedge fund you can do it, but maybe we tell investors that are lending out but there are people like State Street--, yeah, but State Street who custody a lot of equities, they will lend it out and earn the interest rate on the stock and there's obviously a risk. I think there's a bigger risk on that because the difference is that in real stock market exchanges, there's an open and a close. So the gap risk that you talk about, Jonney is much bigger in stocks versus crypto because the U.S. stock market exchange closes and then people could be short and then the next day Tesla has like major earnings and it opens up 50%. It suddenly goes like, let's say a dollar to a dollar fifty. Right? Whereas Bitcoin, unless there's something wrong, is not going to jump from a dollar to a dollar fifty. You're not trading ...

Jonney Liu: I think we should put it in perspective, you know. There are some stocks out there that are probably just risky and they're not traded 24 hours, 24/7, right? So, I think I don't want to scare everyone to say that you should never do any of this, you just have to understand that, I think Bitfinex in general they hold quite a large margin such that it's protectable. Because it could go down 10% I mean, at some point they're gonna put in more margin in order to keep that trade in, right? Otherwise, you get liquidated.

Alex Svanevik: Yeah. And I think it's interesting for people to know about this in a sense that there are many different ways you can get return on your capital. It doesn't have to be just investing in ICOs or going long-- yeah exactly going long on coins. You can actually do this and have fiat in a crypto exchange and get returns on it.

Tim Tam: Exactly.

Alex Svanevik: So it adds to a portfolio.

Tim Tam: Yeah. It adds to the spectrum of investments you can make and then-

Jonney Liu: Exactly right.

Tim Tam: Because I think on top of that is if you're already long crypto and you already believe in crypto, what additional things you can do to enhance that return by earning interest.

Jonney Liu: Right. So there's actually, I sound like I'm the risk freak or whatever, but actually what more risk, or not real risk ... I don't know if you guys know this because we've all been independently lending on Bitfinex, right, that there's actually a prepayment risk. I don't know if you notice but sometimes I think I'm lending for 30 days but actually it turns out that it gets returned to me.

Tim Tam: Yeah, yeah. Right. But is that a risk or is it just kind of a design that's not explained very well?

Jonney Liu: It's a design but actually it's not so different than a bank from when they lend out ... they have a mortgage. Someone gets a mortgage from a bank. The bank actually has to price in a certain amount of the prepayment of the person paying back the mortgage early and it's actually in finance, maybe getting a little too deep, it's actually called a prepayment risk. And actually affects the price of what you can get out of your lending.

Tim Tam: Right. That's too complicated for me. It's good to know. It's all about how you price a 30 day loan on a prepayment.

Jonney Liu: Well that is that, let's keep it simple. You know, you think that, oh I'm lending out for Neo at linear 800% per year, this is easy, I'm going to do it right now and I'm going to take out a year loan somewhere else. But actually this 800% is not really 800% because after three days, the person returns it to you and you are now hooked on the other side for borrowing.

Tim Tam: Yeah.

Alex Svanevik: And truthfully, I wouldn't call that a risk, but that is actually something to consider when you calculate the interest.

Jonney Liu: Yeah, it affects how much you think you're really receiving and in return, that is a risk.

Alex Svanevik: Yeah, that's true.

Tim Tam: This is too risky, I'm like, getting white hair.

Jonney Liu: I mean ... it seems like margin lending is like, the only way to get interest and I know Alex, you were looking at other platforms and stuff like that. Is there anything interesting from there?

Alex Svanevik: So there are a few other platforms for lending in cryptospace. They are quite different though. There's one called Nexo where you can get a fiat loan if you put up cryptos as collateral. So it's kind of a different beast altogether, but it's interesting to know about in the space of crypto and lending. There's also one called Ripio Credit Network that we talked a bit about. This is, as far as I know, a bit more similar to the more traditional peer to peer lending platforms.

Jonney Liu: Okay.

Alex Svanevik: Where you pretty much, you're lending out money to another party but there's no mechanism to for instance, to liquidate them. You have to more or less trust that they will pay you back the money that you lent. So that's why you have like a decentralized process for credit scoring and KYC and all these different things, at least that's what they described in their white paper. I think they just launched a very basic version of their platform recently. But that's kind of a different beast because you don't have the liquidation process, for instance, as you have on margin lending.

Tim Tam: That's really interesting and mapping it back to the real world. And that's, I didn't even know about those, by the way, but it sounds like mapping it back to the real world, you really kind of have two types of lending. One in finance who call like, credit score based lending. So, if I ... this is probably not the best example, but, for instance like a payday loan. Right? I go get ... I'm about to get paid in two weeks but I need cash, so I go get a loan amount and they're basically lending based on my credit score which screening how much they think I'm gonna default and there's another one called asset based lending. So you actually have to put your crypto down in order to get fiat. I guess in the real world, again these are rather extreme examples but, in the U.S. at least they have title born companies where you give your title to your car or your property, asset based.

Alex Svanevik: Actually, in the case of Ripio, it is a bit more nuanced than what I described because you have what's known as a co-signer so essentially the co-signer provides the collateral to some extent meaning if they default, the co-signer will pay back at least some portion of the amount that was borrowed and then the co-signer will pursue the person who borrowed. And that's typically local companies that are basically, what do you call them ... debt collectors.

Tim Tam: Interesting. So I think to demonstrate and to demonstrate to the audience on how this works, Alex, we should go back to the office, I'm gonna take out a big loan on Ripio and you should co-sign it. We gotta do that report back to you.

Alex Svanevik: Yeah, we gotta do that the other way around. You can be the co-signer.

Nate Tsang: Thanks for listening, everyone. We hope you got something out of this conversation looking at crypto-backed loans. You can find the show notes for this episode at CoinFi.com/podcast. Thanks to Tim, Jonney and Alex for taking time out of their busy day to share their thoughts. Be sure to hit subscribe and we'll catch you guys next time on the CoinFi podcast.

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