BETTER MARKETS

CRYPTO

FACT SHEET

Crypto Lending Poses Huge Risks for Retail Investors

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Introduction

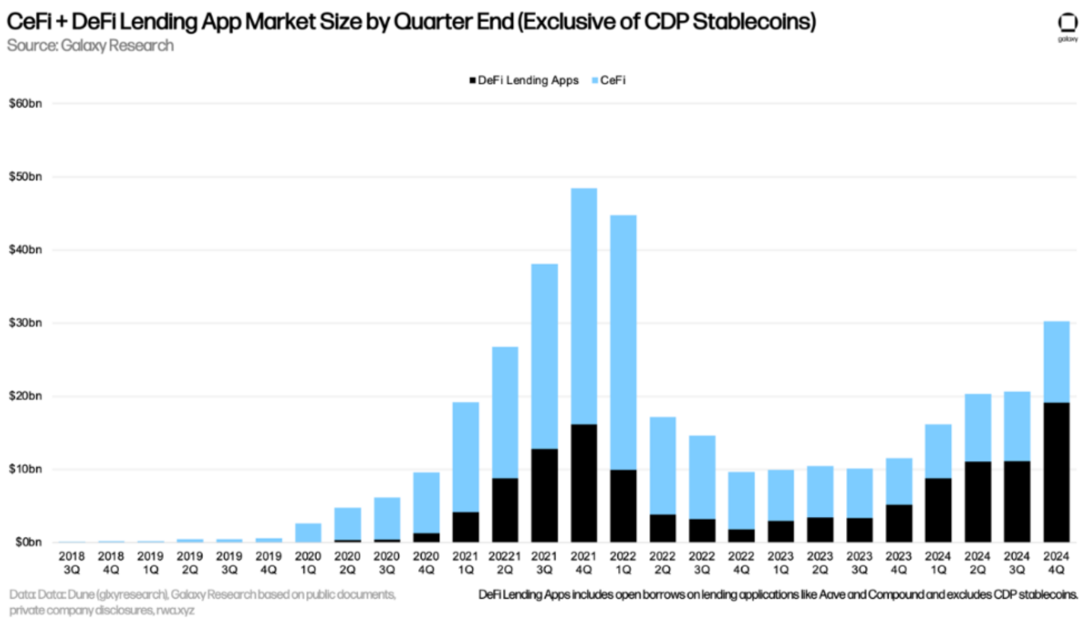
On July 13, 2022, crypto lender Celsius Network filed for bankruptcy. Celsius's business took crypto deposits from retail customers and used them to invest in the crypto market. Celsius promised that retail investors would receive huge interest payments. The lure of big profits led individual investors to pour assets into Celsius and similar platforms. But Celsius's investments quickly soured in the volatile crypto marketplace, and it became unable to meet redemption requests from customers. Celsius's customers lost $5 billion as a result.

One year later, on July 13, 2023, the SEC sued Celsius and Alex Mashinsky, its founder and former chief executive. The SEC alleged that Celsius and Mashinkyk violated the registration and antifraud provisions of the securities laws. The FTC also announced a settlement with Celsius to permanently ban it from handling customers' assets. That same day, Mashinsky was arrested and charged criminally. The cases all stemmed from, among other allegations, misleadingly positive statements Mashinsky made about Celsius's financial health that induced investors to participate in Celsius's "earn" program.

Unfortunately for investors, Celsius's implosion was not an isolated incident. Crypto lenders Genesis Global Capital and BlockFi, among other firms, also filed for bankruptcy after they underwrote unsecured loans to hedge funds or exchanges that blew up after the plunge in crypto prices that destroyed Celsius. The bankruptcies left "millions of depositors who parking savings with such lenders . . . in limbo as they hope[d] to get back some portion of their money in slow-moving bankruptcy proceedings."

At the time, the collapse of these crypto lenders was considered the end of an era. Their collapse highlighted "the shaky foundations, risky practices, and lack of regulation in the sector." The bankruptcies "nearly wiped out the entire crypto-lending industry."

Now, crypto lenders are making a comeback. Some firms that had previously paused their efforts to sell crypto lending products to investors have resumed those efforts. For example, in 2021, Coinbase planned to launch a program that promised users interest in return for lending their crypto. Although Coinbase wanted to diversify its revenue beyond trading fees and catch up to crypto lending competitors such as BlockFi, it ultimately shelved its "Lend" program after the SEC alleged it would constitute an unregistered security. Now, however, Coinbase has introduced a rewards program where users can earn yield on their stablecoin deposits—despite the risks to investors of issuing such a product without the protections of a regulatory regime. These stablecoin arrangements, where users can deposit stablecoins and earn yield at affiliated platforms, essentially replicate banking without being regulated under the banking laws—yet Congress is poised to bless such arrangements in the GENIUS Act. Coinbase's actions mirror a greater market trend, whereby crypto lending fell after the demise of Celsius and similar firms but has risen again as memories of those collapses have faded.



Crypto lending is climbing back, with DeFi apps leading recent growth.
GALAXY RESEARCH

Crypto lending is likely to grow even more as the Trump administration eliminates all guardrails around the crypto industry. So far this growth is being driven by decentralized finance (DeFi) applications that are supposed to be safer. A new type of crypto lending has also emerged, as firms are now allowing retail investors to use their crypto as collateral for loans. So in addition to retail investors trying to earn interest by lending their crypto, they are also taking out loans against the value of their crypto. And Congress is poised to allow virtually unfettered margin lending from crypto brokers to customers in the CLARITY Act, unlike the relatively strict limits on margin lending under the securities laws. As crypto lending proliferates again, it's worth remembering that the failure of Celsius and other crypto lenders once more reinforced this mantra: retail investors "should be wary about the promise of sky-high returns" because if "it sounds too good to be true, it often is."

Celsius Promised Retail Investors Impossible Returns

With the benefit of hindsight, it is not hard to understand why retail investors deposited their crypto with Celsius. Alex Mashinsky, Celsius's founder, "trumpeted an opportunity that seemed too good to pass up: savings accounts where people could deposit cryptocurrencies and receive annual yields as high as 18 percent." Mashinsky "explained that Celsius's rates were so much higher than bank deposit rates not because it was risker than a bank, but because it passed along more of its earnings to customers." According to Mashinsky, it was "the traditional finance system that's ripping people off by taking their deposits, using them to make money, and then claiming it can only pay tiny interest rates." So Mashinsky told his customers that they could make a lot of money, stick it to greedy banks, and help the less fortunate, all at the same time:

> "The beauty of what Celsius managed to do is that we deliver yield, we pay it to the people who would never be able to do it themselves, we take it from the rich, and we beat the index," Mashinsky said during one stream in December [2021]."

The problem was, as should have been obvious, that Celsius could not pay such high interest rates without taking on more risk than a traditional bank. What Celsius was actually doing was relying "on a stream of deposits from retail investors that it lent to large crypto companies and used for risky bets on untested ventures." This reckless pursuit of high returns along with losses from a string of bad bets caused Celsius's downfall.

Retail Investors Now Confront DeFi Lending Applications

As discussed above, DeFi applications are leading crypto lending's comeback. The "seemingly too-good-to-be-true, double-digit percentage yields are coming back in the decentralized-finance sector," as the current crypto boom revives crypto lending. DeFi lending applications now exceed centralized finance apps in market size. These DeFi applications are supposedly safer because they require more collateralization for their loans than did platforms like Celsius and are managed by computer code called a smart contract. The problem is that "DeFi loans function more like sophisticated trading products," and are not necessarily appropriate for the retail investors who were lured by the past promises of crypto lending platforms and who suffered massive losses as a result.

> "That's not a retail or mom-and-pop product. You have to be quite advanced and have a take on the market," said Otto Jacobsson, who worked in debt capital markets at a bank in London for three years, before transitioning into crypto."

Still, it is likely that the crypto lending industry will again seek to entice retail investors to invest in these supposedly safer crypto lending products. The lure will surely be that interest rates on DeFi lending platforms "usually far exceed those in traditional finance." And the industry will have an incentive to ensnare retail investors because, despite crypto lending's renaissance, "[m]any institutional lenders are still staying on the sidelines."

> "Jeffrey Park, portfolio manager and head of Alpha strategies at Bitwise Asset Management, said that his firm used to have a fund to lend to crypto lenders such as Genesis on behalf of their investors prior to the collapse of the now-notorious FTX exchange. 'We're not doing that anymore,' Park said. . . . "I don't think anybody was interested in earning yield in a fashion where they thought that their principal downside risk might be very high."

Retail investors are likely to be less wary of downside risk and more susceptible to the promise of getting rich quick. In the last crypto boom, retail investors were told they could "earn outlandish returns by parking their tokens on now defunct platforms like Celsius." The promise of these returns proved too hard for retail investors to resist. Yet, in the end, crypto lending harmed them. Why should we expect the ending to be any different now?

Lending Through DeFi Applications Is Still Risky

Despite the hype that DeFi is the future of crypto lending, it is not clear that these products are any safer for retail investors. That's because these platforms are still similar to banks but without the protections that banking regulations provide:

> "Fundamentally, crypto lenders have the same business model as banks. But traditional banks are subject to a web of regulations including capital requirements, bank examiners who review the quality of the loans, and a backstop from the Federal Deposit Insurance Corp. to ensure that small depositors are kept whole in case of a bank failure. Crypto lenders don't have such protections."

It is not surprising that these risks were not discussed during the heyday of Celsius and its contemporaries. But it is troubling that they are also not being discussed now. The problems that retail investors encountered with Celsius and similar platforms may recur with DeFi.

> "It's hard to know what the crypto lending firms are invested in as there aren't uniform rules for them to disclose what exactly deposits can and can't be used for. The same goes for decentralized finance, or DeFi, instruments that also lure crypto investors with sky-high interest payments."

The use of smart contracts through DeFi platforms, while supposedly preventing the undercollateralized loans that plagued Celsius and similar platforms, also introduces new risks. Smart contracts have been subject to countless bugs and hacks over the years. "Hundreds of millions are wiped out from DeFi protocols each year."

Indeed, Celsius's problems began when hackers stole $54 million worth of bitcoin that it had invested with a DeFi platform. And Celsius's involvement with DeFi platforms made it riskier generally. The company's biggest misstep was its decision to invest in Lido Finance, a DeFi platform. "Investing in DeFi 'significantly changed the risk profile of what was happening. . . [it] gives you very high yield for immensely higher amounts of risk,' sa[id] Simon Dixon, an investor in Celsius who also ha[d] tens of millions of dollars deposited with the company." Celsius "became a huge source of funds for DeFi projects," and its "rapid entry into DeFi outstripped its ability to manage the risks."

Perhaps the biggest risk that is not being discussed is the risk from crypto's volatility. What really doomed Celsius and similar crypto lenders was the fact that since "deposits are held in cryptocurrency, users are at risk when prices drop." In other words, the risk with lending crypto so others can invest it is that "if their bets turn sour and they can't pay you back, you're left with nothing." And because "the crypto accounts aren't FDIC insured, customers can lose their deposits if a firm goes bust, is hacked, or otherwise loses its customer's funds." DeFi apps are not necessarily insulated from this risk.

> "DeFi lending involves using cryptocurrency as collateral to borrow other assets, but this comes with risks tied to the volatility of collateral values. **If the value of collateral drops sharply, it can lead to undercollateralization, triggering liquidations and potential loss of assets.** Which more often than not happens in a highly volatile market like crypto."

So it is unclear how DeFi is going to be able to protect investors if crypto prices plunge.

In addition to the risk that retail investors will lend crypto and be unable to get it back, crypto's volatility is especially problematic for retail investors who use crypto as collateral for loans. "One big risk is that if the price of bitcoin faces wild swings, the value of your collateral could get affected, leading to a liquidation of some of your bitcoin holdings." Whether investors understand this risk remains to be seen. Coinbase trumpets its bitcoin-backed loans, saying repeatedly on its website that users can borrow up to $100,000 in USDC (a stablecoin) against their bitcoin in under a minute. At the end of its promotion, Coinbase says if "the amount of your loan, including accrued interest, reaches a certain threshold relative to the value of your collateral, liquidations are triggered." Will investors understand that even small price movements in bitcoin could wipe them out?

There's also the potential for predatory interest rates for the borrowers. For example,

> "Bitcoin payments app Strike has also recently launched a lending product, shocking some with predatory loan terms combining a 12% interest rate, 2x collateralization, and the high risk of liquidation if the notoriously volatile asset's price dips."

For these and other reasons, the UK's Financial Conduct Authority is considering restrictions on the ability of retail investors to lend and borrow crypto. The FCA has stated that crypto lending or crypto borrowing presents "risks of significant harm," including loss of ownership, liquidity risks, and a lack of consumer understanding. To put it more bluntly, some economists say that using crypto as collateral for loans "is bonkers banking given cryptocurrencies are risky, volatile, and have no intrinsic value."

Conclusion

In 2020, Celsius's Mashinsky said that Celsius was actually safer than most banks. He said that banks could pay out more in interest but just chose not to.

> "Somebody is lying," said Mashinsky. "Either the bank is lying or Celsius is lying."

As it turned out, Celsius was lying. Mashinsky was convicted of fraud and sentenced to 12 years in prison. The fraud devastated regular people. As part of the bankruptcy, one couple wrote that they had put about $150,000 in Celsius hoping to start a family. Another had invested in Celsius in the hope that he would have money to pass on to his daughters. At the time, the "risky practices at Celsius and other companies that blossomed during the crypto boom . . . present[ed] a challenge for legislators and regulators, who face[d] questions over why they did not do more to protect ordinary investors." Unless those legislators and regulators reverse their current courtship of the crypto industry and take action to protect ordinary investors now, these questions may recur sooner than later.

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