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

Benjamin Dean – Director, Digital Assets
07 Jul 2022

A process of deleveraging is underway in the digital asset industry. The events of past 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 also demonstrated the strengths of decentralized finance (DeFi) applications, which are still running smoothly, and provide transparency and auditability that are so often not present in the traditional financial system.

DeFi vs. CeFi

To start with, it is important to establish what is and is not 'decentralized finance' (DeFi). 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 market capitalisation[4]. The segment comprises a set of decentralized applications (dApps) that operate on one or many layer 1 smart contract networks (e.g. Ethereum, Polygon, etc.). These dApps provide financial services or instruments 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 in time, 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 these DeFi apps do so in possession of their public/private key pair, which means that they self-custody their assets and decide when and how those assets can and are used.

DeFi stands in contrast to what some term Centralized Finance (CeFi) or Traditional Finance (TradFi). Historically these two domains were separate. Over 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 up 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. Three Arrows Capital (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[5]. Much of this lending activity involved US 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 UST/LUNA. At the beginning of April 2022, the LUNA cryptocurrency was valued at the equivalent of around US$41 billion. By mid-May it was worth less than US$300 million[6]. The peak amount of outstanding UST was over US$18 billion on 7 May 2022. By 1 July 2022 one UST was trading at 4cents on the dollar[7].

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”[8]. The next was crypto lender BlockFi, which began to cut headcount[9] before revealing it was one of a number of companies involved in the liquidation of positions belonging to hedge fund 3AC[10]. 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 US$200 million in exposure to LUNA[11] - 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 US$305m, and US$350m of USD Coin (USDC)[12]. Market maker and lender, Genesis, is thought to have hundreds of millions of dollars of exposure to 3AC[13].

At this point in time, a number of takeover and bail-out efforts have been initiated but not concluded. Crypto exchange, FTX, is one of the main parties[14]. Crypto investment firm, Morgan Creek Digital, is another[15]. 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 Economists (or a government bail-out). 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 according to the definition of DeFi explained at the top of this note.

In the coming months expect digital asset prices to remain subdued. The forced liquidation of digital asset positions puts additional supply onto markets that have been characterised 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 (e.g. Aave and Compound), 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[16]. As lines between the crypto and traditional finance systems continue to blur, however, 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 industrialised economies. This trend was already apparent with the Executive Order on Ensuring the Responsible Development of Digital Assets[17] in the US and with the soon-to-be-passed Markets in Crypto Assets (MiCA)[18] in the EU. It will continue to gain pace in the near future.[19]

Sources

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

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

3 ‘A New Asset Class: Investing in the Digital Asset Ecosystem’

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

5 https://defirate.com/lend/

6 https://www.coingecko.com/en/coins/terra-luna

7 https://www.coingecko.com/en/coins/terra-usd

8 https://blog.celsius.network/a-memo-to-the-celsius-community-59532a06ecc6

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

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

11 https://www.wsj.com/articles/battered-crypto-hedge-fund-three-arrows-capital-considers-asset-sales-bailout-11655469932?mod=latest_headlines

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

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

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

15 https://ca.news.yahoo.com/exclusive-morgan-creek-tries-counter-153133748.html

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

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

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

19 https://www.wisdomtree.eu/en-gb/blog/2022-05-19/digital-assets-the-government-is-not-

going-to-ban-them

View the online version of this article here.

Important Information

Marketing communications issued in the European Economic Area ("EEA"): This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

Marketing communications issued in jurisdictions outside of the EEA: This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as "WisdomTree" (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

For professional clients only. The information contained in this document is for your general information only and is neither an offer for sale nor a solicitation of an offer to buy securities or shares. This document should not be used as the basis for any investment decision. Investments may go up or down in value and you may lose some or all of the amount invested. Past performance is not necessarily a guide to future performance. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

The application of regulations and tax laws can often lead to a number of different interpretations. Any views or opinions expressed in this communication represent the views of WisdomTree and should not be construed as regulatory, tax or legal advice. WisdomTree makes no warranty or representation as to the accuracy of any of the views or opinions expressed in this communication. Any decision to invest should be based on the information contained in the appropriate prospectus and after seeking independent investment, tax and legal advice.

This document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public offering of shares or securities in the United States or any province or territory thereof. Neither this document nor any copy hereof should be taken, transmitted or distributed (directly or indirectly) into the United States.

Although WisdomTree endeavours to ensure the accuracy of the content in this document, WisdomTree does not warrant or guarantee its accuracy or correctness. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any affiliate, nor any of their respective officers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.