MONTHLY INSIGHTS DECEMBER 2022

A Crypto Lehman Event

Following the collapse in the Luna crypto network earlier this year, we have now seen the second major negative event this year on crypto where FTX, the second biggest US crypto exchange filed for bankruptcy in November. It is estimated that USD 60 billion were wiped out of the digital currency space when the Luna crypto network collapsed. The impact on FTX implosion is estimated to be more than double, wiping out USD 152 billion from the world's 15 largest cryptocurrencies market value. This article will discuss the implication on the crypto-world from the FTX collapse, where this event is considered as the crypto Lehman moment.

FTX Exchange was a leading centralized cryptocurrency exchange specializing in derivatives and leveraged products. Founded in 2018 by MIT graduate and former Jane Street Capital international exchange-traded funds trader Sam Bankman-Fried, FTX offered a range of trading products, including derivatives, options, volatility products, and leveraged tokens. Cryptocurrency exchanges can be centralized, where there is an entity that manages the platform and holds the user's assets, or decentralized, where the platform is run by the users themselves.

On November 2, CoinDesk published an article that triggered a chain reaction, bringing FTX and Alameda Research to file for chapter 11. Alameda Research, founded and 90% owned by the founder of FTX, is a quantitative cryptocurrency trading firm. According to the company's balance sheet, Alameda Research had USD 14.6 billion worth of assets, a majority of which was FTT tokens. FTT tokens are minted by FTX, and compared to other cryptocurrencies, have little transparency which makes them difficult to track and regulate. When Alameda's balance sheet was disclosed, on November 6, CEO of Binance announced that Binance will sell all its FTT tokens. This caused the price of FTT to tank significantly and resulted in the insolvency of Alameda Research. On November 8, Binance announced that it would acquire FTX to pull it out of bankruptcy. However, on November 9, Binance backed out of the deal citing the mishandling of consumers funds by FTX to be the reason. It was reported that FTX was experiencing liquidity problems due to customer withdrawals from their exchange equivalent to a bank run in prior days. According to an internal FTX memo, the exchange experienced USD 6 billion of withdrawals in the 72 hours before November 8. On November 11, the Wall Street Journal reported that FTX used billions of dollars of clients' funds to place risky bets via Alameda Research. Both FTX and Alameda Research have now filed for bankruptcy.

It is estimated that FTX has USD 8 billion of liabilities that cannot be covered. According to the Wall Street Journal, Alameda Research owes FTX about USD 10 billion and since FTX had USD 16 billion in customer assets, they had lent out more than half of its customer funds to Alameda. Customer assets could come from both retail and institutional traders. Alameda Research had an estimated USD 657k of borrowing on decentralised platforms. VC companies had invested around USD 1.8 billion in FTX's fundraising rounds over the past 2 years, including many large traditional institutional investors. Most large crypto companies and traders made a loss in May and June after the collapse of TerraUSD and LUNA. Creditors had to write down loans they made to companies that went bankrupt. The losses had to be covered as those creditors themselves had borrowed to trade in crypto. According to Reuters, FTX and Alameda's loans to failing crypto companies made large losses. To cover the losses, FTX sent USD 4 billion worth of funds and some assets to capitalise Alameda Research. Those assets included FTT and Robinhood shares. Some of those funds also came from FTX customer deposits. Hence, customer deposits were used as collateral to leverage up for trading. Customers were unaware their deposits were used in this way, in what appears analogous to a highly leveraged hedge fund. The bitcoin and cryptocurrency price falls are likely to have the largest impact on the crypto industry and its companies. Crypto exchanges, lenders, miners are all being watched closely by investors.

The contagion from the fall of FTX has spread among other major players – Genesis, BlockFi and Gemini in the cryptocurrency space. Institutional trading firm Genesis had earlier announced that it had USD 175 million worth of funds locked in FTX, but said that it would not affect its operations. However, a few days later, the company announced that it had to suspend redemptions and new loan originations at its lending business. This had further downstream effects as cryptocurrency exchange Gemini announced that it had to halt redemptions on its yield program targeting retail investors, since Genesis was a key partner of this program. On the same day, Gemini saw net outflows of close to USD 500 million, with digital asset balances on the platform dropping from USD 2.2 billion to about USD 1.7 billion within 24 hours and Binance saw outflows of USD 424 million. Crypto lending firm BlockFi also announced that it had significant exposure to FTX, later halted client withdrawals on the platform, and is currently preparing to file bankruptcy. Other affected parties include large investors in the project such as Sequoia Capital and Temasek, with both firms marking down their multi-million dollar investments in FTX to zero. Hedge fund Galois Capital and venture capital firm Multicoin Capital also has half of its total capital stuck in FTX. However, the contagion from this event is currently to be limited to the crypto lending space.

Groundwork towards greater regulatory clarity now begins. Crypto regulation is being developed in the US with the most recent bill up for discussion called the DCCPA (The Digital Commodities Consumer Protection Act). The key point of debate relates to how decentralised finance (DeFi) applications should be regulated and if certain parts of their operations should follow similar rules to centralised platforms. DeFi allows users to remain pseudonymous, allowing banking services for all without blocking any individual user. In contrast, the bill that was publicly supported by FTX's owner, suggested that DeFi needs regulatory oversight and was in support of regulator enforceable blacklists, excluding certain wallets.

Later in the month saw interested institutional investors increasing their exposure to the space with crypto funds seeing net inflows of USD 42 million, the largest inflows in 14 weeks. Digital-asset exchange Binance Holdings Ltd. saw a substantial boost in trading activity, where it jumped by 30% in November. The fall of FTX also benefited US-regulated exchanges such as Coinbase and Kraken, which have gone through significant layoffs. Trading volume from the exchanges were on the rise in November as well, while activity on smaller exchanges fell, given the higher volume from users and institutions who have become wary of off-shore exchanges. The innovation in the space continues to grow and the viability of the future of the decentralized use cases using cryptocurrency and blockchain should not be decided on the basis of the wrongdoings of an unregulated centralized exchange.

The Bloomberg Galaxy Crypto Index tumbled about 18% in November, while the index is down about 67% this year. Bitcoin fell 16%, while Ethereum fell 17% for the month. That being said, the price actions on Bitcoin and Ethereum have been relatively stable, in line with broad market decline. From a technical perspective, we see strong support level on Bitcoin and Ethereum at USD 15,000 and USD 1,000 respectively. Trading volumes have been dominated by institutional crypto traders this year. Based on Coinbase report, 84% of trading volumes on Coinbase were with institutional participants and only 16% with retail. In direct contrast with the 2018 bear market where 80% of volumes were with retail. Retail investors are likely to have held onto positions during the 2022 bear market.

In Bordier, we have partnered with Sygnum bank on providing crypto trading and custody. Sygnum bank is a regulated bank supervised by the Swiss Financial Market Supervisory Authority, while Sygnum's regulated multi-custody solution has been architected to provide institutional grade security and is hosted at Swisscom, a leading player in banking infrastructure. Below is an extract from Sygnum after the FTX implosion.

Here at Sygnum Bank:

- We did not execute a single trade, or sell a single product in Switzerland before we were fully regulated as a Swiss Bank; the same applies to our CMS license in Singapore
- Our clients' crypto assets are held off balance sheet and hence – whatever happens to Sygnum – our clients' assets are segregated and safe
- Sygnum has a strong balance sheet that is subject to bank-grade capital adequacy rules, for example comprehensive risk frameworks, liquidity ratios and concentration risk limits
- Our processes, financials and cyber security are subject to continuous audits and disclosures
- We don't take any short cuts in terms of governance. Our Board is constituted by a majority of independent Directors with extensive, relevant experience – see our Board here.
- We empower our clients and partners to invest in the digital asset economy with complete trust. The continuous inflows of net new money into Sygnum at an accelerated pace over the last 48 hours are testament to this

We may look back to this time and realise that it was the moment where true innovation, good governance and integrity overtook short-term thinking, greed and naïve business models.

Blockchain technology is real, it works, and thousands of entrepreneurs and developers are building great products that leverage its potential every day.