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Free Borrowing: Next stop for Securities-Based Lending?

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Decentralised Finance and protocol rulesets can be (and have been) developed to extract as much value as possible in the most convoluted of approaches. But there are some protocols that keep things simple, as they ultimately should be, in order to appeal to a broader audience.

Although the hype around DeFi has waned significantly over the past year, there are some outliers that could prove to give the ecosystem a second-coming. In this In-Depth, Copper looks at some of the collateral-based protocols that could begin to pave the way to a much more interesting financial system in the long-term. Against non-volatile tokenised assets, easy access to interest-free borrowing may potentially set a new global standard.

Anyone immersed in this space understands well that assets are heading into digital format. Whether tokenized securities or NFT representations of real estate, the opportunities for capital efficiency are emerging out of DeFi.

For now, collateral based lending will have to deal with cryptocurrency market whims that fluctuate greatly.

It would be difficult, although not impossible given the blockchain, to prove that current DeFi usage of borrowing and lending isn't predominantly a leverage tool. It more than likely for the most part is just that. But the understanding of investing and leverage is becoming a much more popular topic.

Buy, borrow, die

While this research team would love to take credit for 'Buy, borrow, die', this was in fact the headline of an article out of the Wall Street Journal last year that discussed how wealthy clients are increasingly using their investment portfolio to borrow at low interest rates.

And while the continued ingenuity of crypto developers can be applauded, a great deal of the current financial system has been ported onto the blockchain. In the crypto ecosystem, there are now several projects in DeFi that are offering perpetual interest-free collateral loans. Same, same but different.

There are a few keywords to highlight from the paragraph above which allows for a very simple breakdown (see table).

	TradFi	DeFi
Who	Wealthy clients	Everyone
Interest	Fluctuating Rates	Interest Free (Perpetual)
What	All assets (sans Crypto)	Crypto
Volatility	Low / High	High
Tax	Upon sale of assets	Upon sale of assets
Fees	Bank	Exchange, gas, loan origination, bank transfer
Rewards	None	Stablecoin or Tokens (Protocol-dependent)
Risks	Liquidation, Margin calls	Low liquidity of stablecoin into fiat (depeg), Technological ,Liquidation

Buy, borrow, and hope you don't get liquidated

As the ecosystem grows across multiple chains, so are the products replicated on each network. Some of the interest-free borrowing platforms include Liquity (Ethereum), QiDao (Multi-Chain), Hedge (Solana), Yeti (Avalanche) and Zero (Sovryn).

Copper estimates that there is currently well over $250mn in outstanding loans across these protocols. Collateral value is already in the billions. However, these platforms have gained little attention. While there are plenty of problems that need ironing out, tied with US equity products will certainly increase eyes on tokenised-Securities-Based Lending (tSBL).

Will the real USD please stand-up?

Every time a loan is originated on any of these platforms, the token received by the borrower will be a dollar-pegged cryptocurrency that the platform itself issues. There is a different stablecoin for each platform.

The reality is that as it stands, off-ramping these tokens back into the banking system to spend outside of what is available in the crypto ecosystem is difficult at best.

For starters, there are few direct routes to conversion into bankable deposits. And depending on the size of the loan, and the issued dollar-pegged token, neither liquidity, nor equal conversion stand to the test.

Liquity's LUSD for example, the largest interest-free protocol, does have a market pair into USD on US exchange Gemini which was only actually listed last month. As it stands, market depth is near non-existent, and the peg doesn't really hold up (see chart).

Of course, this is the current status. Increased use will ultimately iron out these specific issues as was the case with Maker's DAI when first launched. A depegged USD offers an opportunity to pay back a loan at a discount. These arbitrage opportunities will likely find bots taking advantage as demand grows.

Regardless, there are other routes to exchange into other liquid stablecoins on DeFi protocols that have deep enough volumes before off-ramping. Executed swaps on Uniswap prove that much.

Stacking cents

Interest is one thing, but fees in crypto transaction can add up very quickly. From on-ramping into an exchange to begin the process, and off-ramping back into fiat, there would be a minimum of nine steps and fees at every stage. Back of the envelope calculations show that fees would be around 3% in total, one-off.

Even with these costs, the perpetual interest free loan would still be much more favourable than what is currently being played out in traditional markets starting at over 4% per annum (see table).

Protocol valuations

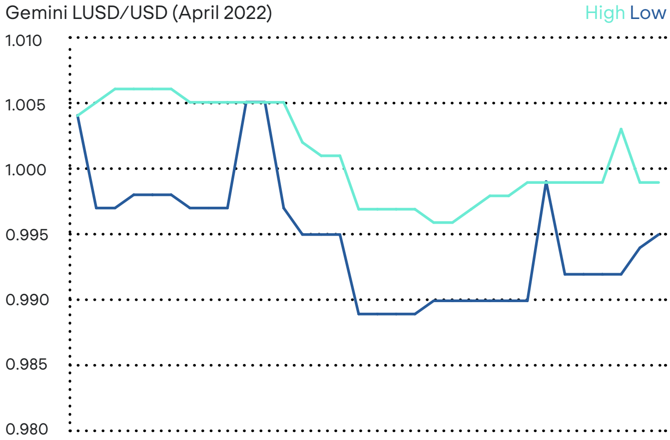
While we've discussed the use-case of these protocols, it would be remiss of us to not mention the platform valuation has taken a good beating (see chart).

With that said, Liquidy has moved into full decentralization (excluding nuances of the Ethereum dependency points). Token holders of LQTY earn a portion of the fee revenues that have rolled in just north of $28mn, which for a one-year old platform is nothing to scoff at. Its fully-diluted market cap stands at $180mn.

On the other side, Hedge, which promises much of the very same on the Solana blockchain just secured a $3.7mn round from reputable investors only last month. The idea clearly has insiders interested (pun-intended).

This report however is not assessing the platform valuation. We are however highlighting the potential of what these platforms can do. The idea of interest free loans against collateral is here, which will likely prove a much more interesting seed than protocol valuations. And for good reason, as we assess below.

Gemini LUSD/USD (April 2022)

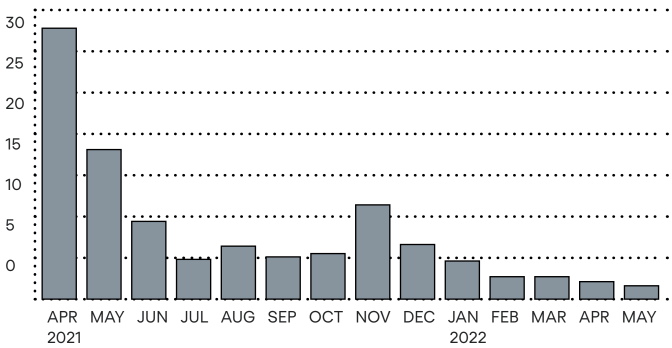


TD Ameritrade Securities Based Lending interest rates

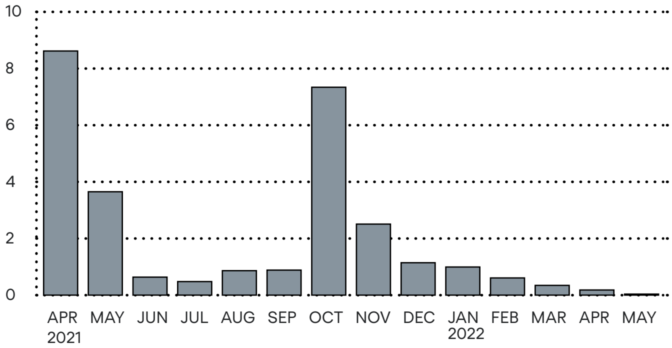
Credit line amount	Base rate p.a.
$100,000 - $249,999	SOFR + 4.10%
$250,000 - $499,999	SOFR + 3.10%
$500,000 - $999,999	SOFR + 2.60%
$1,000,000 - $2,999,999	SOFR + 2.25%
$3,000,000 and above	SOFR + 1.60%

Source: tdameritrade.com/investment-products/collateral-lending-program.html

Liquity token price ($)



Liquity: Protocol revenue ($mn)



Project	Market Cap	P/E Ratio
Aave	$2.5bn	106x
Compound	$1.2bn	92x
Liquity	$125mn	90x

Close, and yet far…

Efforts on the blockchain to tokenise stocks have for better lack of words failed quite miserably. Last year Uniswap, the largest decentralised exchange, was forced to remove synthetic versions of US equities off the platform as the SEC swooped in against the Brooklyn-based outfit.

And the Mirror protocol that also tokenises equities is currently seeing premiums versus the oracle price as high as 30% on some tokenized stocks.

But then again, there is a middle ground, of sorts. FTX has tokenised stocks and some ETFs trading on their platform through licensed issuer DAAG. The tokenised stock issuer has $100mn AuM since its initial rollout less than a year ago.

Unlike synthetics, these tokenised stocks do pay out dividends. These assets are transferable on the Solana blockchain. And the potential of these tokenised equities being wrapped and ported into other chains is very plausible.

It's not hard then to imagine how these token representations, which do have a licensed broker behind them and met KYC requirements can find their way as collateral on DeFi protocols in the not so far future.

Trend to zero

It seems inevitable that these open-source protocols continue to be replicated with one platform eventually figuring out the incentive dynamics and offer a near 0% origination fee.

Still, realistically speaking, mass adoption of tSBL requires a great deal more than education on the risks of liquidation be it crypto or otherwise. But the real potential isn't in what we're seeing today at all.

MicroStrategy borrowed money on Bitcoin collateral. Goldman Sachs tested the waters with Coinbase. The viability of tokenised assets being used as collateral is now without a shadow of a doubt reached a viable product offering.

What needs to be resolved is the user experience that requires quite a bit of blockchain knowledge and financial education. And friction will likely remain as a better transaction flow will be dependent on the custodial and fiat ramping infrastructure.

But the potential of perpetual interest-free loans against non-volatile traditional assets is just around the corner. Wealth management capital efficiency has arrived to the people. Not only with much better terms, but immediate access. And access is key.

Over 50% of QQQ composition (Nasdaq100) already tokenized
- via DigitalAssets.ag & Mirror Protocol

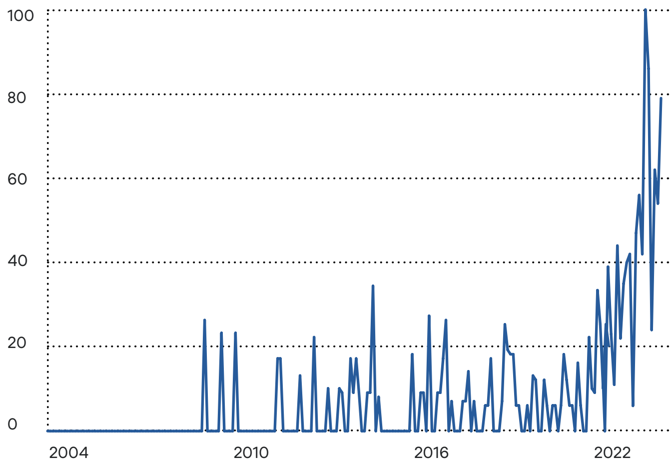
Symbol	Holding	% Assets
AAPL	Apple	13.02%
MSFT	Microsoft	10.45%
GOOG	Alphabet	7.25%
AMZN	Amazon	6.16%
TSLA	Tesla	4.73%
FB	Meta	3.71%
NVDA	NVIDIA	3.44%
INTC*	Intel	1.51%
AMD	AMD	1.28%
PYPL	PayPal	0.84%
Total		52.39%

*Not tokenized on Mirror

Tokenized products

Symbol	Name	DAAG	Mirror
SPY	SPDR S&P 500		
QQQ	Invesco QQQ Trust		
SLV	iShares Silver Trust		
USO	United States Oil Fund, LP		
VIXY	ProShares VIX Short-Term Futures		
IAU	iShares Gold Trust		
GLD	SPDR Gold Trust		

Google Trends: "Borrow against stocks" (USA)



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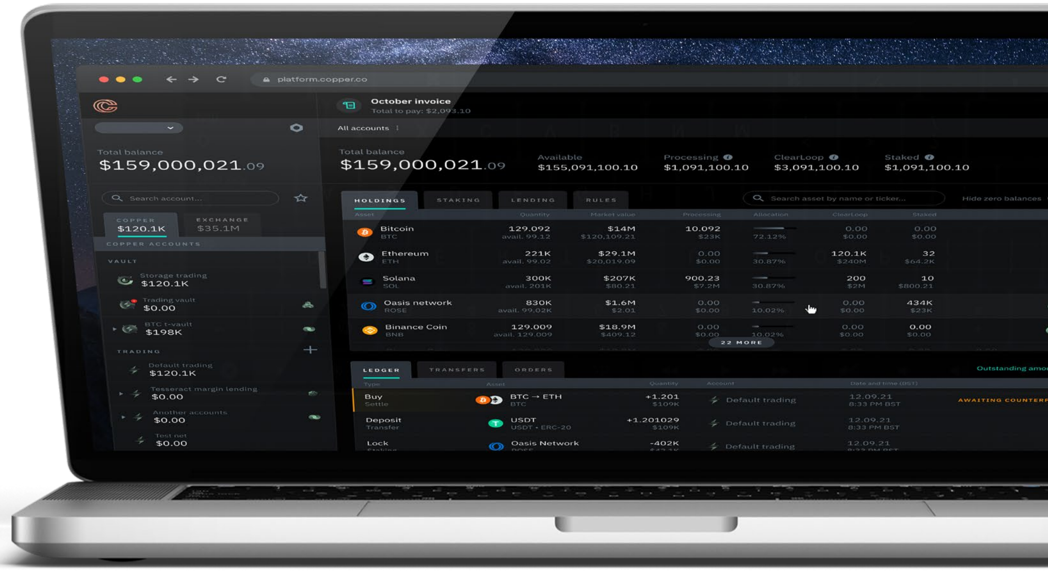

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