

Bitcoin-backed lending: opportunities and considerations for financial institutions

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As the cryptocurrency market continues to evolve and mature, traditional financial institutions such as banks and credit unions (FIs) are increasingly seeking opportunities to engage with this rapidly growing sector, albeit in a cautious and conservative manner. One area of particular interest is bitcoin-backed lending, where FIs provide loans secured by bitcoin as collateral. This market has gained significant traction, benefiting from the proliferation of regulated U.S. and Canadian cryptocurrency custodians that hold spot bitcoin on behalf of investors.

The success of bitcoin ETFs has paved the way for FIs and other traditional financial entities to look beyond these investment vehicles and focus on more direct engagement with cryptoassets. Over the last four months, bitcoin has seen unprecedented price movement reaching highs above US\$106,000,^[1] thereby increasing its attractiveness as an alternative asset class. Bitcoin-backed lending has emerged as an intriguing opportunity, offering lenders the potential for relatively high returns (i.e., annual percentage returns (APR) of upward of 10%). This shift represents a new frontier for FIs, moving from passive investment products to active participation in the cryptoasset ecosystem. As institutional interest grows, understanding the opportunities and challenges of bitcoin-backed lending becomes crucial for FIs looking to expand their services in this innovative space.

This article explores the opportunities which bitcoin-backed lending presents for FIs, discusses key legal and operational considerations and provides best practices for safely navigating this evolving market.

Opportunities for financial institutions

New revenue streams

Bitcoin-backed lending offers FIs a novel way to generate revenue. With the growing adoption of cryptocurrencies, there is an increasing demand for loans that allow bitcoin holders to access liquidity without selling their assets. For example, BIGG Digital Assets Inc., owner of Netcoins, Blockchain Intelligence Group and TerraZero, recently announced a partnership with APX Lending, a crypto-backed lending platform that provides crypto-backed loans to their clients in the United States.^[2] APX Lending is a crypto-backed lender certified by the Canadian Lenders Association.^[3] Through this partnership, Netcoins USA and APX

Lending will provide services across each other's platforms such as onboarding processes, preferred lending and trading rates for shared clients and lower-fee services.

Market expansion

By entering the bitcoin lending space, FIs can position themselves at the forefront of financial innovation, potentially gaining a competitive edge in an emerging market. According to HFT Market Intelligence, as of August 2024, the global bitcoin-backed lending market is comprised of US\$8.5 billion in outstanding bitcoin-backed loans and is on track to grow to approximately US\$45 billion by 2030.^[4] In the first half of 2024, Ledn, a Canadian-based cryptoasset lender, processed \$1.16 billion in cryptocurrency loans.^[5] In July of 2024, Cantor Fitzgerald announced the launch of its \$2-billion investment in the launch of a bitcoin lending program.^[6] These moves signal significant growth in the bitcoin lending space.

Risk diversification

Bitcoin-backed loans can offer a way for FIs to diversify their loan portfolios, potentially hedging against traditional market risks. Institutional confidence in bitcoin as a portfolio diversifier continues to grow. By August 2024, Goldman Sachs and Morgan Stanley had purchased a collective US\$600 million in spot bitcoin exchanged-traded funds.^[7]

Key considerations and challenges

Regulatory compliance

The regulatory landscape for cryptocurrency is still evolving. FIs must stay abreast of changing regulations and must comply with anti-money laundering legal requirements that are unique to the cryptoasset space. FIs must consider legal issues surrounding the taking of collateral and securities transfer legislation and take the necessary steps to perfect their security interests by registration. In all Canadian provinces except for Québec, the *Personal Property Security Act* (the PPSAs) and *Securities Transfer Act* (the STA) govern the security interests in personal property. Canadian PPSAs do not explicitly contemplate cryptoassets or confirm whether they can be used as collateral. This issue underscores the need for lenders to perfect their security interests in cryptocurrency in compliance with PPSAs.

Volatility management

Bitcoin's price volatility presents a significant challenge in collateral valuation. FIs need to implement robust systems for real-time monitoring of collateral value and establish clear protocols for margin calls or liquidation. By using well-established metrics such as the loan-to-value ratio (or LTV), FIs can determine the percentage of the collateral's value that can be borrowed. In doing so, FIs can use the LTV to obtain additional collateral from borrowers in the event of value fluctuations that require borrowers to provide additional collateral or make payments to maintain an agreed-upon LTV. Lenders may also err on the side of caution by requiring over-collateralization as a pre-condition for granting a loan. By taking these steps, lenders can help ensure there are sufficient assets to mitigate against potential losses from price volatility or events of default.

Custody and security

Securing and managing bitcoin collateral requires specialized knowledge and infrastructure. FIs must either develop in-house capabilities or partner with reputable cryptoasset custodians to ensure the safety of the collateral. Bitcoin custodians offer solutions to store

and manage bitcoins on behalf of investors and institutions. Some bitcoin investors delegate responsibilities to custodians who in turn manage their private keys, authenticate users, authorize transactions and move assets on the investors' behalf. By using regulated bitcoin/cryptoasset custodians, FIs can achieve greater security against threats such as hackers, fraud and lost private keys. Anchorage Digital, Coinbase Custody Trust, Tetra Trust Company, Balance Trust Company, Fidelity Digital Asset Services and PayPal Digital are examples of licensed institutions that offer custodial services.

Technological infrastructure

Implementing bitcoin-backed lending requires a technological and educational investment. FIs must interface comfortably with blockchain technology, monitor cryptoasset markets and be prepared to manage cryptoasset collateral.

Market liquidity

While bitcoin is the most liquid cryptocurrency, FIs cannot ignore potential liquidity issues, especially for larger loan amounts. A liquidity crisis may arise, for example, when a cryptoasset trading platform lacks the cash or "convertible to cash" assets to finance transactions. A recent example is the Singapore-based crypto exchange and lending platform Vauld, which suspended its operations after facing financial difficulties. These troubles arose from defaults on loans to its borrower, Three Arrows Capital; issues with its business partner, Celsius Network; and the broader fallout from the collapse of Terra (LUNA).^[8] Establishing relationships with multiple cryptoasset trading platforms is a prudent risk management decision.

Legal considerations

The legal framework surrounding bitcoin ownership and transfer is still developing. FIs must carefully consider the legal implications of taking bitcoin as collateral, including perfection of security interests and enforcement in case of default.

Legal issues surrounding custody

It is critical that lenders use regulated bitcoin custodians. When choosing a custodian, FIs should choose regulated custodians in countries with stable regulatory regimes that have strong internal controls to protect cryptographic private keys against theft, loss and corruption. Positive indicators for a reliable custodian include

- controlling its own custodial capabilities
- having an ISO/IEC 27000 certification
- geographically distributing backup keys as part of disaster recovery
- providing robust end-user security with 2FA/MFA
- having established KYC/AML procedures
- conducting on-chain transactional analysis
- having a chief compliance officer
- providing a "proof of reserves" report
- conducting penetration tests

Ledn, for example, is the first digital asset lending company in the cryptoasset market to complete a "proof-of-reserves". This is significant because it establishes a level of verifiability whereby each Ledn client can use a unique hashed ID to confirm that their balance of bitcoin is accounted for.

Legal issues related to taking PPR security on bitcoin

FIs must ensure that when taking security over bitcoin, they consider PPSAs. As we noted in a previous Osler Update dated February 6, 2023, personal property legislation does not currently expressly include reference to bitcoin or cryptocurrency in general, and it most likely falls under the definition of "intangible property". Lenders should ensure that, when taking security over cryptocurrency, they consider personal property security legislation accordingly and take the steps necessary to perfect by registration.

An FI may obtain control over bitcoin by entering into a control agreement, taking possession of the cryptographic private key necessary to unlock the assets from a digital wallet or appointing a properly licensed trustee or custodian mutually agreeable to all parties to hold the crypto assets. Similar to disclosure relating to other types of assets, lenders should ensure that cryptoassets are described in accurate detail and that cryptocurrency wallets are sufficiently identified and disclosed.

The STA may also be relevant, depending on the nature of the underlying cryptoasset, as it governs the property rights that exist when securities are bought, sold or used as collateral. Lenders should consider tax regulations and transfer limits which may apply to bitcoin-backed loans. Lenders should protect themselves by using reputable custodians and contractual mechanisms in their loan agreements that allow for timely enforcement of security interests.

Best practices for financial institutions

1. Start small and scale gradually to manage risks effectively.
2. Develop clear policies and procedures specific to bitcoin-backed lending.
3. Invest in staff training to ensure a thorough understanding of cryptocurrency and blockchain technology.
4. Implement robust due diligence processes for borrowers in the crypto space.
5. Consider partnering with established crypto firms for expertise in areas like custody and blockchain analysis.
6. Maintain open communication with regulators to ensure compliance and contribute to the development of appropriate regulatory frameworks.
7. Engage competent legal counsel who have sufficient experience working with digital asset companies.

Conclusion

Bitcoin-backed lending represents a significant opportunity for FIs to participate in the growing cryptocurrency ecosystem. While challenges exist, careful planning, robust risk management and a commitment to compliance can position lenders to navigate this new frontier in lending successfully. As the market matures and regulatory frameworks solidify, early movers in this space may find themselves well positioned to capitalize on the growing intersection of traditional finance and digital assets.

For more information on how your institution can explore bitcoin-backed lending opportunities, please contact our Digital Assets and Blockchain Group.

[1] CoinDesk (2024 December 19), [Bitcoin price: BTC to USD price index and Live Chart](#).

[2] Bigg (2024 October 8), [Netcoins USA announces partnership with APX \(US\) lending to offer crypto-backed lending services.](#)

[3] GlobeNewswire (2024 October 8), [Netcoins USA announces partnership with APX \(US\) lending to offer crypto-backed lending services.](#)

[4] EINPressWire (2024 August 5), [Bitcoin Loan Market Is Set To Fly High Growth In Years To Come | YouHolder, Uniswap, SALT Lending.](#)

[5] CoinDesk (2024 August 1), [Crypto Lender Ledn Handed Out \\$1.16B Worth of Loans in First Half of 2024.](#)

[6] Cantor (2024 July 27), [Cantor Fitzgerald to launch Bitcoin financing business.](#)

[7] Reuters (2024 August 14), [Goldman Sachs, Morgan Stanley took stakes in US spot bitcoin ETFs in Q2, filings show.](#)

[8] Reuters (2022 July 4), [Singapore-based crypto lender Vault suspends withdrawals.](#)