

The ultimate guide to crypto- backed loans

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Overview

The world of crypto is constantly evolving, going far beyond just buying and selling digital assets. One exciting development is the rise of crypto loans, also known as cryptocurrency loans.

With a crypto loan, you can borrow a traditional currency (like USD or EUR) or a stablecoin (like USDC) by using your cryptocurrency as collateral just like you would use other assets - like a house or a car.

This concept brings more flexibility and a unique opportunity to leverage existing crypto assets to secure financing. But how exactly do crypto loans work? What are the benefits and risks involved? And how do crypto loans compare to traditional loans?

Whether you're a seasoned crypto user or just exploring the possibilities, this guide will help you understand everything you need to know about how crypto loans work.

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What is a crypto loan?

Navigating the world of crypto lending can feel like wading through a sea of jargon and technical terms. But don't worry—we're here to help. Here's a breakdown of the most common terms you'll encounter, making it simple and straightforward for you to understand how crypto loans work.

Term	Definition
Borrower	An individual or entity that takes out a loan by pledging their crypto assets as collateral
Lender	An individual or entity that provides a loan in exchange for interest payments and collateral
Principal	The initial amount of the loan that must be repaid, not including interest
APR <small>(Annual Percentage Rate)</small>	The annual rate charged for borrowing including any fees or additional costs
Collateral	Assets pledged by a borrower to secure a loan. With crypto-backed loans, this typically involves cryptocurrencies such as Bitcoin, Ethereum, or other digital assets
Loan-to-value ratio	A ratio that represents the amount of the loan relative to the value of the collateral. For example, an LTV of 50% means a loan of \$5,000 would require \$10,000 worth of crypto as collateral
Margin call	A demand by the lender for the borrower to add more collateral or repay part of the loan when the value of the existing collateral falls below the LTV ratio
Liquidation	The process of selling off the collateral by the lender if the borrower fails to meet the margin call requirements in order to cover the loan amount
Interest rate	The cost of borrowing, typically expressed as an annual percentage rate (APR). This is the fee charged by the lender for the loan
Loan term	The duration over which the loan is to be repaid. This can vary from short-term (e.g., a few months) to long-term (e.g., several years)
Repayment schedule	The agreed-upon timetable for repaying the loan, which may be monthly, quarterly, annually, or at the end of the loan term
Refinancing	The process of taking out a new loan to repay an existing loan, often to benefit from better terms or interest rates
Interest-only loan	A loan where the borrower only pays interest for a specified period, with the principal amount due at the end of the term
Default	The failure to repay the loan according to the agreed terms, which can lead to collateral liquidation

Term	Definition
Variable rates	DeFi loans feature interest rates that adjust in real-time based on market conditions
Fixed rates	Interest rates that remain constant and unchanging throughout the entire term of the agreement
Rehypo- thecation	When a lender uses your deposited collateral for further lending or to secure their own loans or investments, increasing liquidity but adding risk
Centralized finance <small>(CeFi)</small>	A financial system where a central entity or company controls and provides financial services, such as crypto-backed loans, with full authority over the platform
Decentralized finance <small>(DeFi)</small>	A financial system where a central entity or company controls and provides financial services, such as crypto-backed loans, with full authority over the platform
Smart contract	Self-executing contracts with the terms of the agreement directly written into code. These are used in DeFi platforms to automate the loan process
Stablecoin	A type of digital asset designed to have a stable value, often pegged to a fiat currency like the US Dollar. Examples include USDC (USD Coin)
Crypto wallet	A digital tool that allows users to store and manage their digital assets. Wallets can be hardware-based or software-based
MPC wallet <small>(Multi-Party Computation)</small>	A digital asset wallet in which the private key is divided and shared among multiple parties, ensuring that no single party has complete access to the key
Gas fees	Transaction costs paid to miners or validators on a blockchain network to process and validate transactions, ensuring the network's security and functionality

Now that you've familiarized yourself with the most common crypto lending terms, let's understand what crypto-backed loans are and how they work.

A crypto loan is a type of secured loan in which you pledge digital assets as collateral to receive a loan in fiat currency (e.g. USD, EUR, BRL) or stablecoins (e.g. USDC, USDT). It's similar to a traditional secured loan, like a mortgage or a car loan, in which the asset acts as a security for the lender.

How are crypto loans different from traditional loans?

Unlike traditional loans that typically require credit checks and extensive paperwork, crypto loans offer a more streamlined and accessible lending process:

1 No credit checks

Crypto-backed loans do not require credit checks. The collateral itself reduces the lender's risk.

2 Faster approval

The process is usually fast and straightforward, with funds often available quickly.

3 Transparency

Some crypto loans leverage blockchain technology, offering a decentralized and transparent process that eliminates many of the inefficiencies of conventional banking systems.

4 Tax benefits

Crypto-backed loans may provide some borrowers with certain tax benefits.

Types of crypto loans

There are two types of cryptocurrency loans: DeFi and CeFi.

Decentralized finance (DeFi)

DeFi loans are cryptocurrency loans managed by smart contracts on a blockchain network, which means no intermediaries. They offer greater transparency, accessibility and, often, lower fees, but come with higher risk and complexity.

Pros and Cons



Control and Ownership

Users maintain control over their funds, with no central authority having the ability to freeze accounts.

Transparency

All transactions and protocols are publicly auditable on the blockchain.

Lower Fees

DeFi platforms often have lower fees due to the lack of intermediaries.



Complexity

DeFi platforms can be more complex and require a higher level of technical knowledge.

Security risks

Smart contract vulnerabilities and the lack of insurance can expose users to higher risks.

No customer support

DeFi platforms typically lack customer support, relying on community forums and self-help resources.

Variable rates

DeFi crypto loans often come with variable interest rates which are generally determined based on market demand and supply conditions. The dynamic nature of these rates could impact the overall cost and feasibility of maintaining a borrower's position.

Centralized finance (CeFi)

CeFi loans are crypto loans offered by centralized institutions or platforms. Similar to traditional loans, they may be easier to use but require trusting a central entity with your crypto.

Pros and Cons



User-friendly

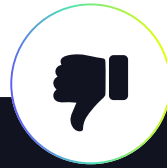
CeFi platforms often offer intuitive interfaces and customer support, making them easier for beginners to navigate.

Security

Centralized entities may offer more robust security measures and insurance against hacks.

Compliance

CeFi platforms typically adhere to regulatory standards, offering a sense of legitimacy and legal protection.



Centralized

The central entity has full control over the funds and can freeze or limit access. Certain CeFi entities offer MPC wallets which enhances user security since the CeFi platform does not control all of the wallet keys

Privacy

CeFi platforms require KYC (Know Your Customer) verification, which involves sharing personal information

Higher fees

CeFi platforms might charge higher fees for transactions and services

Choosing between DeFi and CeFi for crypto loans depends on your preference. DeFi provides greater control, transparency, and potentially lower fees, but requires technical know-how and carries higher security risks. CeFi offers ease of use, compliance, and customer support, but at the cost of higher fees and less control.

How to get a crypto loan?

There are many ways to take out a crypto-backed loan, each offering unique advantages to suit different needs. You can choose centralized finance (CeFi) platforms for straightforward, secure loans, or explore decentralized finance (DeFi) options for greater control but require greater technical knowledge to use.

Here's a general overview on how to take out loans on each type of platform. For more specifics, please refer to the specific platform's instructions on their respective websites.

CeFi lending platform

- STEP 1** Create an account on a CeFi platform
- STEP 2** Send collateral
- STEP 3** Borrow funds

DeFi lending platform

- STEP 1** Set up a crypto wallet
- STEP 2** Install and configure wallet
- STEP 3** Transfer the crypto assets you plan to use as collateral to your wallet
- STEP 4** Connect to DeFi lending platform
- STEP 5** Deposit collateral
- STEP 6** Borrow Funds

Loan monitoring

Taking out a DeFi crypto loan generally requires more constant monitoring compared to CeFi loans due to the nature of smart contracts.

In DeFi, smart contracts are programmed to automatically liquidate collateral if certain conditions, such as a LTV ratio, are met. This automation ensures prompt action but also means that borrowers must vigilantly track the value of their collateral and market conditions to avoid sudden liquidation.

Unlike CeFi crypto loans, where there might be more flexibility and time to respond to margin calls, DeFi loans generally offer no such leniency, making continuous monitoring essential to manage the risk of automatic liquidation effectively.

Interest rates

DeFi crypto loans often come with variable interest rates, which are generally determined based on market demand and supply conditions.

Unlike traditional loans with fixed rates, DeFi loan rates are determined by algorithms within smart contracts that adjust in real time. This variability can lead to opportunities for lower interest payments during periods of high liquidity but also carries the risk of rising rates during times of increased borrowing demand.

You must be aware of these fluctuations and manage your loans accordingly, as the dynamic nature of DeFi interest rates can impact the overall cost and feasibility of maintaining your positions.



Crypto loans and margin calls

One critical aspect of crypto loans is the risk of margin calls. If the value of your crypto collateral drops significantly, the lender may issue a margin call and require you to deposit additional collateral to maintain the agreed LTV ratio. If you fail to do so, they might liquidate your collateral to cover the loan.

Not all lenders issue margin calls, and in some cases, collateral may be automatically liquidated.

What happens to my loan if my crypto collateral goes down in value?

Consider a scenario in which you take out a \$10,000 loan backed by 1 Bitcoin (BTC) as collateral. At the time of the loan, the price of Bitcoin is \$30,000, resulting in an initial Loan-to-Value (LTV) ratio of 33.33%. This is calculated by dividing the loan amount by the value of the collateral and multiplying by 100.

However, if the price of Bitcoin falls to \$20,000, the value of your collateral decreases to \$20,000. Consequently, the LTV ratio increases to 50%, as the loan amount remains the same while the value of the collateral has dropped. This new LTV ratio is also calculated by dividing the loan amount by the new value of the collateral and multiplying by 100.

Scenario: \$10,000 loan backed by 1 BTC



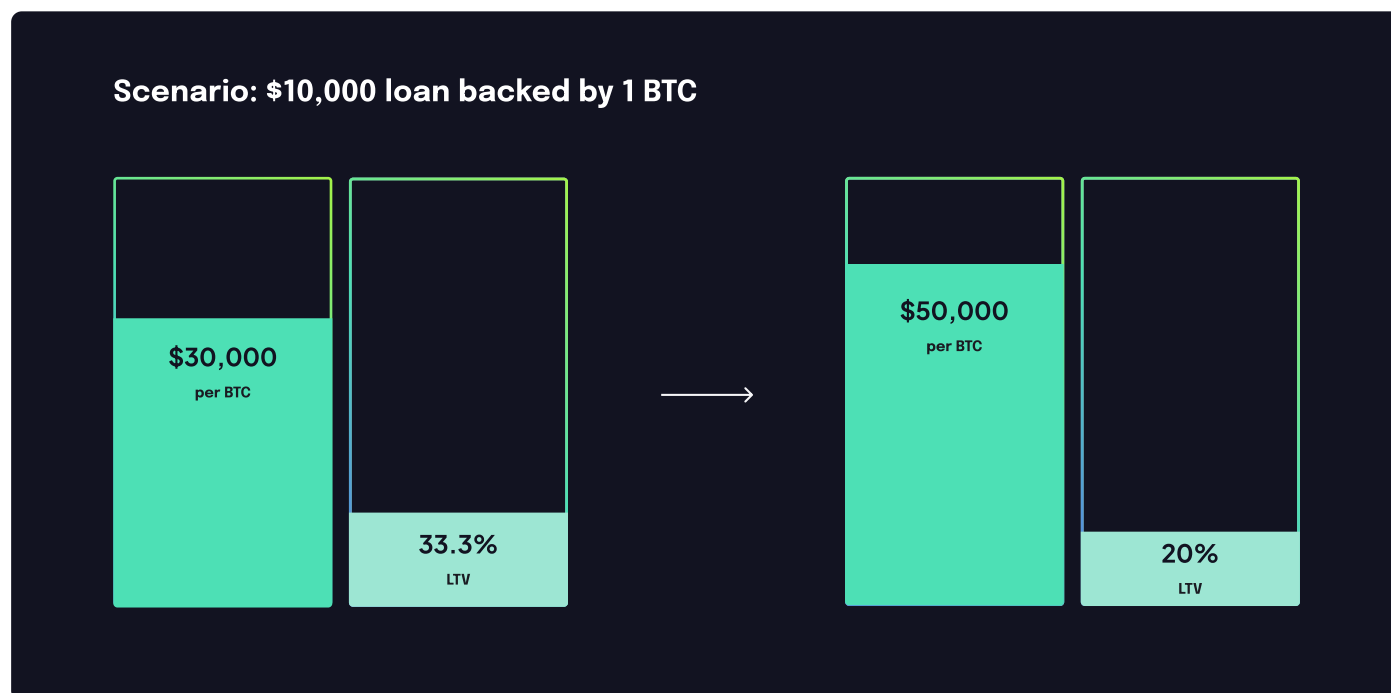
When a borrower's LTV reaches a specific threshold, a margin call may be issued, requiring them to deposit additional crypto to lower their LTV.

An increase in the LTV ratio indicates higher risk for the lender because the collateral is now worth less relative to the loan amount. If the LTV ratio exceeds a certain threshold, such as 70-80%, the lender may issue a margin call, requiring you to add more collateral or repay part of the loan. Failure to meet the margin call could result in the lender liquidating your collateral to cover the loan.

What happens to my loan if my crypto collateral goes up in value?

Consider a scenario in which you take out a \$10,000 loan backed by 1 Bitcoin (BTC) as collateral. At the time of the loan, the price of Bitcoin is \$30,000, resulting in an initial Loan-to-Value (LTV) ratio of 33.33%. This is calculated by dividing the loan amount by the value of the collateral and multiplying by 100.

However, if the price of Bitcoin rises to \$50,000, the value of your collateral increases to \$50,000. Consequently, the LTV ratio decreases to 20%, as the loan amount remains the same while the value of the collateral has increased. This new LTV ratio is also calculated by dividing the loan amount by the new value of the collateral and multiplying by 100.



A decrease in the LTV ratio indicates lower risk for the lender because the collateral is now worth more relative to the loan amount. This increased security reduces the likelihood of a margin call or the need for additional collateral. Additionally, you may be eligible to borrow more funds against the increased value of your Bitcoin collateral.

What are the U.S. federal tax implications of taking out a crypto-backed loan?

When considering taking out a crypto-backed loan in the United States, it's important to understand the potential tax implications. Here's a breakdown of key considerations. This is not tax, legal, or investment advice, and applicable tax rules and guidance are subject to change, please consult with tax professional:

Receiving the loan

Generally, receiving proceeds from a loan, including a crypto-backed loan, is not considered a taxable event. You do not incur a tax liability on the loan amount received when you open the loan.

Interest payments

Interest payments on a crypto-backed loan may or may not be deductible. If the loan is used for investment purposes, the interest may qualify as a deductible expense. However, if the loan is used for personal purposes, the interest is typically not deductible.

Collateral liquidation

- If your collateral is liquidated to repay the loan, this triggers a taxable event. You may owe capital gains tax if the value of the cryptocurrency has increased since your purchase date. The gain is generally calculated based on the difference between the sale price of an asset and its cost basis (generally, the original purchase price plus acquisition costs).
- The tax rate depends on how long you held the asset before it was liquidated. If held for more than a year, the gain may qualify for long-term capital gains rates, which are generally lower than short-term rates.

Loan repayment

Repaying the principal amount of the loan using cash (i.e., fiat) is generally not a taxable event.

Reporting requirements

Any gains from the liquidation of collateral must be reported on your tax return.

Whether you need cash to cover unexpected expenses, for an investment opportunity, or to diversify your portfolio, a crypto-backed loan can provide the financial flexibility you need while keeping your crypto holdings intact.

Crypto-backed loans often come with lower interest rates compared to traditional unsecured loans, and they typically don't require credit checks.

About Figure Markets

Figure Markets combines the liquidity of traditional finance with decentralized asset control. Individual and institutional investors can trade digital assets, access secure crypto-backed loans, and explore investment opportunities in a single, convenient platform. Learn more at www.figuremarkets.com.

Contact us today at marketing@figuremarkets.com.