OneRiverDigital
ASSET MANAGEMENT

market notes: Resilience — Stables & COIN

May 12, 2022

Everyone is asking us. Is stablecoin a systemic risk? No. Are assets at Coinbase secure? Yes. Digital assets are demonstrating resiliency. But market pressures also demand accelerated regulatory clarity. We see regulatory principles being agnostic to technology, embracing those who welcome oversight.

Marcel Kasumovich,
Head of Research,
One River Digital

1/ I have built my career around hunting for macro vulnerabilities. Starting at the Bank of Canada and Quebec's potential separation from Canada in 1995. The Asia crisis and Hong Kong's resolve to combat it defined my transition to Goldman Sachs. The global credit crunch caused by US housing excesses dominated my attention at Soros Fund Management. At the International Monetary Fund, the European crisis was the focal point. I published on the looming liquidity crisis ahead of March 2020. Identifying unsustainable imbalances isn't a hobby – it is a big part of my (lonely) way of life.

2/ I will never forget my first interview with Goldman Sachs. How do you perform under pressure? It's a vanilla interview question. The answer never offered, though almost surely contemplated: "Horribly, sir, I break out in hives and scream for help." The reality is that nobody knows until they are in the moment. There are no war heroes without a war, after all. And the first response when one is under pressure is not the preordained future. You can learn, you can bend, you can build, and you can manage the stress.

3/ The digital ecosystem is yet again under that pressure. Only this time is different. A 50% decline from a $3 trillion market capitalization is assured to get more focus than the same drawdown from $3 billion. Breathe. Giving birth to a new global financial system is hard – and worth it. Grandparents will tell you how it should be, teachers will tell you how it could be, farmers will tell you how the world works – reading all those books won't feed the cows. Charting a new path takes resolve. Great amounts of ink have been spent on risks in the digital ecosystem. But those stresses must be lived.

4/ We want to set a couple of things straight: (1) stablecoin will thrive, and (2) those who embrace oversight, such as Coinbase, are incredibly valuable to regulators.

5/ Let's start with stablecoin. The economics behind the Terra protocol were not sustainable. Reminding the founders and supporters of this, after massive losses, does not qualify as grounding analytics. It is hindsight reporting that the founders are very aware of. Do Kwon, the leader of Terraform Labs and architect of the Terra Luna stablecoin (UST), linked to critical analyses of the protocol for those who did not appreciate the economics. The protocol was transparent. It was not ignorance. The plan came to a screeching halt.

6/ What was the plan? Escape velocity, in the words of our portfolio manager Paul Ebner. The high yields offered on UST were subsidized by the Luna Foundation Guard. If those could last long enough for the Foundation to diversify into a broader pool of assets, UST could be a mathematical stablecoin with a reserve of bitcoin and/or other assets. A network effect could be enough to create a competitive stablecoin out of code and thin air. The network did not have enough thrust to make it into bitcoin's digital orbit. The attempt was not pointless, it was risky. The 20% yield on a UST deposit was commensurate with the risk.

7/ What's not happening under pressure is important. Who is asking for a bailout? Nobody. Where are systemic risks emerging? Nowhere. What are other stablecoin doing? They are being tested with outflows and are largely stable. The difference between market risk and financial stability is a critical one. It is not a footnote. MakerDAO, the protocol behind the largest algorithmic stablecoin, Dai, has been steady. In traditional finance, given the tendency toward contagion in times of crisis, Dai's stability would be unfathomable. It is happening because Maker is built to accommodate a massive decline in valuation – $1.2 billion now from a peak of $6 billion – to preserve longer-term financial stability. The digital ecosystem is handling the pressure. It is resilient.

8/ The race to build algorithmic stablecoin was to stand outside of regulatory purview. Can regulations help? Well, the regulated market for digital assets is not being spared the volatility. Regulators should be overjoyed by digital asset players voluntarily raising their hands to be regulated. Coinbase Global Inc. is the most recognizable player to do so, with an independently capitalized custodian and money transmitter that provides regulators with timely information on suspicious transactions through the Financial Crimes Enforcement Network. Yet, if anything, regulators are adding stress to regulated entities.

9/ Buried in the archives of regulatory discussions are core principles. They are centered on being agnostic to technology. The Bank of International Settlements (BIS), the central bank for central bankers, employed this approach through its Principles for Financial Market Infrastructures. The BIS did the same in bank regulatory guidelines. US regulators are steering away from these principles. New disclosures in the latest Coinbase 10Q were required to satisfy the Staff Accounting Bulletin (SAB) Number 121. It is not agnostic to the technologies. Instead, it calls into question the future of custody of digital assets.

10/ The issue is what happens in bankruptcy. Forget about the fact that Coinbase has more than $6 billion in cash and less than $4 billion in debt without a principal risk trading business. Bankruptcy risk is remote to non-existent. The attention over the new disclosure, a requirement of SAB 121, was amplified by the downturn in digital assets and the downfall of Terra. The uneven nature of the application of regulation is the problem, not the security of on-chain assets. It is an important issue for institutional adoption.

11/ The Coinbase 10Q reports $256 billion of assets in its platform in the first quarter and a total balance sheet of $21 billion. Roughly $10 billion are custodial funds owed to customers, a small share of the $256 total assets. This is not unusual. State Street Corp. reports $41.7 trillion in assets under custody and $4.0 trillion of assets under management with a gross balance sheet of $322 billion. They are not 142-times leveraged (45.7/0.322). The $45.7 trillion is the asset of the individuals and institutions using State Street services. If State Street were bankrupt, creditors would not have a claim on customer assets. Clearly.

12/ Digital is no different. All Coinbase customer assets are separately legered, and vaulted assets are uniquely identified by a wallet. That wallet is the digital, on-chain representation of ownership. There is no confusion and precisely no uncertainty about that ownership. Let's imagine the black-swan event of Coinbase being bankrupt. Would a bankruptcy court allocate assets with known ownership to a pool of general creditors? It is nothing short of absurd to think the answer to this question is in doubt. The answer is no.

Disclaimer

ONERIVERDIGITAL
ASSET MANAGEMENT

w: oneriveram.com | e: info@oneriveram.com

2200 Atlantic Street, Suite 310, Stamford, CT 069027

NFA ID: 0461647 | FINRA: 167835