Welcome to Money for the Rest of Us. This is a personal finance show on money, how it works, how to invest it, and how to live without worrying about it. I'm your host, David Stein. Today's episode, 410, is titled "Is cryptocurrency dead?"

FTX Bankruptcy

Last week FTX, the third-largest crypto exchange in the world by trading volume, with a 10% market share, filed for bankruptcy. FTX was founded in 2019 by Sam Bankman-Fried. It had over a million customers in 2021. This past February, during the Super Bowl, FTX ran an ad featuring Larry David, the comedian. In the ad, he was highly skeptical of numerous inventions throughout time. The tagline of the ad was "Don't be like Larry. Don't miss out on crypto. NFTs. The next big thing." Now, apparently, FTX's customers are missing out on over a billion dollars of their funds that they had custodied at FTX. The money's gone, and the Security and Exchange Commission and the Justice Department are investigating.

John J. Ray III, the new CEO of FTX - because Bankman-Fried resigned - said that chapter 11 is "appropriate" to provide FTX Group the opportunity to assess its situation and develop a process to maximize recoveries for stakeholders. In an interview with New York Times journalist David Yaffee Bellany, Bankman-Fried said that his affiliated trading firm, Alameda Research, had a large margin position on FTX, which means Alameda had borrowed a significant amount of money from FTX. Bankman-Fried said "It was substantially larger than I had thought it was, and in fact, the downside risk was very significant." He continued, "Had I been a bit more concentrated on what I was doing, I would have been able to be more thorough. That would have allowed me to catch what was going on on the risk side."

Alameda Research and FTT

Bankman-Fried founded Alameda Research in 2017. It was a trading firm. It had offices in Berkeley, California, and it made millions of dollars initially exploiting inefficiencies in the Bitcoin market. There was a close linkage between FTX and Alameda. Alameda would trade on the FTX platform, which means sometimes it was taking the opposite side of the trades of FTX's customers; potentially, a conflict of interest. Bankman-Fried in the past has suggested that Alameda was providing crucial liquidity for customers to be able to trade.

Ian Allison of Coindesk pointed out just over a week ago that Alameda largest asset was a token, a crypto token issued by FTX. That token was FTT. Alameda, as of June 30th, had almost $15 billion of assets, but close to $4 billion was FTT, this is token.

Cory Klippsten, CEO of the investment platform Swan Bitcoin said it's fascinating to see that the majority of the net equity in the Alameda business is actually FTX's own centrally-controlled and printed out of thin air token. Holders of those FTT tokens could get discounts on FTX trading fees, but as Nick Carter, partner at venture capital firm Castle Island Ventures says, they printed this token out of thin air, endowed it with some valuation, and then Alameda used it as collateral.

Private Money

A lot of money is printed out of thin air. We discussed last week how the International Monetary Fund created billions of dollars of SDRs, their monetary token, out of thin air. They just allocated these SDRs. Their value is set by a basket of fiat currencies, which as we know can be created out of thin air.

Money in and of itself is a made-up thing. What we need is trust for that money to be effective. It needs to it needs to be trustworthy, it needs to be convenient, so we can have transactions, and it needs to maintain its value. When trust dissipates, we can have bank runs, particularly when the crypto token in question is private money.

Private money is money created by non-government entities. Checking accounts, which are liabilities of commercial banks - that's private money. So are saving accounts. Money market mutual funds are private money issued by the fund's sponsors. They're liabilities of those sponsors; hopefully backed by assets, but commercial bank checking and savings account deposits, money market mutual funds are backstopped by the government through insurance programs, or it's backed by central banks that at times will step in and protect depositors. That is not the case for cryptocurrency. And when investors became concerned about this house of cards of FTX, and Alameda, the FTT token fell to under $5, and then customers of FTX began taking out their funds, in a true bank run. And unfortunately, there wasn't the money there.

The Financial Times got a look at FTX's balance sheet, which was a spreadsheet that Bankman-Fried prepared, and that spreadsheet - I'll link to it, you can pull it up - it showed that FTX had only $900 million worth of liquid assets backing $9 billion of liabilities. There was $1.4 billion of Bitcoin liabilities, presumably deposits that FTX's customers had on hand, but there were no Bitcoin assets. Most of FTX's assets are illiquid venture capital investments, or crypto tokens that aren't widely traded, which means the deposits that FTX's customers had weren't there. FTX either lent it out to Alameda, in some type of loan arrangement, the money was lost... We don't know. FTX's largest asset, $2.2 billion, was cryptocurrency called Serum. Serum is a decentralized exchange built on the Solana platform. It's similar to Uniswap, Sushi, Bancor... Basically, a way to trade cryptocurrencies and lend on them, but clearly not very liquid either. Where did the customer's deposits go?

Brokerage Firms’ Moral Duty

Brokerages have a basic duty, if they're taking money in a custodial relationship, to allow investors depositors to trade those assets, to store those assets. If it's a US broker for stocks and bonds, they have to follow SEC Rule 15-C-33; it's known as the customer protection rule. It requires brokerage firms that have custody of customers' assets to keep those assets separate from their other accounts, to not commingle them. All those assets, including cash, should be kept separate. And we've seen that in many cases, cryptocurrency exchanges have not done that.

Securities Lending

A number of traditional brokers are offering to lend out their customers' assets, so stocks ETFs they might own - mostly stocks - and then the customers get income. It's known as securities lending. In securities lending, the way it works is the broker lends out the security and gets collateral, usually Treasury bills; and it's over collateralized, so they'll get 102% of the value of the securities that are lent out. That's for US Securities. For non-US Securities, it's 105% collateral. It's fairly low-risk.

I've had a number of questions recently on securities lending - it's been around for decades. It's a way that pensions and endowment foundations have been able to earn some additional income on the assets that they hold. And now, these programs are being made to individual investors. The risk of securities lending is potentially borrower default, but because of the over-collateralization, that's really not been an issue. The other potential risk is how is the brokerage investing that collateral. Are they selling it and buying something else? But again, a well-structured securities lending program is incredibly low-risk. Yet here we have FTX, either lending out the crypto tokens, or who knows where they went, but they were not available to the customers when they wanted to withdraw, and now there's a big hole in the balance sheet.

For a traditional brokerage, there's usually insurance. In the US it's the Securities Investors Protection Act, SIPC, that protects customers if their brokerage goes bankrupt, up to $500,000 for securities that are in each account, and $250,000 in cash, and that's per legal customer. That doesn't apply in this case, and it certainly didn't apply in the case of Voyager, another crypto exchange that filed for bankruptcy in June 2022. We discussed that company in episode 393. I had about $500 of exposure, because I had a crypto wallet, Circle, that was bought by Voyager. This is all sort of interconnected.

FTX Bankruptcy Impact on Voyager and BlockFi

I got an email last week from Voyager Digital. It was from the Voyager official committee of unsecured creditors. That's what depositors are for cryptocurrency exchanges that go bankrupt - unsecured creditors. They're in line with everybody else, hoping to get some money. The letter said that Voyager was terminating its agreement with FTX, because FTX wasn't just buying Super Bowl ads, they were out trying to save the crypto industry early this year and agreed to purchase Voyager out of bankruptcy. Now, FTX is bankrupt, and Voyager has reopened the bidding process to find alternative bidders; who knows who's going to buy Voyager? I figured my $500 or so of crypto tokens is gone. Small potatoes; there are obviously depositors that lost significantly more.

Voyager mentioned they hadn't transferred any assets to FTX, and they were actually able to recall some loans that they had with Alameda Research, of 6,500 Bitcoin and 50,000 Ether. Voyager did have $3 million at FTX, which they will probably not get back either, because again, they were an unsecured creditor also. So that's Voyager.

The other firm that's caught up with FTX is BlockFi. BlockFi provides cryptocurrency lending accounts. I added a position to BlockFi in April 2021. It was earning 8.6%. I knew that BlockFi was lending against those deposits, which were in the stablecoin GUSD. That was their business model. BlockFi said that many, or most of those loans are collateralized, and that turned out not to be the case. It was less than 20%. BlockFi settled with the US Securities and Exchange Commission in February 2022, agreed to pay $100 million in fines for making materially false and misleading statements. I withdrew my funds and closed my BlockFi account in May 2022. I just was no longer comfortable lending on an unsecured basis to a company that provided no transparency in terms of its financial situation. That was venture capital-backed, but clearly could be subject to bank runs. And that's exactly what happened the next month, June 2022. When Voyager went bankrupt in June, there was a bank run at BlockFi. And who came in to save the day? FTX. July 1st 2022 Sam Bankman-Fried (FTX) agreed to provide a $400 million revolving credit facility to BlockFi, with the option to buy block five for $240 million. BlockFi just released the following statement: "We do have significant exposure to FTX and associated corporate entities that encompass obligations owed us by Alameda. Assets held at FTX in undrawn amounts from our credit line with Ftx.us."

BlockFi has paused withdrawals from their service, because they lent money to FTX, and the money's not there, based on FTX's balance sheet. The fallout from FTX is having an impact on Bitcoin. Bitcoin's price dropped below $16,000 on Monday. Last I looked it was at $17,000. It's lost a quarter of its value since November 5th. When the price falls, that that certainly hurts Bitcoin miners that are verifying transactions, many of which are highly leveraged. We don't know who all is going to be impacted by what's going on with FTX.

Venture Capitalists' Lack of Due Diligence on FTX

Now, surely, professional investors, venture capitalists that invested millions and millions of dollars in FTX - weren't they providing some oversight, understood the business model, made sure that their limited partners' funds were protected? No. Apparently, Sam Bankman-Fried's venture capitalists basically gave them a take-it-or-leave-it offer. He said he planned to run his firm with little oversight, and that investors should just support him and observe. And venture capitalists lined up. Some of the premier firms in the world gave FTX, invested $500 million in FTX as early as 2022. Valued the company at $32 billion. Now it's essentially worthless.

Some of the firms that invested in FTX: Sequoia Capital, which has written down their investment to zero. Softbank. Lightspeed Ventures. BlackRock. Tiger global. And the list goes on. They didn't even have a board seat on FTX, which is highly unusual in the venture capital space. That's the whole point of having venture capitalists - they are involved in the oversight and management of the companies. Or at least have some type of board representation. In this case, none at all, leaving their investors, their limited partners exposed to the fallout from FTX.

Takeaways

What can we learn from this? Well, first off, don't keep cryptocurrency on an exchange if it's a meaningful amount of money, because you're completely unprotected if the brokerage goes bankrupt. We saw it in the case of Voyager. We're seeing it in the case of FTX. I have assets at Coinbase. They say they don't lend out customer funds, and that the assets are fully reserved. And that appears to be the case when you look at their balance sheet. But I'm moving my assets off Coinbase, because I can look at their financials and see that they lost $2 billion through the third quarter of 2022, that they're losing client assets, and so I'm worried about their ability to continue as an ongoing entity, because their trading revenue has fallen 44% from quarter to quarter. They still have $5 billion of cash down from 7 billion at the beginning of the year, and this doesn't include customer deposits that are segregated, supposedly, although it's listed on their balance sheet... But it's just not worth the risk of keeping assets there. And it's a small portion of my overall cryptocurrency exposure. But even then, it's like, why keep it there? It also raises the question "Why own cryptocurrency at all when you have this type of potential fraud? And if not that, incompetence." Money is a made-up thing, it's based on trust, and this does not create trust.

Speculative Case for Bitcoin

A few months ago, on a Plus episode, I discussed the speculative case for Bitcoin. Why I own Bitcoin, which makes up about 2% of my net worth, and Ethereum, which makes up less than 1%. I own them because potentially, they will be useful currencies, at least as digital gold in the case of Bitcoin. It's a simple algorithm. I think it's advantageous to have some exposure to currency that's not fiat currency. That is, to some extent, decentralized. It is actually fairly convenient to own, to be able to have access to a currency, apart from the overall financial system. Most of my cryptocurrency I store on a Trezor USB wallet. That's where the private keys are. It's offline. I can carry it with me if I need to. That's convenient. I don't have to go through the traditional financial system.

Ethereum is interesting, because they are involved in building out decentralized finance. But then we have all this other stuff going on, and fraud, and collapses and bankruptcies, which at times makes me wonder why I continue to stay involved in this space in a small way. Maybe there's a better way to go about speculating. Speculations are where there's disagreement between whether the return will be positive or negative, and I've repeatedly said, with speculations only invest amounts that you're willing to lose. And the losses keep piling up, with both Ethereum and Bitcoin down 60% this year.

So I continue to hold them, but it's incredibly disappointing and disheartening to see more fraud and incompetence in this space. It doesn't build trust.

There are times when - and Camden and I talk about this frequently, where money just seems crazy. The fact that the whole financial system and how money is made up, and it's just trust, and it's not backed by anything, and cryptocurrency appears that way, but so does fiat currency. And we've seen again and again, even with fiat, when trust dissipates, when households and businesses don't want to hold a fiat currency, they won't. And the result is the currency falls in value, significantly, and that leads to inflation, because then the governments are oftentimes printing more of it, trying to get ahead, and then we get hyperinflation.

That's why most of our assets shouldn't be in cryptocurrency or fiat currency. They're denominated in it, there's a unit of account, but the actual investment should be something real, that's generating some cash flow. It could be real estate, it could be stocks, which is ownership in companies. Diversified. Having cashflow-generating assets allows us to keep pace with inflation, which is the other problem with holding currency. In and of itself, it loses value over the long term due to inflation. A decent currency will keep its value in the short-term, so we're not having to spend it today because its value is losing significant amounts day to day, due to hyperinflation.

So is cryptocurrency dead? Not yet, but it sure seems like it's trying to kill itself, and we haven't even begun to see the rest of the fallout from FTX. We'll see how this space evolves, but tread very, very carefully. That's episode 410. Thanks for listening.

Everything I've shared with you in this episode has been for general education. I've not considered your specific risk situation; I've not provided investment advice. This is simply general education on money, investing and the economy. Have a great week.