



The Guide to Crypto Backed Lending



Introduction

This list of questions with respect to loans secured by crypto-assets should not be considered exhaustive, and some of the answers cannot be taken as definitive, given that the development of laws and regulations pertaining to crypto-lending is currently ongoing. Indeed, the current legal regime with regards to secured transactions is ill-equipped to provide a proper legal framework for the use of crypto-assets to secure loans and no legislation currently exists in Canada to specifically address the use of this type of collateral.

As such, it should be emphasized that crypto-lending involves increased risks associated with the inherent volatility of crypto-assets cases, system anonymity, regulatory uncertainty, non-reversible transactions, unprotected deposits, as well as cyber-crimes, such as hacking and theft to name a few. It is therefore vital to follow the “Know your client” and “Know your product” guidelines to mitigate the risks associated with crypto-lending.

Question:

What is a crypto-asset? Is it the same as cryptocurrency?

Answer:

A crypto-asset is a broad term that encompasses various types of digital assets that create, verify, and secure transactions using cryptography, peer-to-peer networks, and blockchains. There are many different categories of crypto-assets, the two most prevalent ones being cryptocurrency and non-fungible tokens (“NFT”). Crypto-assets may also include stablecoins which are sometimes captured under cryptocurrency and at other times constitute a crypto-asset type in themselves.

Cryptocurrency is the term used to signify digital money or virtual currency, and it operates in a peer-to-peer payment network through an open source software, independent of any central authority, banking intermediary or government. Cryptocurrency is secured through the use of blockchain, a decentralized peer-to-peer network of computers that collectively processes, maintains, and distributes a single authoritative record of confirmed transactions, thereby ensuring that only the owner of the cryptocurrency is able to spend it. Some examples of cryptocurrencies include Bitcoin, Ethereum, Ripple and Cardano.

Non-fungible tokens are blockchain-based tokens that represent ownership of unique digital or physical assets like art, digital content, or media. NFTs can be thought of as digital certificates of authenticity and ownership of particular assets. The main difference between NFTs and cryptocurrency is that NFTs are not mutually interchangeable, meaning that it is impossible for one NFT to be “equal” to another.

The umbrella term “crypto-asset” is apt for our purposes and will be used throughout this Guide.

Question:

What is collateral?

Answer:

Crypto asset collateral (or crypto collateral) refers to the use of crypto assets as collateral to secure loans or other financial transactions. In this context, the crypto asset serves as collateral that the borrower pledges to the lender as a form of security, reducing the lender's risk. If the borrower defaults on the loan or fails to meet certain conditions, the lender can seize or liquidate the collateral to recover their funds.

Here's how crypto collateral works:

1. **Borrower:** A borrower, often a crypto asset holder or trader, wants to access funds without selling their crypto asset holdings. They can, however, use their crypto assets as collateral to secure a loan.
2. **Lender:** A lender, which can be an individual or a financial institution, provides the borrower with a loan in the form of fiat currency or another crypto asset, backed by the collateral.
3. **Collateralization:** The borrower deposits a certain amount of crypto asset as collateral with the lender. The amount of collateral required depends on various factors, including the value of the collateral, the loan amount, and the terms of the loan.
4. **Loan Terms:** The loan agreement specifies the terms and conditions, including the interest rate, repayment schedule, and any other requirements or covenants pertaining to loan default or loan liquidation.
5. **Liquidation:** If the borrower fails to meet the repayment obligations or if the value of the collateral falls below a predetermined threshold (known as a "margin call"), the lender may have the right to liquidate the collateral to recover their funds. This typically involves selling all or a portion of the collateral on the open market.
6. **Repayment:** The borrower must repay the loan according to the agreed-upon terms. Once the loan is fully repaid, the lender returns the collateral to the borrower.

It's important to note that crypto asset collateralized loans come with risks, including the potential need for liquidation if the value of the collateral decreases significantly. Borrowers should carefully consider the terms and risks associated with crypto asset collateralized loans before entering into such arrangements. Certain advanced crypto asset backed lending platforms, such as Toronto-based APX Lending, have developed proprietary technology to monitor the collateralization value (or "health") of outstanding loans in real-time and liquidate margin called loans automatically, thereby substantially decreasing the risks associated with taking on crypto assets as collateral.

Question:

Can any asset be used as collateral?

Answer:

Limits to what can be taken as collateral are effectively set by possession, registration and control requirements. Canadian statutory frameworks governing secured lending have provisions with respect to the possession, registration and control of collateral which are important because they set enforceability of the secured party's rights in the collateral against third parties.

In Canadian common law provinces, the PPSAs govern the rules for taking security interests in personal property, including the creation, perfection, priority, and enforcement of collateral. The most common types of collateral are equipment, inventory, accounts receivable and investments (such as stocks and bonds). For example, the Ontario PPSA delineates categories of personal property that are registrable as collateral, including: chattel paper, documents of title, goods, instruments, intangibles, money and securities. The Ontario Securities Transfer Act (STA) provides additional rules for investments.

Another common type of collateral is real property — i.e. lands, buildings, estates, immovables — but these are governed by separate acts, such as the Land Titles Act (LTA), the Registry Act, and the Mortgages Act in Ontario. In Quebec, the CCQ governs secured transactions mainly through its provisions relating to hypothecs, which is a charge that can be taken on all types of assets, movable and immovable, corporeal and incorporeal, and on a universality of property. Hypothecs are registrable at Quebec's centralized Register of Personal and Movable Real Rights (RPMRR) if taken over movable property or at the Land Register if taken over immovable property. Similar to the PPSA regimes, registration ensures that the secured party's rights are enforceable against third parties.

Neither the PPSAs nor the CCQ currently have provisions that specifically address crypto-assets or confirm their status as possible collaterals. It is therefore unclear at this time whether crypto-assets are able to be subject to security interests or charged with hypothecs in favor of a secured party. Nevertheless, borrowers and lenders must comply with the regulatory regimes relating to security interests in personal property to ensure the validity and enforceability of rights.

Question:

What laws in Canada provide the statutory framework for loans secured by collateral?

Answer:

As outlined above, all Canadian provinces provide a comprehensive statutory framework to regulate security interests or hypothecs in personal and real property. In common law provinces, relevant legislation includes the PPSAs and the STAs for personal property (or equivalent legislation, as applicable), as well as the Land Titles Act (LTA), the Registry Act, and the Mortgages Act for real property.

In Ontario, for example, the PPSA is the provincial act that regulates the creation and registration of security interests in personal property and gives creditors the right to seize and sell debtor's assets in case of default. This act protects the various parties involved in lending transactions — lenders, creditors and lessors on the one hand, and borrowers and lessors on the other. The STA sets out the rules relating to the transfer of securities, specifying the rights and obligations of issuers of securities, intermediaries, investors, and secured parties. The STA addresses securities that are held both directly and indirectly by investors, and specifies that perfection of security interest can be achieved through control. The LTA, Registry Act, and the Mortgages Act govern mortgages — that is, loans secured by real property. These acts set out the rules for mortgagors and mortgagees, as well as registration requirements for title in order to prove ownership.

In Quebec specifically, the CCQ governs all secured transactions through the provisions on hypothecs. The Code of Civil Procedure (CCP) provides complementary procedural rules.

Question:

How is a crypto-asset identified?

Answer:

Crypto-assets vary in types, code, structure, use and technology. There is no single method for identifying all crypto-assets, which explains why due diligence by lenders is essential. Since crypto-assets mobilize cryptography and blockchain technology, any crypto-asset is identified through the information found in the specific underlying blockchain on which it exists.

Question:

How does a security interest “attach” or a hypothec “hypothecates” a crypto-asset as collateral for the purposes of the PPSA or the CCQ, respectively?

Answer:

In Ontario, the PPSA stipulates that attachment happens “when value is given, the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party” and the debtor signs an agreement containing a description of the collateral sufficient to identify it. Thus, in order to use crypto-assets as collateral, the holder has to enter into a security agreement with the secured party and specifically describes the crypto-assets.

In Quebec, while there is no notion of “attachment”, the concept of hypothecation is similar: there needs a proper agreement that creates the hypothec by the grantor in favor of the secured party that sufficiently describes the hypothecated property. Likewise, registration of rights in the RPMRR or the Land Register involves a mandatory description of the property being registered.

The secured party must consequently rely on the borrower’s good faith and accuracy in describing the crypto-assets by reference to its cryptological information on the blockchain to ensure that the assets given as collateral are distinguishable from other crypto-assets. For this reason, it is also recommended that the secured party conducts its own due diligence on the crypto-assets securing the loans and understands the nature of the assets used as collateral.

Question:

How is cryptocurrency perfected for the purposes of the PPSAs and the CCQ?

Answer:

Perfection is the necessary step in securing interest in collateral by rendering it enforceable against third parties. The Ontario PPSA provides that “a security interest is perfected when, (a) it has attached; and (b) all steps required for perfection under any provision of this Act have been completed, regardless of the order of occurrence.” The CCQ provides a similar approach to render a hypothec enforceable against third parties through possession, registration of control.

Generally, the steps required for perfection include registration, but perfection differs depending on the type of collateral, as provided by regulations. For example, the PPSA, the STA and the CCQ all stipulate that investment properties (such as certificated and uncertificated securities) can be perfected by control.

Since there are no laws that clearly delineate the required steps for perfection of security interests or hypothecs in crypto-assets in Canada at this time, it is necessary to first classify crypto-assets into a category of collateral in order to determine how it can be perfected. The most likely category into which crypto-assets currently fall is “intangibles.” Neither the PPSA nor the CCQ allow this type of collateral to be perfected by control as of now. As such, any security interest or hypothec in crypto-assets would need to be perfected by registration. This of course offers little protection to secured party considering the inherent qualities and characteristics of crypto-assets.

Question:

What is “priority” over collateral?

Answer:

Priority refers to the ranking of creditors in secured transactions. That is, the order in which creditors will be paid in the case of default and liquidation of the borrower’s assets. Generally, this order is determined by the “first in time, first in line” rule: the first creditor to perfect their security interest will have first priority rights in the collateral. It is therefore common for competing creditors to enter into priority agreements to vary the order of priority of their respective securities.

However, statutory nuances exist in both the common and civil law systems in Canada that set super-priorities, which effectively trump rights of secured creditors irrespective of the date of registration or publication of those rights, and regardless of the existence of priority agreements.

Question:

How is priority determined for security interests or hypothecs taken in crypto-assets?

Answer:

Since no laws or regulations currently exist to specifically address the “perfection” of security interest or hypothecs in crypto-assets as collateral in Canada, it is unclear at the present time whether registration of the crypto-assets under the PPSAs in the common law provinces and under the CCQ in Quebec would be sufficient to establish uncontestable priority. While the current legal framework, as discussed above, may allow for the registration of rights relating to crypto-assets, there is no guarantee that such registrations will be upheld against third parties. In the absence of a regulatory framework providing certainty to both lenders and borrowers, parties to a secured transaction using crypto-assets as collateral are encouraged to establish security structures conventionally, that is in the loan agreement and ancillary documents among themselves, as well as to enter into priority agreements with other interested parties in order to secure their interests.

Question:

What is a “custodian” of crypto-assets?

Answer:

A custodian is a holder of electronic or physical assets for safekeeping from theft or loss. Since crypto-assets exist on blockchains, custodians thereof do not actually store the assets themselves. Instead, crypto-asset custodians usually protect users’ private keys, which grant access to the funds held in digital wallets.

Traditionally, custodians have been financial institutions (i.e. banks), as required by law. However, no laws currently exist in Canada for custodianship of crypto-assets. As such, there are two main types of crypto custody available: self-custody and third-party custody.

Self-custody is when a company or individual holds their own crypto-assets, meaning that they are the only party able to access holdings and prove ownership of funds. In large transactions, however, third-party custody of crypto-assets is usually preferred because a certified company can be hired to hold digital assets on behalf of transacting parties while also offering protection of assets against theft, hacking, loss, and error.

Question:

How can lenders and borrowers take into account the fluctuation in value of crypto-assets used as collateral?

Answer:

Lenders should consider and establish effective protections against potential risks associated with the inherent market volatility of crypto-assets, especially in cases where such assets represent a large portion of the secured collateral. When the value of crypto-assets decreases, so too does the value of the collateral, effectively changing the loan-to-value ratio and exposing the lender to significant risk of under-recovery in the event of default.

As such, lenders should designate appropriate mechanisms for obtaining additional collateral from borrowers in the event of value fluctuations. For instance, crypto lending platforms can require borrowers to either provide additional collateral or make payments under the loan to restore the original loan-to-value ratio stipulated under the loan agreement. In some cases, the restoration of the loan-to-value ratio could take the form of monthly borrowing rate calculations based on protocol formulas, while more volatile situations could involve requiring borrowers to immediately cover the percentage of the collateral value lost. As already seen in traditional lending, respecting these ratios may be a requirement under any new advance for revolving or demand loans.

Lenders could also opt to require over-collateralization as a pre-condition for granting the loan. This entails the borrower putting up collateral that exceeds the loan value, in order to ensure that there are more than enough assets to cover potential losses in case of default. Lenders could therefore require that borrowers provide crypto-assets worth, for example, 20% more than the loaned amount.

What happens when the value of the crypto-assets used as collateral falls or rises should be determined conventionally between the loan parties. Indeed, considering the volatility of the collateral assets, it is important that lenders and borrowers, as well as interested third parties, address this issue in the terms of the loan agreement in the manner suggested above.

Question:

What happens when a borrower defaults on a loan secured by crypto-assets as collateral?

Answer:

This depends on terms of the loan agreement and the security agreement or hypothec, which should be negotiated and agreed-upon by the parties prior to proceeding with the loan. As in any situation of a defaulted loan, a secured party may take steps to enforce their security interests or hypothecs, such as seizing collateral and selling it to satisfy the loan and related fees.

However, current regulations relating to the enforcement of security interests in Canada do not reflect the fact that blockchain transactions are completed quickly, are irreversible, and can be almost impossible to track. This means that lenders looking to exercise their rights as secured creditors might be at a loss to even find the crypto-asset that was pledged to them in the first place, if it was improperly transferred.

As such, absent crypto-asset custodians with special expertise in holding crypto-assets, lenders in this market would be best protected through contractual mechanisms and remedies built into the loan agreements themselves, ensuring timely enforcement of security interests if needed.

The exact consequences of default can vary depending on the terms outlined in the loan agreement and the policies of the lending platform or institution, as well as applicable laws. However, the general steps and potential outcomes that may occur when a crypto collateralized loan goes into default are as follows:

Margin Call: Many crypto lending agreements include a mechanism for margin calls. A margin call is typically triggered when the Loan-to-Value (LTV) ratio exceeds a certain threshold due to a drop in the value of the collateral, for example 80%. When a margin call is triggered, the borrower is often required to take corrective action, such as adding more collateral or repaying a portion of the loan to reduce the LTV ratio.

Collateral Liquidation: If the borrower does not respond to the margin call or fails to take appropriate action to bring the LTV ratio within acceptable limits and the LTV drops to below a certain threshold, for example, 90%, the lender may initiate the process of liquidating the collateral. This involves selling the collateral on the open market to recover the outstanding loan amount and any associated fees.

Recovery of Loan Amount: The lender will sell the collateral at the prevailing market price. If the sale of collateral covers the outstanding loan amount, including interest and fees, the lender may keep the excess proceeds. If the sale falls short of covering the loan amount, the borrower may still be responsible for the remaining balance.

Losses and Fees: The borrower may be responsible for any losses incurred by the lender during the liquidation process, as well as additional fees and penalties specified in the loan agreement.

Question:

Who determines whether a loan is in default?

Answer:

Generally, default occurs when there is a breach of the terms of the loan agreement. As such, looking at the provisions on default in the loan agreement between the parties is helpful in determining whether a loan is in default. An independent party may also be retained for the purpose of determining whether a loan is in default.

Question:

What happens when a borrower declares bankruptcy?

Answer:

Bankruptcy is a legal procedure that releases borrowers from most of their debts if they are insolvent or facing serious financial problems. Generally, when a borrower declares bankruptcy, their assets are frozen for the duration of the bankruptcy procedures, and their property is subsequently seized – subject to certain property being exempted by law – and used to pay off creditors. Any remaining assets or moneys leftover after all loans and fees are satisfied are returned to the borrowers.

Generally speaking, the process and outcomes are governed by Canadian bankruptcy laws and regulations, primarily under the Bankruptcy and Insolvency Act (BIA) and the Companies' Creditors Arrangement Act (CCAA).

Question:

After the seizure and sale of the crypto-assets as collateral upon default, does the borrower get anything back from the lender?

Answer:

When there is a default on a loan, lenders generally have the right to seize property given as collateral and sell it in order to cover the remaining amounts owed by the borrower. Any remaining assets or moneys leftover after all loans and fees are satisfied are usually returned to the borrowers. As such, borrowers could obtain from lenders leftover amounts from the sale of the crypto-asset that was given as collateral.

Question:

When does the borrower get its crypto-asset in collateral back?

Answer:

The terms of the loan agreement and the security agreement or the hypothec should provide mechanics for the return of the collateral to the borrower.

If the crypto-asset was pledged as collateral for a loan, but perfection occurred through registration and the crypto-asset was never transferred to the lender, then the crypto-asset remains with the borrower as long as the terms of the loan agreement are met and the borrower does not go into default. On the other hand, if the crypto-asset is transferred to the lender or a custodian, then the asset is only returned once the borrower has satisfied their obligations and repaid the loan in full.

Question:

What are the KYC and KYP guidelines?

Answer:

In Canada, financial institutions and other regulated entities must follow “Know Your Customer” (KYC) and “Know Your Product” (KYP) guidelines and requirements established by FINTRAC to comply with regulations on anti-money laundering (AML) and counter-terrorist financing (CTF). This includes institutions dealing with crypto-assets.

KYC includes the verification of the identity of each customer based on reliable information and official identification documents as well as a proper due diligence and risk assessment of the activities of the customer. Understanding the activities of the customer and properly assessing the risk associated thereto allow the lender to put in place appropriate measures to monitor, control and support such customers.

KYP includes proper due diligence on the financial product and services offered or mobilized. Because crypto-assets involve developing technology, this could require special expertise from analysts capable of understanding the whitepaper, the code, the blockchain, the uses, the community, and all other important elements and characteristics for crypto-assets in particular.



The Guide to Crypto Backed Lending

The foregoing does not constitute legal advice and serves for informational purposes only. Anyone interested in using crypto-assets as collateral should obtain legal and accounting advice prior to entering into a loan.