TruthDAO Newsroom

Three Arrows Capital Relied on Massive Debt to Generate Returns

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"Leverage Up Dramatically" Co-Founder says

By Kathy Chu, TruthDAO

On an April podcast last year, hedge fund founder Su Zhu explained to his audience how crypto investors could be successful: "leverage up dramatically on the stablecoin trade."

Basically, Zhu was saying, investors could borrow heavily to generate high
show, called "Where Do the Yields Come From in Crypto," has been streami
than 23,000 people on YouTube alone.

**Three Arrows Capital**, also known as “3AC,” co-founded by former schoolmates Zhu and Kyle Davies, followed this advice. They borrowed hundreds of millions from high-yield crypto lenders and exchanges and invested in decentralized-finance projects, cryptocurrency and other digital assets. One of the investments was in *Luna*, a token that lost nearly all its value in mid-May after its linked stablecoin, TerraUSD, de-pegged from the U.S. dollar.

3AC filed for Chapter 15 bankruptcy protection in early July. The filing, in New York, came on the heels of a liquidation order by a British Virgin Islands court. This week, a judge for the Southern District of New York granted permission for subpoenas to be issued to Zhu and Davies after court-appointed liquidators said the two hadn’t cooperated “in a meaningful way” with efforts to unravel the hedge fund’s assets. The founders’ whereabouts are currently not known, the liquidators said.

Zhu, on his Twitter feed, responded by saying that 3AC’s “good faith to cooperate with the Liquidators was met with baiting.” In a letter to the liquidators -- made public by Zhu -- the co-founders' lawyer said the men and their families have faced threats of physical harm. The letter said they have been busy answering questions from the Monetary Authority of Singapore. 3AC, a BVI-domiciled firm, was formerly based in Singapore.

Crypto assets have lately been imploding. As of Wednesday, the industry’s total market cap stood at $884.5 billion, less than a third of the $3 trillion it commanded in November 2021, according to CoinMarketCap.com. As the bankruptcy proceedings are in their early stages, it’s not clear how highly leveraged 3AC was before its downfall. But Zhu’s remarks to his podcast audience reflect a common practice in the industry: relying on massive amounts of debt to chase investment returns. High-flying returns during the bull market allowed crypto lenders like *Celsius Network*, which filed for Chapter 11 bankruptcy Wednesday, to promise customers up to 18% yields on their deposits.

**Frances Coppola**, a U.K.-based independent analyst and economist, says lofty promises like these are a big problem in the industry. "This is another risky iteration of shadow banking that we've seen before, and it always ends in tears,” she said.

Liquidators for 3AC in the BVI case will be tallying the hedge fund’s assets and liabilities.
in the coming days. So far, public statements by a half dozen crypto lenders, exchanges and traders suggest that 3AC currently owes between $1 billion to $2 billion to these players alone. One of its largest creditors, crypto lender Voyager Digital, issued a notice of default to 3AC in June for more than $650 million. The hedge fund also owes $80 million to crypto derivatives exchange Deribit and an undisclosed amount to crypto lender Finblox, which advertised yields of up to 90% to depositors. 3AC has stakes in both companies.

In recent years, 3AC's investment portfolio included non-fungible tokens, or NFTs. Significant positions were also staked ether (stETH), a derivative crypto token, and a $1 billion investment in the Grayscale bitcoin trust as of December 2020, according to 3AC's statements, public filings and data blockchain analytics firm Nansen. In a June report, Nansen named 3AC and Celsius Networks the “biggest withdrawers” of staked ether and ether. Between them, Nansen said the two ventures siphoned off nearly $800 million of liquidity from the system on a single day, May 12.

According to analysts, the selling pressure partly fueled a de-peg between staked ether and ether, which usually trade in line with one another. Staked ether — a derivative that can be exchanged for the cryptocurrency ether in the future — is meant to be a long-term investment. It can't be converted to ether until after the so-called "merge," which is basically when the Ethereum blockchain moves away from an electricity-intensive model of verifying transactions.

Crypto's troubles are not symptoms of fundamental problems with staked ether, says Jon Wu, who heads marketing at Aztec Network, a smart-contract platform focused on privacy. Rather, he says, the problem arises when crypto players like Celsius Network invest in staked ether but need liquidity. Crypto firms that have to sell the staked ether on the secondary market at a discount could face steep losses.

Besides crippling debt loads, some lenders are overexposed to 3AC. In Voyager's case, more than half of its crypto loans were to 3AC at the end of June. Voyager disclosed its loan book in July as it was suspending withdrawals from the platform. Voyager, one of the few crypto lenders required to file financials publicly because it is listed on the Toronto Stock Exchange, filed for Chapter 11 bankruptcy last week.

In a tweet, Wu asserted that Voyager’s recent filings show such high levels of "a tiny markdown in their loan book” would wipe out all the value in the business. Wu was
referring to Voyager's 95% leverage ratio at the end of March, when the lender reported $6 billion in assets and $5.7 billion owed to depositors. Voyager didn't respond to a request for comment.

Analysts say the ongoing troubles of the centralized finance sector — which relies on people to manage assets, not smart contracts — reveal a basic mismatch between crypto companies' pursuit of high returns and their ability to hedge against investment risks.

“This is a gross failure of risk management,” said Campbell Harvey, a finance professor at Duke University's Fuqua School of Business.

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