5 Risks to Know Before Using Crypto Lender Like Celsius

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Crypto lending has been one of the most prominent activities in crypto markets. The activity has developed over the years with several crypto lenders like Voyager and Celsius emerging to meet the demand for crypto loans.

Centralized crypto lending platforms (CeFi), such BlockFi, Celsius, and Nexo, offer high-yield products to users. By depositing crypto funds into these products, users receive high-interest payments. However, with recent turbulence in the crypto markets and challenges in their business models, centralized platforms are contending with problems that highlight the riskiness of depositing funds in crypto lending apps.

Celsius is the latest example, which has started filing for bankruptcy protection. The embattled exchange has finally turned Chapter 11 rumors into reality after a month of turmoil with constant speculation and rumors. This has fueled controversy in an already battered crypto market.

In the interest of protecting your funds, you will learn what risks you should evaluate before using centralized crypto lending platforms.

Celsius bankruptcy highlight risks of CeFi lenders

Amid wider market instability affecting crypto markets, Celsius announced on June 12, 2022, a pause on all customer withdrawals, swaps, and transfers between accounts citing extreme market conditions and the need to balance liquidity. And now it is in the process of filing for bankruptcy protection.

The immediate result was the plummeting of Celsius' native token, CEL, by over 70% within 24 hours. This was against the backdrop of a giant crypto selloff that saw the total market capitalization drop to below USD 1trn. (However, since then, CEL erased all its losses and is now trading substantially higher than before the crash.)

Celsius is one of the largest crypto lenders with reportedly close to two million users from all over the world. In November 2021, the crypto lender was valued at over USD 3bn after raising USD 750m in a funding round.

Celsius reportedly uses customer deposits to lend out financial assets to institutional investors and traders on short terms basis to generate income through arbitrage, shorting stocks, and certain digital assets and market-making. Celsius also uses several DeFi protocols to lock client assets in liquidity pools to generate yield.

In exchange, customers have earned up to 7% returns on stablecoins such as USDC and USDT, 7.25% on MATIC, 6% on ETH, and 6.25% on BTC. However, the recent turmoil in the crypto market has eroded the potential returns an investor can earn on Celsius, bringing to question the viability of its business model.

A short-term cause of Celsius's troubles has been the depeg of **Lido**'s staked ETH (sETH), which is pegged to Ethereum's ETH. Celsius had locked funds in stETH, and a stETH depeg means that stETH cannot be sold easily on the open market to get needed ETH liquidity to honor ETH redemptions on the Celsius platform.

This comes after some regulators have in the past referred to crypto lending products like Celsius as unregulated securities.

Unfortunately, Celsius is not the only crypto lender in trouble as Babel Finance also halted withdrawals, creating rumors that more lenders might be staging bankruptcy in the face.

5 risks to watch out before lending crypto

The Celsius debacle has put the spotlight on some of the vulnerabilities of centralized crypto lending platforms.

To begin with, CeFi loans are custodial, with a central entity taking custody of all collateral. This means you can only access your collateralized asset when the lender allows you to as he is the one controlling your private keys.

Unlike CeFi lenders, DeFi lending protocols provide crypto loans absent of centralized counterparties and use smart contracts to govern collateralization, loan disbursement, and interest payments. (However, DeFi is also known for being more centralized than its name might suggest.)

Having said that, here are some of the most important risks you must be aware of when lending your cryptoassets.

All funds may be lost in case of bankruptcy

In traditional finance, bank deposits are insured which guarantees that a portion of your deposits will be refunded in case of bank insolvency. This means the risk of you losing your deposits is low, and the lender is assured of some compensation in the event the institution is bankrupt.

In CeFi lending, only a small portion of the total assets managed are insured, and therefore, you stand to lose some of your cryptoassets in case of insolvency. Also, since you don't have custody of your collateral, the platform provider can keep the cryptoassets of lenders and borrowers.

Since borrowers don't control their private keys, they can lose their collateralized assets if a CeFi platform goes under. Because of these factors, you are advised to risk only a portion of your cryptoassets (if any), instead of holding all of your digital money on such a platform.

Accounts can be locked at any time

CeFi lending platforms sometimes freeze accounts based on any number of issues including security breaches, anti-money laundering concerns, and even platform liquidity. Unfortunately, if your account is being frozen it means you are unable to access your crypto assets or transact in any way.

Unlocking your account can turn out to be a long and tedious process, which must be approved by the platform provider. Compare this to DeFi lending platforms, which are non-custodial and anyone can lend and borrow assets without fear of arbitrary shutdowns.

Transaction fees are not always transparent

The presence of several counterparties in CeFi lending systems results in layers of transaction and service fees. Depending on the CeFi platform you are using, some of the fees may be hidden or bundled together with transaction fees. The result is that CeFi lending platforms tend to be relatively expensive compared to DeFi lending protocols.

Risks of Counterparty

Customers lending out their cryptoassets to CeFi lending platforms don't have a clear view of the counterparty transactions.

For instance, Celsius users dealt directly with the platform and had no relationship with other asset managers and DeFi protocols interacting with Celsius. This lack of transparency poses a risk for customers with little or no say in investing strategies and their results.

APY changes may occur at any time without notice

Finally, the CeFi Lending Platform's Annual Percentage Yield (APY) is subject to change. The platform provider can adjust the APY based on crypto market conditions or the regulatory environment without much notice to users.

This has happened on many occasions and again highlights how risky it can be to trust a centralized entity with your crypto assets.

Related Reading:

Troubled Crypto Lender Celsius Files for Bankruptcy

What Happens If Crypto Exchanges Such as Celsius or Coinbase Goes Bankrupt?

Behind Voyager Failure: How Crypto Broker Went Bankrupt Like a Bank?