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PODCAST

Let's Talk Digital Assets: Incorporating Digital Assets as Additional Collateral for Loans

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In this episode of *Let's Talk Lending*, Winston & Strawn Partner and Co-Chair of the Structured Finance Practice, Francisco Flores and Associate Collin Groebe are joined by guest speaker Kelechi Ogbunamiri, Chief Investment Officer at the Hankey Group. Listen as they discuss an innovative bitcoin custody lending program structured by Winston & Strawn and Hankey Group's direct lending verticals Hankey Capital and Midway Leasing that incorporates bitcoin as additional collateral for real estate and luxury auto loans.

Highlights from this episode include:

- Genesis and description of Hankey Capital and Midway Leasing's $5 million to $300 million real estate and auto loan program with bitcoin as additional collateral.
- Asset based lender's benefits in taking bitcoin as additional collateral, loan-to-value metrics, and foreclosure mechanics.
- Challenges with bitcoin as collateral and how to address risks from a secured lender's perspective.
- Dealing with bitcoin volatility and how to protect a secured lender through legal documentation.
- Uniform Commercial Code perfection and control considerations.
- Choosing a bitcoin custodian.

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Audio Transcript

Francisco: Welcome to Winston and Strawn's Let's Talk Lending podcast. I am Francisco Flores, partner and co-chair of Winston's Structured Finance Practice. I am delighted to be joined today by our guest speaker, Kelechi Ogbunamiri, CIO at the Hankey Group, and Collin Groebe, Associate Attorney at Winston & Strawn. Today, we will be discussing an innovative lending program structured by Hankey Group's directing lending vertical Hankey Capital that incorporates digital assets as part of the collateral package.

Let's dive right in and start with a general description of Hankey Capital and its alternative lending business. What differentiates Hankey from traditional lenders?

Kelechi: Thank you, Francisco. Hankey Capital is one of eight companies that are owned and started by Don Hankey, our Founder and Chairman. They are one of the largest direct lenders originating private bridge financing in the Southern California market. We do loans anywhere from $5 million to $30 million and we've funded over $2 billion dollars of loans over the course of our inception. Don also owns companies—a car rental company called Midway, an auto lender called West Lake, an insurance company called Night Insurance, and several other companies. I think what differentiates us on the real estate side is that we're able to really put together differentiated and creative solutions for our borrowers.

When a borrower has an easy, simple underwriting, I think the banks can typically underwrite that with little hassle, but for kind of the more complex and creative stories, I think that's where we really shine.

Francisco: Thank you for that general description. Now, turning to the crypto lending program at hand, how did you get interested in digital assets?

Kelechi: That's a great story. Don Hankey's family owned a car dealership about 40 years ago. Don has an investment background but moved to run a family business, and he saw that one of the impediments of selling more cars was that he couldn't get his customers approved. So, Don said, "You know what, I could sell more cars if I can get more customers credit approved." Therefore, Don began carrying his own paper, meaning he started offering financing to his own customers.

Don quickly learned he was making more money from the financing than he was from selling cars. So, Don said, "I'm sure there are a bunch of small independent dealers just like me who don't have a big bank behind them. What if I became their bank?" You fast forward almost 40 years now, his company, West Lake Finance, is one of the largest full-spectrum auto lenders in the U.S. They have $15 billion on their balance sheet and completed $1.2 billion in profit last year. So, Don has always been kind of a hard money lender. Lending is a hard asset, whether it's cars or real estate that's always had collateral behind its loans.

During the pandemic, one of the borrowers came to us and asked Don if he would you be interested in lending against crypto. Don being very opportunistic, he viewed it as any other hard asset. I can ascertain the value that asset, I can lend against it at a level that makes me comfortable. Even though it sounds like a big leap of faith to go from lending against cars and real estate versus lending against crypto. At the end of the day, we view it as an asset-based loan.

Francisco: That's a great story indeed. So, turning now from the general to the more granular. Can you please give us a general description of the program? What does that collateral package look like from Hankey's perspective?

Kelechi: If a borrower comes in and wants to buy an investment property, say, for $1 million. Our traditional loan would be a 75% LTV (loan to value). So, we want to loan 75% of the value of the property. For a $1 million property we would normally loan $750,000. That's our traditional loan product. With this product, if a borrower wants to buy this $1 million property but wants to pledge by crypto collateral, we would lend a 100% LTV, meaning that $1 million of value will lend you $1 million. But as collateral for us lending more money than we normally would, we also take your crypto as collateral.

In a traditional loan, we had a $1 million property and we're loaning 75% against it, and with the program we have a $1 million property and we're loaning the full amount against it. But in addition to having real estate as collateral, we also have your crypto as collateral. That's the program, and we think that it's attractive for people who are long-term believers in crypto because your crypto will be pledged as collateral. Our loans typically run from six months' to two years' duration. So, for those who need more immediate liquidity or access to collateral, this program may not be the best for them. But for long-term believers who can pledge collateral and not need it for the duration of the loan, it fits very well.

The other benefit is tax implications. In a traditional loan, you need to come up with the cash and the funding equity portion of that loan. In this program, you don't need to do that. So, rather than having to sell your crypto and lose out on a continued appreciation and potentially incur tax liabilities, you can continue to own a crypto and hopefully see it rise and not incur any tax implications. For a certain segment of the market, it's very appealing to them.

Francisco: Now turning to Collin. We've heard from Kelechi about the program, as well as how they view the underwriting as well as the loan program itself. From a legal perspective, what are the issues and risks to be considered when you first hear a client talking about a program that involves digital assets as part of the cloud package?

Collin: From the perspective of a secured lender, when thinking about any asset that's going to be pledged as collateral, whether that asset is cash securities, equipment, or, in Hankey's case, bitcoin, the primary issue is making sure that our lender client is perfected in their security interest, and for Hankey's case, Kelechi already knows how to perfect security interest in real property. So, what Winston was focused on was the method of perfection under the U.C.C. for bitcoin. Now, what makes the correct method of perfection of bitcoin so fascinating is that right now the U.C.C. is currently being amended. The whole reason that the U.C.C. is being amended is because of the ambiguity of bitcoin, and what their clients are coming to them and asking to pledge bitcoin as collateral.

Literally as we speak, the United States is working on adopting proposed legislation that will amend the U.C.C. to address digital assets. Those amendments are set to go into effect on July 1, 2025.

Francisco: How can these issues and risk involved with digital assets be addressed through legal documentation and structuring? In other words, what you just identified are the main issues. But now that we know what they are, how can we address them to make the risk manageable?

Collin: The big picture is that Winston needed to draft the loan documents so that Hankey's security interest in bitcoin is perfected both pre-U.C.C. amendments and post-U.C.C. amendments. The reason for that is because, as Kelechi just mentioned, they have loan tenors that extend six years, so that would go beyond July 1, 2025. Now, what helps is that I was there and took part in drafting the U.C.C. amendments. During one of these drafting sessions, I brought up the exact legal structure that Hankey is now using for their crypto custody loan program. I asked during that session if you have a borrower that is pledging bitcoin and transfers that bitcoin to a custodian under the U.C.C. amendment of "how do I perfect security interest." The members of the American Law Institute, the Uniform Law Commission Committee, and the lawyers on that call said the appropriate method of perfection in this instance both pre- and post-U.C.C. amendments, is that you execute a control agreement between the lender, the borrower, and the custodian. Via that control agreement, the lender will have the sole right to control the bitcoin held in that custody account and then will be perfected via article 8 of the U.C.C.

Francisco: In this program we're using existing technology with—but with—an eye towards the incoming amendments so that the program can function seamlessly when the transition occurs. Kelechi, back to you. How do you get comfortable with the risk profile involved in this asset class as well as the solutions described by Collin that were proposed by Winston & Strawn?

Kelechi: When I think what the risk is, I think there's probably three risks versus you have the borrower, right? Ultimately, even though we're at the base lender, we don't like to take collateral back, whether that's to the real estate loan or an auto loan having to foreclose on a home. Obviously, we must do it in order to protect our interests, but that's not our preferred method. So, the first underwriting and risk factor is: Can this borrower pay this loan? What is their credit history? What is their income? What is the cash flow? Traditional credit underwriting still exists despite this being a digital asset.

The second part, which is important, is if you have collateral back in this loan, then how well am I able to get access to this collateral if something were to happen? We do a lot of due diligence on who the appropriate custodian is because they know who would impact on our ability to have control of the collateral should it be needed in a liquidation scenario.

Lastly, Winston & Strawn was instrumental in figuring out the right structure as Collin alluded to, so we felt comfortable that in an adverse situation where we need to get access to the collateral, we could do that. Those are the risk scenarios. It's the risk that the borrower can make payments on this loan. The risk that we could have access to the collateral and then the risk that we know we have the legal structure, so we can do that and not be impeded in any way.

Francisco: To stay for a moment on this theme about risks and concerns. Kelechi, one of the big concerns with digital assets is volatility. How do you get comfortable with it? That's one of the one of the big issues in the marketplace with respect to bitcoin and other digital assets.

Kelechi: That's the big elephant in the room, when you have bitcoin that has significantly more volatility than any other asset. How do you properly structure a loan? You look at other things that you can have as collateral, whether it's stocks or real estate, those also move but not nearly the same level volatility as crypto. We thought we needed to add in a larger margin of safety. So, as I mentioned before, with real estate, we may do it at 75% LTV, meaning that asset needs to drop from, call it a $100 the $75, for us to be at risk of losing money.

While that's possible, we felt that's an appropriate amount of marginal cushion for real estate. For crypto, given increased volatility as you just alluded to, we built in more cushion so we're not doing a 75% LTV loan when it's just based on crypto. We're going to do a 50% LTV loan. So, on a one-million-dollar property, we're going to require a borrower to put up one million dollars of crypto. From our perspective, our million-dollar loan is collateralized by a

million dollars of crypto and one-million dollars of land. So, you have two million dollars of assets backing our one-million-dollar loan.

So, we have a 50% loan to value. What that means is crypto needs to fall over 70% going from one million to call it $300,000 for us to be back to a 75% LTV. Because we still have real estate collateral with that one-million-dollar property. From our mind, if you structure it with enough collateralization, we can still feel good even though we must acknowledge that this asset is volatile.

Francisco: Kelechi addressed volatility from Hankey's perspective, and particularly the underwriting loan-to-value ratio and how do you protect yourself in that regard. From a legal perspective, how do you address volatility? Is there anything that can be done with terms of legal structure and documentation to address volatility?

Collin: Before talking about the legal issues, there's just one thing I want to point out about the volatility. I think that when people talk about volatility of bitcoin, what they're really saying is day to day, week to week, month to month, bitcoin is super volatile. People talk about the tweets of Elon Musk; you know there is a hack of an exchange and bitcoin drops. But what normal people don't understand is that bitcoin held for a period of three years or longer, has never lost an investor's money. In other words, if I bought bitcoin at any point since its creation in January 2009, and then held it for longer than three years, I would have never lost money. Now, we'll see if that remains true. The all-time high of bitcoin was reached November 8, 2021; it hit, I believe, $67,000, so we'll see what the price of bitcoin is going to be November 2024. But, historically, just wanted to point that out. Since 2009, an investor that has held bitcoin for longer than in three years has never lost money. Now, regardless of all that, Winston does address the day-to-day volatility within the loan documents.

The way that this works—Kelechi will set a loan-to-bitcoin-collateral ratio, and to make things simple, say that Hanky has a loan-to-bitcoin-collateral ratio of one to one. They have an outstanding loan balance of $100. If at 8 a.m. on any day the bitcoin collateral value, which is calculated by multiplying the market price of bitcoin on that day against the bitcoin that's held in that custody account, falls below $100, then there's a shortfall, and the borrower has one day to either prepay the outstanding loan or transfer additional bitcoin into that custody account. And if the borrower doesn't do one of those things and fails to eliminate the shortfall, then Kelechi and Hankey, they have the right, which is acknowledged by the custodian and borrower, to order the custodian without any approval or consent to transfer the bitcoin, convert it to cash into an account held at Hankey, and then Hankey can do whatever they want with those cash proceeds, whether it's pay down the loan or hold it there.

Francisco: We've discussed the origins of the program and the interest in digital assets, which was an interesting story. You also discussed the underwriting process as well as the legal framework. But let's turn now to talk about the process for getting one of these loans. Kelechi, can you please walk us through the loan process? So, a borrower comes to Hankey and they hold bitcoin and request a loan. What's the process and what's next?

Kelechi: Francisco, I'll use you as an example. You come to Hankey and say I want to buy this nice investment property that is probably $5 million. We will start the traditional underwriting process, as we will for any other loan and see that we can approve you for this loan, and, as I mentioned before, that goes back to the value of the property, how much you want to lend against it in your own credit profile, and credit history. Once you approve the loan, we tell you we're able to advance. You send 5% against the value, you tell us that you don't want to pledge any cash—rather, you want to do 100% financing—and I have a ton of crypto. At that point, this switches from my 75% traditional loan to 100% financing. We're now going to ask you for $5 million, but now we need you to pledge your crypto in accounts.

So, we then must get you set up with our custodian, which should be pretty quick because some of the information we gathered for the credit approval will be used to set up your accounts. You get a setup for a custodian, and then you have an account, and then you move over your $500 worth of crypto into that account. We then have the documentation that Winston & Strawn put together that gives us a security interest in that account. Whereby you know that asset is pledged as collateral to our loan, and if the asset is pledged to be collateral as a loan, you don't have access to remove it or to sell it or do anything as long as it's pledged.

We articulate very clearly to you what that margin threshold is as Collin alluded to. In this case, it'd be somewhere in the 70% range. When your crypto falls close to 70%, we tell you that your LTV is falling below the comfort level that

we discussed when we put this loan together. You have a few days to either bring more bitcoin or to bring more cash, so that our LTV is where it needs to be. As soon as you do that, you need to pay interest on your loan. At the end of your loan tenor, we are repaid in full and then we release our security interest from your pledge and from your accounts. Any appreciation that crypto has enjoyed is yours—we don't own the asset, it's just pledged to us—and you do whatever you want with the asset.

Francisco: Collin, Kelechi brought up the borrower transferring bitcoin to a custodian to be held in trust. When you were describing the legal framework, you indicated that was one of the key protections in the program as well as for lenders in the digital assets space. Can you please describe the marketplace for bitcoin custody? What will be the considerations when choosing a custodian since it's a key component of crypto?

Collin: The aspects surrounding custody of bitcoin are the most complicated and the most significant part of this entire transaction. We can have a whole podcast just talking about custody with public keys, private keys, merkle trees, FDIC insurance, bank failures. But for purposes of this podcast, what I would like to communicate is the main takeaway is as of March 2023, the custody of bitcoin is not being done by federally regulated banks that fall under the purview of the U.S. banking regulations. Due to that, the custodians are not regulated the same way as the banks are, so there's less transparency and less prohibited actions.

Because of that, it's really important to understand how crypto custodians are operating, how they're structured, how they make money, and how much they cost as assets. Basically, there's two broad categories. There are crypto exchanges, and then there's crypto trust companies. For the exchanges, the biggest ones are Finance Coinbase, Gemini, Kraken. For the trust companies, you have NYDIG, Northern Trust, and Bitco. I think when you're assessing the risk between trust companies and exchanges, it's really on a case-by-case basis. There's lots more to discuss on that subject, but at least for now, that's how I generally look at the marketplace for custodians.

Francisco: So now we have described the program, the origins, the business case, the underwriting, and the legal framework. Turning a little bit towards the future, Kelechi, where do you see the Hankey's program expanding from here? Where do you see the opportunity?

Kelechi: This has been kind of a one-and-a-half-year labor of love to kind of get this across the finish line. We just launched this product officially earlier this month. We think there's significant white space in the real estate market for investors to use crypto to buy real estate assets. This product was a much harder sell when real estate mortgage rates were 3-4%, and what we charged was a little bit higher. That delta was too much. Now that you know short-term rates have increased so much, I mean, it's really mortgage rates up to 6%, and our rates are a little bit more attractive.

I think that for real estate, we are just scratching the surface. As I mentioned, we are doing anywhere from $5 million to $300 million. We're starting in California looking to expand that. In the few weeks since we launched the product, we've gotten a good number of inbound calls for investors who are interested. One other area that we're looking to expand is in exotic car financing and leasing. I mentioned at the onset that another one of Don Hankey's companies, Midway Auto Rental, is one of the largest luxury leasing companies in the U.S.

Imagine if you want to purchase a new Bentley. You have significant net worth and are tied up in digital assets. We're willing to finance your vehicle collateralized by crypto. We're in the early stages for that product. I think about where we can go with this real estate just beginning. One important point is that the institutional adoption of crypto has really picked up over the years. I think, as banks still kind of take a wait and see approach, that offers a lot of white space to offer creative solutions for borrowers.

Francisco: It looks like there are a lot of opportunities so that that sounds very exciting. We're just about ready to wrap it up. I am going to ask each of you for some closing remarks. So, Kelechi, do you have any closing remarks with respect to Hankey Capital's digital asset program? Secondly, if a listener buys bitcoin and wants to use it as collateral for a loan, what is the best way for them to contract you?

Kelechi: I just want to thank Winston & Strawn. As you can tell, Collin is a bitcoin enthusiast. I learned a lot just working with him last year and helping to really craft this product. We initially sought out a law firm who could help us with a legal structure, but Winston has helped even on the business side of it and giving us other things to think

about that we didn't initially think about. I really want to thank Winston for their creativity and for being a leader in the space from our standpoint. We're ready to start taking applications if there is interest in this product. You can email me at kogbunamiri@hankeygroup.com.

Francisco: Collin, any closing remarks with respect to the legal framework available for digital asset transactions and any key points to one address before we wrap this up?

Collin: I want to close by saying that I'm very thankful to have the head of Winston & Strawn's Structured Finance Practice moderating this podcast. I think I speak for Francisco and myself when I say that we're really excited about the future in space, and our partnership with such an innovative forward-thinking, cutting-edge lender.

Francisco: Thank you to Kelechi, Colin, for joining me today and thank you to all for listening to our Let's Talk Lending podcast. You can subscribe to the podcast at Apple iTunes, Spotify, or Google, or by visiting the Winston and Strawn website for more insights on the latest market updates and trends in the finance practice area.

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