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What Is Funding Rate and What Does It Do?

If you have ever traded crypto futures, you must have encountered the so-called funding rate. This small percentage can eat away your position. But what does it do? Let’s find out!

What Is the Funding Rate?

Funding rate was introduced to maintain the balance between the price of perpetual futures and the price of the underlying instrument. It changes depending on how big of a gap exists between spot and perpetual futures, in order to close the gap again.

If an exchange needs to push perp price up to close the gap, the funding rate will be lowered to incentivize buying (or short closing). In contrast, if the perp price needs to be adjusted downwards, the funding rate will increase to incentivize selling (or long closing).

How Does It Work?

As discussed, the funding rate is adjusted to incentivize certain behaviors. It (simply put) works by having one side of the trade pay a small fee to the other side of the trade.

Let’s elaborate using a scenario where perpetual trades above spot. To bring the price of perpetual down, exchanges need to incentivize selling. To do this, they will increase the funding rate to 0.05%.

After the change, everyone with a long position on perpetual will have to pay 0.05% of their position size to the shorts (which get paid 0.05% of their position sizes, respectively), each funding period. The funding period is usually eight hours long. Obviously, having to pay 0.05% every eight hours isn’t great. Some people close their positions (or open short positions to get paid 0.05%!), and mission accomplished! In the opposite scenario, short positions pay to longs.

However, if you expect to make more than the cost of funding, funding is not the reason to close the position.

How Is Funding Rate Used As A Trading Indicator?

Funding rate can serve as a sentiment indicator of sorts. When it is high, there is a high interest in long trades on leverage, whereas a low or even negative funding rate shows that the short is quite crowded.

You can leave it at that and just be the contrarian that goes against the herd, but I don't think you'll be very successful. As explained, if the price just goes up more than the cost of funding, the longs will be fine. Your expectation of price moves relative to funding rates could be the start of an idea.

So, what do we do? There are multiple levels of analysis you can put into funding rates, but I'll try to keep it simple.

As an example, funding rate increasing with price tells me the trade is getting crowded. This is moderately bearish, as the masses are usually wrong. Funding going down while price increases can be considered a strong buy signal, because it tells you the majority is trying to countertrade a move upwards. This generally does not end well.

It is not advised to trade based on funding rate alone though. Like any other metric, large players can manipulate it to trick you. A confluence of various factors instead will give you a much more reliable picture to base your trades on. For example, entering a long position at high time frame support, combined with funding rate going negative.

Funding Arbitrage – Make Money at Low-risk

You can also make money with funding without betting on a direction at all. This is called funding arbitrage. Funding rate is not universal across exchanges; one usually has higher funding rate than another. Therefore, if (for example!) you short 400 dollars on Binance and long an equal amount on Bybit, the difference in funding rates goes into your pocket. You don't lose any money on market moves, because the losing position will be covered by the winning one.

These are just a few simple ways to get started with funding rates and use them to your advantage.

There are far more complex ways to analyze funding, but that is beyond the scope of this article. You can start your own research to learn more, have some fun and make some money!