FUTURE OF CUSTODY CONTINUED

After more than a decade of dealing with unprecedented low interest rates – institutional investors are now re-positioning their portfolios to insulate themselves against looming inflationary risk and geopolitical tensions. A growing number of investors have recently started scoping out ever more esoteric asset classes — including digital assets. In a recent discussion led by Nadine Teychenne, Citi Securities Services' Global Lead Digital Assets, a number of leading digital asset custodians shared their insights into the dynamics shaping the nascent market's development.

Digital assets: Moving beyond the retail fringes

Digital assets are diverse in nature and can be compartmentalised into four separate categories. The most commonly traded type of digital asset is crypto-currencies (e.g., Bitcoin, Ethereum) — whose market capitalisation increased by $1.5 trillion in 2021 to reach $2.3 trillion[1]. Similarly, StableCoins — a crypto-currency whose value is collateralised by a real asset — grew to $180 billion last year[2] while the market capitalisation of NFTs (non-fungible tokens) — a non-interchangeable unit of value stored on a Blockchain — hit $22 billion last year. And finally, there are security tokens — a digital, fractionalised representation of an asset which is issued, traded and settled on a Blockchain. While trading in security tokens remains limited, experts are bullish the market will benefit from strong growth in the future.

Whereas previously, digital assets were overwhelmingly traded by retail investors, they are now becoming more popular among institutions. "We have seen a notable shift in our dialogue with institutions about digital assets," comments Teychenne. This is also evidenced in the 2021 Fidelity Digital Assets℠ Institutional Investor Digital Assets Study.

Manuel Nordeste, Director of International Business Development at Fidelity Digital Assets℠, says the asset manager's flagship study found 56% of European institutions own digital assets, as do 71% of allocators in Asia. In Europe, this represents an 11-percentage point increase since 2020. According to the Fidelity report: "Asian investors have had a more positive view of digital assets and were early adopters of more traditional digital payments. For example, in China, a projected 32.7% of point-of-sale payments are made via mobile — double the UK (15.3%) and US (15%)."

Institutions tread cautiously into digital assets

Attitudes towards digital assets have undergone a marked transformation in the institutional client segment. "When I first joined Coinbase in 2017, our institutional business was really only serving family offices, high-net-worth-individuals and market makers. Today, we have penetrated nearly every major institutional client segment including hedge funds, asset management companies and corporates. Right now, we are serving over 10,000 institutional clients," says Kayvon Pirestani, Head of APAC Institutional Sales & COO Coinbase Singapore.

1. Bloomberg (December 20, 2021) Crypto barrels towards 2022 after adding $1.5 trillion in value
2. Coin Telegraph (February 23, 2022) Total Stablecoin supply hits $180 billion — report

Looking to the future – De-Fi

"Looking ahead, there is growing interest about the potential of decentralised finance (DeFi), an umbrella term denoting protocols or applications built on distributed ledger technology (DLT) which automate financial services in code without the need for traditional intermediaries, for example, lending (Aave) and exchanges (Uniswap)," says Teychenne.

Could De-Fi disrupt not just capital markets but also consumer banking and insurance through its digital peer-to-peer capabilities? Today, there is approximately $243 billion in total value locked into the De-Fi markets, although experts believe this will dramatically increase over the next few years.[3]

Quaglini argues De-Fi – through the introduction of standardised smart contracts – could remove intermediary providers from a number of day-to-day activities. "Take a lending or borrowing transaction. All that has to happen in a De-Fi environment is that a couple of lines of code need to be deployed on a Blockchain, and then the transaction is executed and settled instantaneously and automatically," he explains.

"On the flip-side, digital assets are still a fraction of the size of the gold market and an even smaller fraction of the $90 trillion in global institutional assets under management, so there is still room for growth," he adds.

Nonetheless, some institutional investors are yet to embrace digital assets. "Despite the sheer enormity of the assets held in FX reserves by sovereigns, crypto-assets are not represented at all. In addition, we do not really see sovereign wealth funds (SWFs) investing in crypto either, although I am confident this will change," notes Pirestani. Other speakers broadly echo this sentiment. "SWFs are not directly invested into digital assets, but they are indirectly invested into companies which are building up digital asset infrastructure, or who are themselves invested into digital assets. SWFs are just one step away from being directly invested in digital assets," says Alessio Quaglini, Founder and CEO, Hex Trust.

An evolving digital asset market landscape

There are a number of reasons as to why some investors are choosing to wait on the side-lines with digital assets. For instance, the Fidelity study found volatility and a lack of fundamentals to be among investors' biggest reservations about digital assets.[4] However, Nordeste notes that investors are slowly becoming more comfortable with these instruments. "While volatility and valuation issues continue to be challenges, it is interesting to note that investors previously cited things like market manipulation and hacking as being their biggest concerns about digital assets – but this is no longer the case. The market infrastructure supporting digital assets has evolved given that investors are thinking mostly about market risk – versus someone walking away with their bitcoin,' he adds.

So what exactly has changed in terms of the market infrastructure supporting digital assets? Whereas unregulated crypto-exchanges are notoriously vulnerable to cyber-attacks – with several providers suffering downtime and sharp losses following hacks – the calibre of service providers now operating in the digital asset ecosystem has become more institutional. In addition to a number of fintechs, several global custodians – for example – are currently developing digital asset custody solutions.

"With institutional money coming into digital assets, the infrastructure is improving. But what should investors be looking for at their crypto-custodians? Any quality crypto-custodian must have an unblemished track record and demonstrate that it has kept assets secure at scale

3. Coin Telegraph (November 6, 2021) De-Fi can be 100x larger than today in five years
4. Fidelity Digital Assets[SM] 2021 Institutional Investor Digital Asset Study (September 2021)

for a meaningful period without a loss of funds. The custodian must show they have the financial resources to make good on their obligations to safekeep assets," says Pirestani.

"Security is also vital. Investors must evaluate the physical and cyber defences of the crypto-custodian and assess whether the firm has a security first culture. Crypto-custodians must also have robust compliance and audit protocols in place with third party oversight, for example SOC audits performed by one of the big four accountancy firms," continues Pirestani.

Efforts to better regulate the digital asset market are also providing institutions with reassurance. Teychenne points out that a number of global regulators are looking to introduce supervisory regimes for digital assets which facilitate investor protection but also stimulate innovation — citing the recent Executive Order from President Joe Biden as an example. In addition to promoting research into the potential applications for a US Central Bank Digital Currency (CBDC), the Executive Order lays the framework down for future regulation of digital assets and the development of global standards around them.[5]

Nordeste highlights that regulators in Europe and Asia are also evolving their own digital asset rules. In the case of the EU, the Markets in Crypto-Assets Regulation will harmonise digital asset requirements across the 27 member states — including registration and licensing obligations for crypto-asset issuers and servicers. "Up until now, the regulatory focus on digital assets has been on combating money laundering and terrorist financing. Now, we are seeing more emphasis on creating frameworks that are suitable for this new asset class, focusing on the quality of the service provided and investor protection," according to Quaglini.

Digital Assets – the next frontier

While digital assets will most likely co-exist with traditional financial instruments for some time yet, experts are confident the next 12 months will be hugely transformative. "I anticipate 2022 will be a watershed moment for crypto-assets, as sovereigns begin entering the market. I believe that development will be the ultimate validation of crypto as an asset class. On Bitcoin, given that global markets are at a key inflection point, we might finally see whether Bitcoin is truly a safe haven asset," says Pirestani.

Others largely agree, with Nordeste echoing, "In the next two years, most incumbents will likely be active in the crypto-market rather than sitting on the side-lines.". This gradual leaning towards digital assets has ultimately been made possible by the institutionalisation of crypto-asset service providers and the emergence of sensible regulation at a time when conventional returns are difficult to come by.

5. JD Supra (March 17, 2022) Biden Executive Order on crypto-currencies and other digital assets emphasises innovation and regulation

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