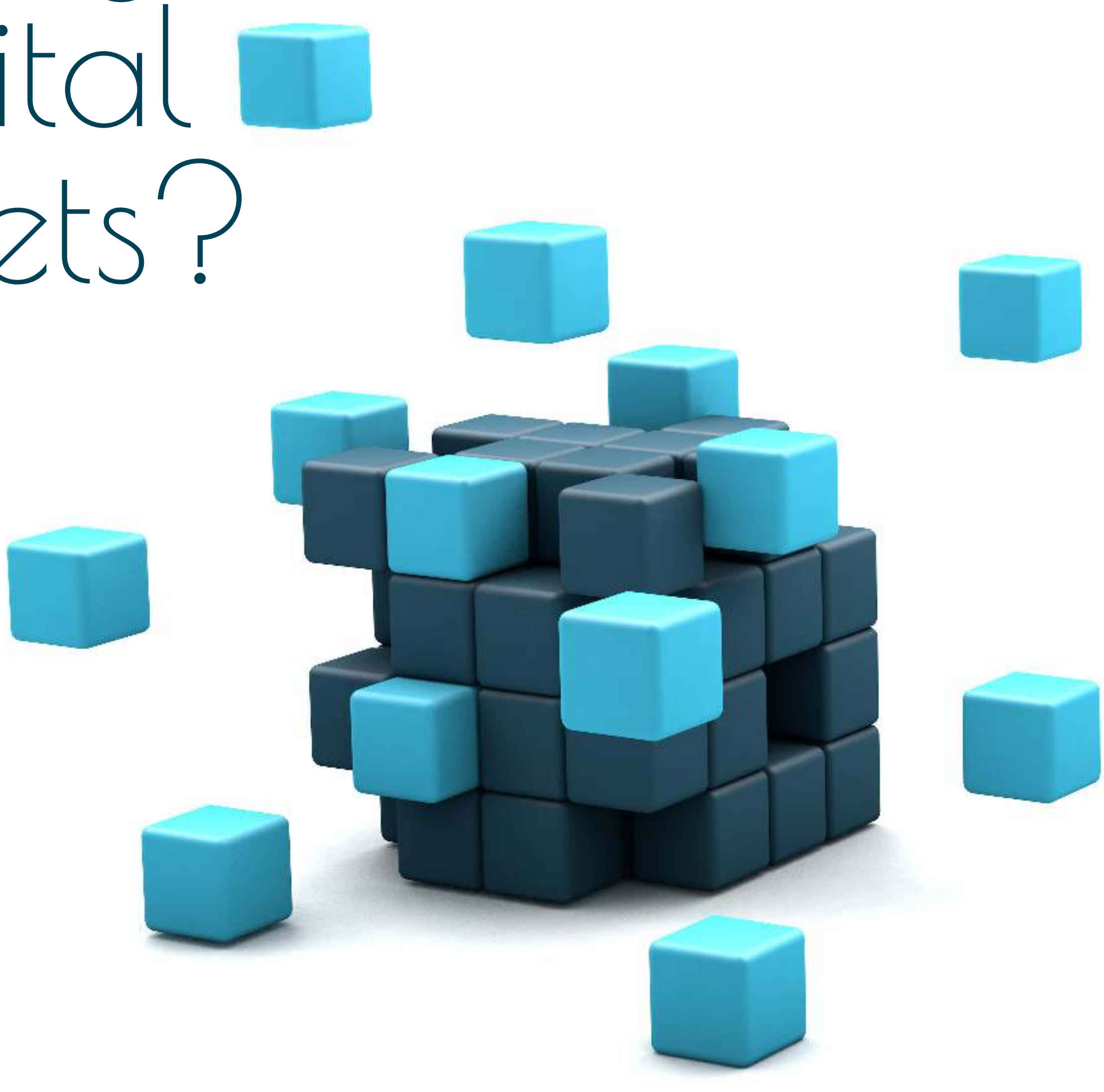
Is the securities services industry ready for digital assets?



Is the securities services industry ready for digital assets?

Interest in digital assets has been growing among both institutional investors and their service providers. How are organisations prioritising digital assets and what are some of the challenges that need to be overcome?

The term 'digital assets' has rapidly gained purchase in the financial services industry as a contrast to the traditional scope of established financial markets. Frequent use of the term is, however, rarely accompanied by a definition.

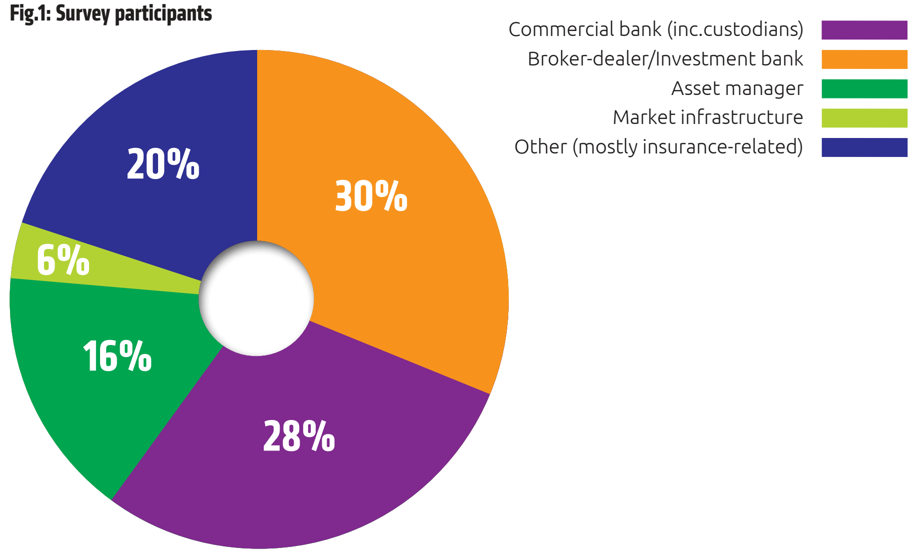
In this paper, we take digital assets to mean essentially a basket of different asset classes enabled by a common technology, cryptographically secured on distributed ledger technology (DLT). These assets can include cryptocurrencies, stable coins (cryptocurrencies pegged to fiat money or other assets), central bank digital currencies, security- and asset-backed tokens and NFTs (non-fungible tokens), representing anything from music to art and other collectibles. In addition, other relatively illiquid assets, such as private equity and real estate, have the potential to be digitalised and fractionalised.

While cryptocurrencies are currently the most recognisable of these assets, other native digital assets as well as tokenised versions of traditional investments are likely to gain in public profile.

To explore how institutional investors and their various service providers are engaging with digital assets, Citi and Global Custodian conducted a survey over the months of March and April 2021 among banks, broker-dealers and asset managers, inter alia, to assess levels of interest and commitment. The survey attracted more than 220 validated responses. Figure 1 indicates the breakdown of participants by industry segment.

In summary, the results show that the financial services industry recognises the potential of digital assets to become a key technology supporting the asset lifecycle and, in the years to come, capture a significant portion of the activity in the world of tradeable assets. Many individual firms, however, have yet to refine their own strategies for engagement.

Fig.1: Survey participants



Current reservations notwithstanding, there is an overwhelming expectation (91%) that digital assets will become dominant over time. Figure 2 shows the attitude of survey respondents to digital assets in the broader context of the financial markets in which they operate. Some 63% of participants indicated they were in the process of developing a strategy to invest in or support these assets, while 28% said they already have a clear strategy in this regard. Only 2% said they did not see digital assets playing a role in the future.

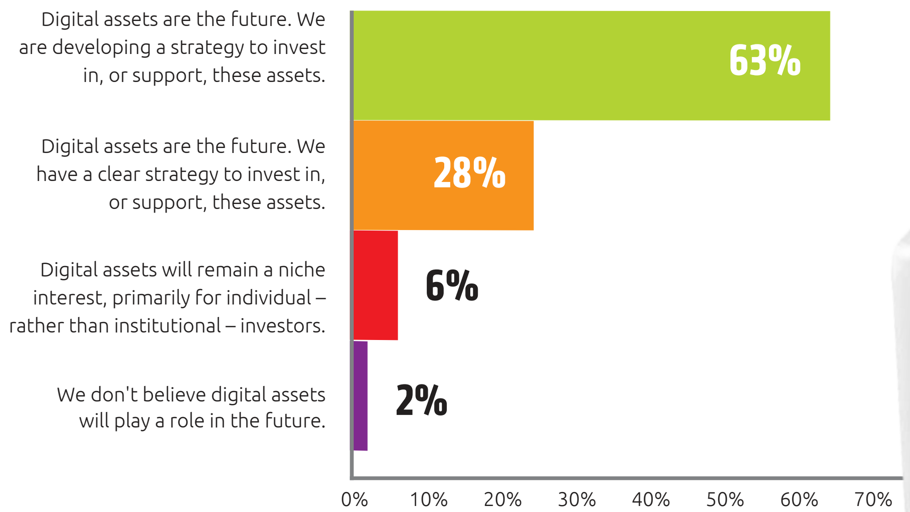
PACE OF ENGAGEMENT

Despite periodic bouts of extreme volatility, market capitalisation for cryptocurrencies alone has at times exceeded US$2 trillion in H1 2021. Yet, 48% of survey respondents expect investor interest in digital assets and related services to grow rapidly, while only 6% expect it to remain at current levels.

Not surprisingly there is a gap in perception between asset managers and brokers in this respect. Some 43% of asset managers in aggregate anticipate rapid growth in investor interest compared with 51% of broker dealers and investment banks. This perhaps reflects the additional regulatory constraints on the former, particularly in relation to their own institutional clients.

Drilling down into the practicalities of involvement in this market, survey participants were asked about the timeframes they were envisaging for engagement with digital assets. Those with no plans to engage are a tiny minority – below 3% overall which strongly suggests that firms are investing in digital assets in the near to mid-term. Firms claiming to be already actively participating average 47% across the survey as a whole and 49% among broker-dealers. A further 38% of respondents overall expect to be participating in live use cases within the next two years (see Figure 3). Asset managers however appear to be somewhat more cautious with 38% actively participating and 50% expecting to participate in live use cases within two years.

Fig 2: General attitude to digital assets



These proportions did not vary significantly by industry segment. Only one or two percentage points, for example, separated asset managers and broker dealers in their response patterns.

Though some service providers are closer than others to enunciating a clear strategy for digital assets, there appears to be broad recognition that decisions will need to be made soon.

WHAT ARE THE BARRIERS?

The need to adapt workflows to the constraints of the COVID-19 pandemic has eroded some of the residual resistance to digitalisation such as the removal of 'wet' signatures, and facilitation of e-voting and virtual Annual General Meetings in some markets. This could open the way for DLT to play a greater role in traditional markets, which would remove the barrier of unfamiliarity with the technology on which digital assets rely.

Still missing is a common set of global standards for DLT with multiple divergent protocols and initiatives. Previous progress in securities market reform has depended on common principles, such as the G30 Recommendations and common messaging standards (e.g., ISO, FIX and SWIFT), which allow for interoperability among otherwise variant systems. This suggests that industry associations have an important role to play in focusing collective effort.

At the level of individual firms, there are, however, other acknowledged constraints. 34% of asset managers in the survey cite regulatory concerns as the main barrier to engagement with digital assets compared to 30% of the overall response pool. For broker dealers, by contrast, the most significant barrier is seen as lack of secure market infrastructure (See Figs 4 and 5). While the latter is within the grasp of financial services stakeholders to address, the former is not.

Fig. 3: Expectations for direct involvement

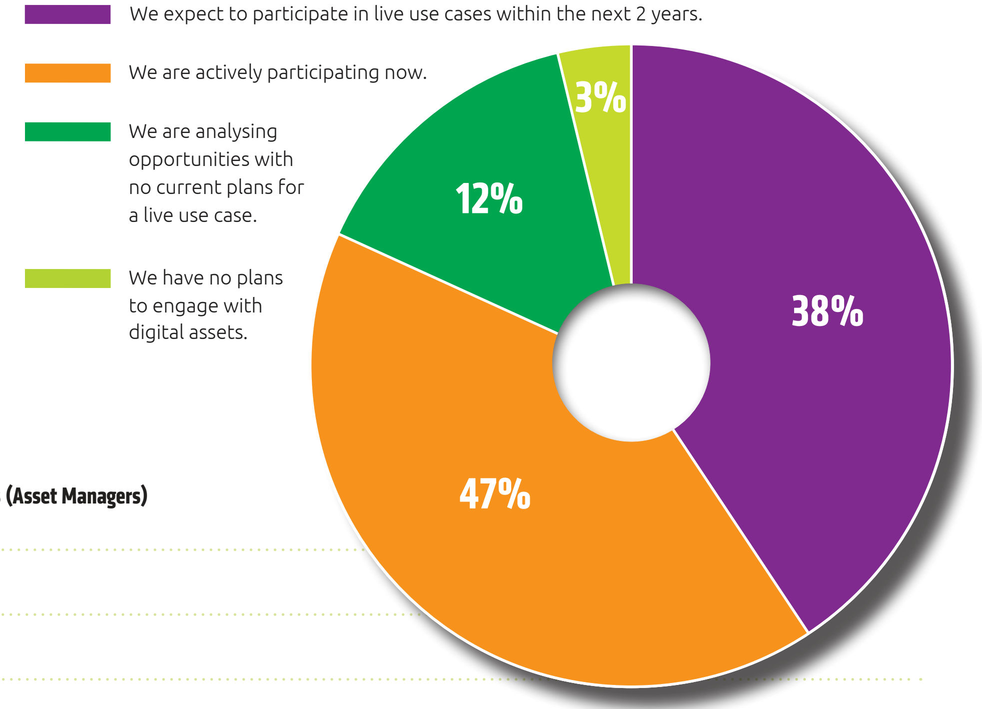


Fig. 4: Main barriers to engagement with digital assets (Asset Managers)

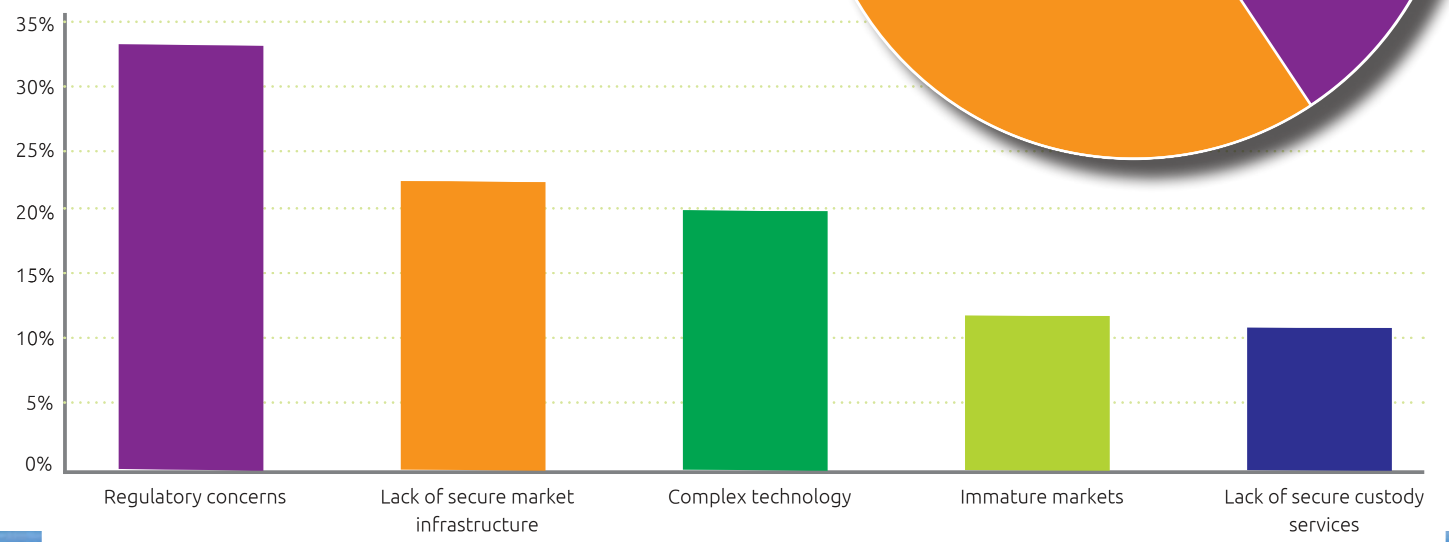
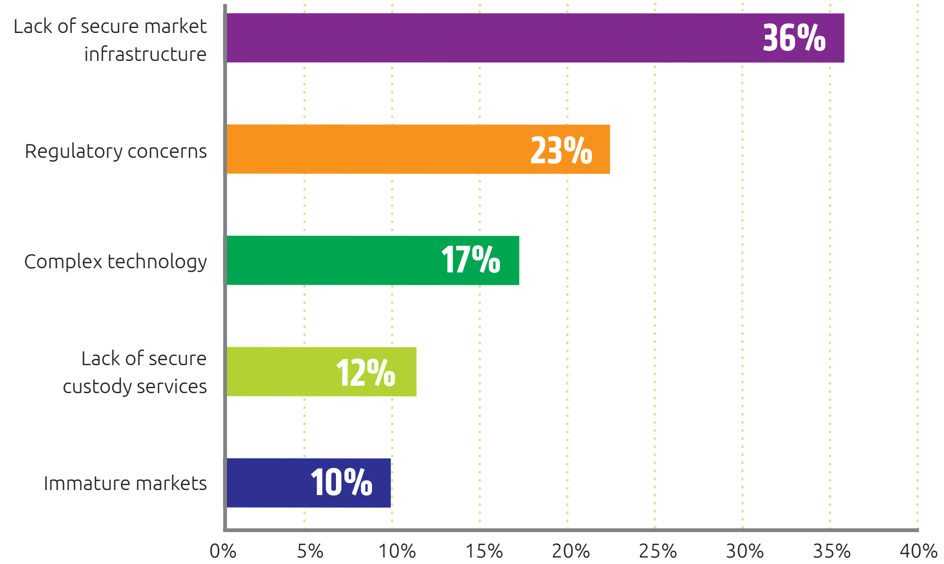


Fig. 5: Main barriers to engagement with digital assets (Broker Dealers and Investment Banks)



ADVANTAGES OF DIGITAL ASSETS

None of these perceived drawbacks are unique to digital assets and, with collective will, can be addressed as they have in the past, through an interplay of individual entrepreneurship and industry cooperation. Interestingly, when it comes to perceived advantages of digital assets, more respondents cited greater efficiency in investment and trading process (30%) than the potential for higher returns (25%), (see Figure 6).

By contrast, the perceived advantages of tokenisation for market liquidity appear not to be front of mind for most market participants, possibly owing to the relative lack of developed initiatives.

NOT ALL DIGITAL ASSETS ARE EQUAL

The survey questionnaire invited participants to indicate the likelihood of their firm's direct engagement with a range of digital asset options on behalf of their clients over the next three years. On a scale of zero to six, with the former being 'not at all' and the latter being

Fig. 6 Perceived advantages of digital assets

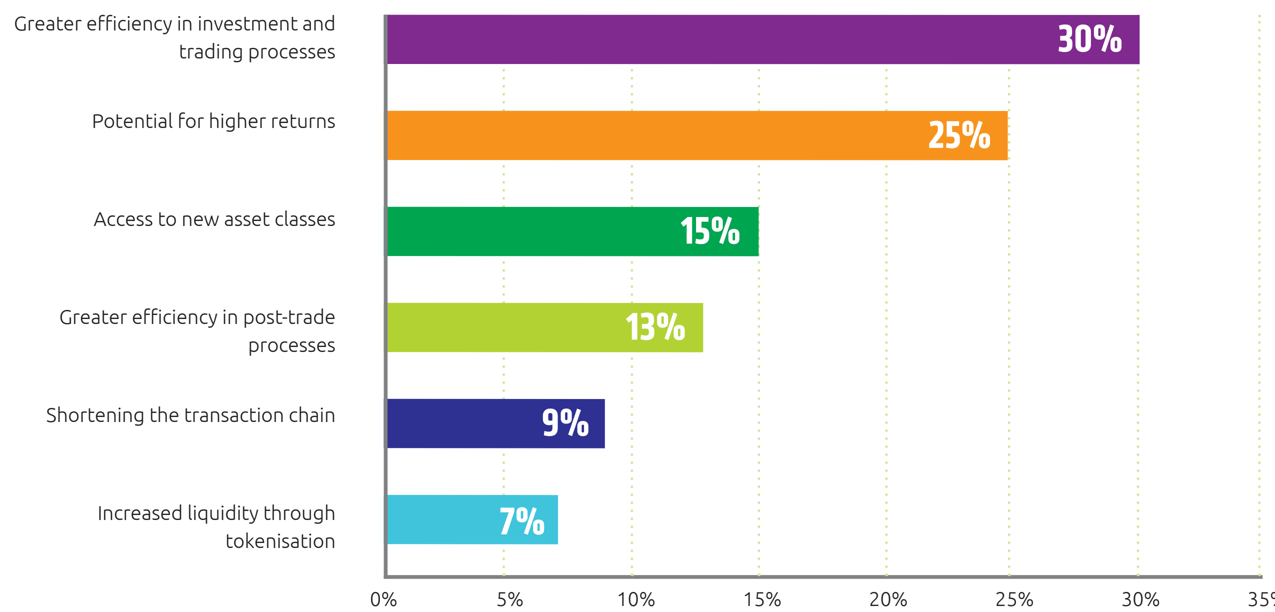
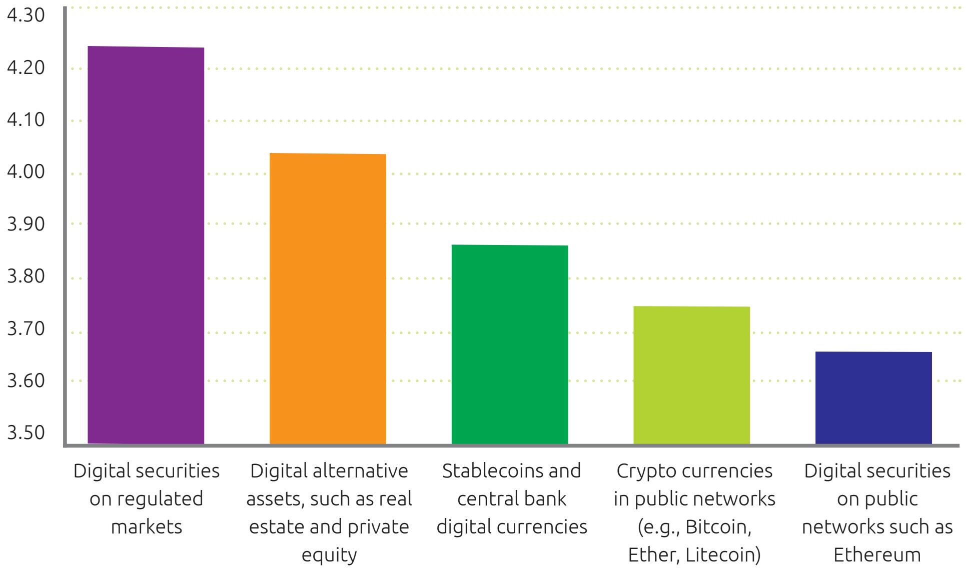


Figure 7: Average expectations of engagement by asset type



'definitely', digital securities on regulated markets and digital alternative assets such as real estate and private equity were, on average, regarded as most likely to attract direct investor interest, followed by crypto currencies (see Figure 7).

ASSET ADMINISTRATION

With the evolution of securities markets away from physical form over the past few decades, the range of assets a custodian may be safekeeping for a client is already broad. The addition of digital assets to a portfolio should not, in principle, be outside the remit of traditional service providers.

In a digital context, custody involves managing and storing the private keys that control the assets on behalf of the owner. That is not unlike holding physical certificates in bank vaults for clients – the original notion of custody. Nevertheless, the custody of digital assets remains a priority, particularly for institutional investors focused on asset safety.

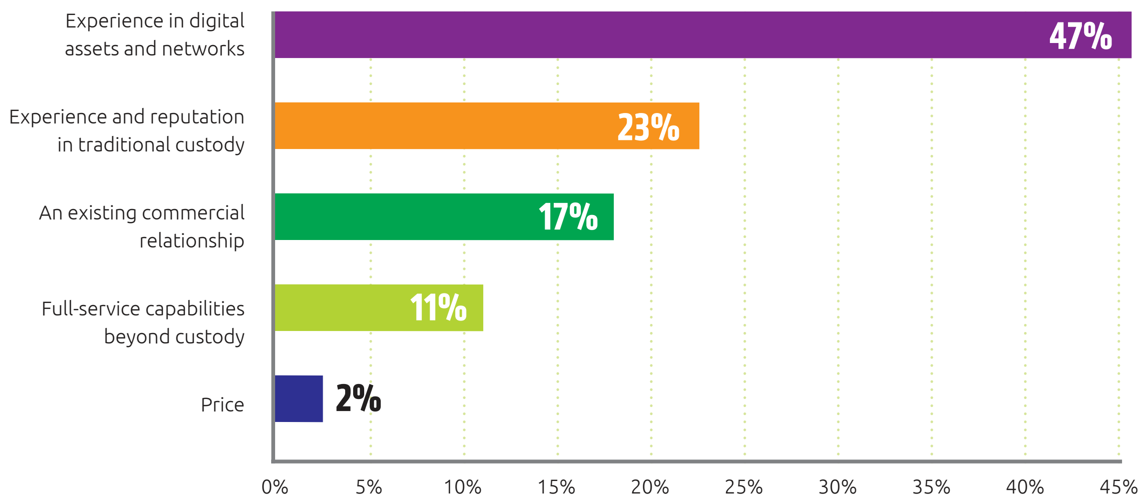
The need for that function to be conducted by a bank has been challenged by several FinTechs now offering "digital custody" services. The survey found that while expertise in traditional custody was seen by just under a quarter of respondents as the most important consideration in appointing an external custodian for digital assets (see Figure 8), 47% of survey participants cited experience in digital assets and networks as the key factor.

This figure was significantly higher among asset managers alone (57%), though 20% of the same segment pointed to an existing commercial relationship as their most important consideration. If traditional securities services providers can acquire the requisite capabilities, whether organically or through partnership, they should be in a position, not only to retain existing clients who move into digital markets, but to attract the custom of new funds and institutions with an exclusively digital focus.

CONCLUSION

When it comes to mainstream institutional engagement with digital assets, the survey results reinforce the encouraging trends we are seeing both in our own industry observations and as part of our conversations with market participants and investors. There is no doubt increasing momentum in digital asset investment and in the technologies being developed to support it. We are excited to see how these trends will evolve over the next few years.

Fig. 8: Most important factor in appointing 3rd party custodian



APPENDIX

Participant comment

In addition to quantifiable input, our survey afforded the opportunity for respondents to express a view in their own words on the market for digital assets would develop over the next decade. While anecdotal in nature, these comments do add colour to the observations above.

The table below provides a selection of opinion from survey participants, the bulk of whom predicted an inevitable growth in the proportion of investment activity accounted for by digital assets.

BROKER DEALERS/INVESTMENT BANKS

"I think it will be a very slow, very cautious growth with a lot of regulation in place"

"Digital assets will be full part of regular investment strategies"

"They will grow slowly over the next 10 years"

"Their use will become normalised and ubiquitous"

"This is where everything is heading. We're looking at the future of trading"

"My belief is that it will become more widely accepted and with that will come more regulation. With all that, there needs to be a way for these digital assets to be safeguarded from hacks or theft"

"Digital assets will be at least as important as traditional assets"

ASSET MANAGERS

"I believe they will become more and more accessible"

"Digital assets are the future"

"Will become regulated and used more widely on a day-to-day basis"

"I think digital assets will replace traditional assets in 20 years"