The meteoric rise of cryptocurrency

How banks compete in the digital world has changed forever. Paritosh Gambhir elaborates on the growing market acceptance of cryptoassets, the rapid advancement of cryptocurrency technology, and the burgeoning participation of financial institutions in the this market.

Is it time for banks to get ready for virtual assets? Recently, His Highness Sheikh Mohammed bin Rashid Al Maktoum, Vice President and Prime Minister of UAE and Ruler of Dubai, approved a first-of-its-kind law to regulate virtual assets in Dubai. An independent authority has also been established to oversee the regulation, licensing and governance of virtual assets, non-fungible tokens (NFTs), and cryptocurrency. The authority's main responsibilities include regulating the issuance and release of virtual assets and NFTs, licensing, and protecting personal data, among others. Banks must ask themselves whether they are well prepared for this innovative regulatory release.

Institutional cryptoasset adoption is driving innovation in core banking products and services across custody, brokerage, trade clearing, settlement, payments, lending, and more. At the same time, a new operational infrastructure for banking is emerging, which has set the foundation for resilience and growth in a fast-changing industry.

In fact, the global crypto market cap has reached USD 2.03 trillion[14] — almost 18% the market capitalization of gold.[15]As of 6 January 2022, the total crypto market volume over the last 24 hours was USD 137 billion. Forbes identified the "cryptofication of banks" as one of the top five FinTech trends of 2022, due to increased demand, supply, and indeed banks' fear of missing out. It commented: "For banks, crypto will be to 2022 what social media was to 2015."[16]

Crypto products and services have demonstrated tremendous growth potential in the banking sector. There are multiple areas of opportunity for traditional banks, FinTechs, and digital native banks to deliver solutions for storing, moving, and using cryptoassets easily and securely. Three banking segments – prime brokerage; yield generation via lending, borrowing and staking; and payments – stand out for their profit potential.

1. Prime brokerage services

Custody – the management of assets and the underlying cryptographic keys that cryptoasset owners use to execute transactions – allows banks to add additional operations and services to their portfolio, including cash management, securities lending, leveraged trade execution, and other white-glove support.

2. Yield generation: crypto lending, borrowing and staking

The demand cycle for crypto borrowing and lending has risen dramatically across the full spectrum of crypto-market participants. This demand cycle is reflected in the dramatic growth of user adoption of centralized lending platform organizations. In both centralized and decentralized crypto-borrowing and lending models, users can deposit their cryptoassets to generate yield. Yield generation has proven to be critical value-adding service layer for participants who have taken investment positions with long horizons.

3. Payments

Around the world, digital payments are exploding in the business-to-business and business-to-consumer arena. Across these models, there has been an acute focus on cross-border payments to realize efficiencies in cost and settlement provided by stablecoins. Mobile payment apps have exploded in popularity, especially since social distancing has restricted the use of physical cash to some extent.

Key challenges

- Compliance with regulatory obligations: A patchwork of regulations has emerged and continues to evolve. Maintaining compliance with laws and regulations related to an array of financial crimes is already a major challenge.
- Fork management and governance: Forks occur when a single crypto blockchain breaks into two separate chains. They have a significant impact on crypto businesses.
- KYC and cryptoasset provenance: Crypto owners are identified not by names or account numbers but by cryptographic addresses that can be created at any time, by anyone, anywhere – this presents a unique challenge to KYC programs.
- Securing cryptoassets: Given the potentially high value of cryptoassets and the natively digital nature, crypto businesses and their customers are prime targets for cyber criminals.
- Accounting and financial reporting: Cryptoassets challenge traditional financial reporting boundaries. The accounting for these assets is an emerging area, with limited industry guidance.

A battle for custody

Further adding complexity is the fact that the regulatory environments affecting crypto custody businesses vary greatly from one jurisdiction to the next. Differences in rules at the state, national and international level are creating substantial compliance challenges for global financial institutions that deliver custody solutions.

Custody – the management of the cryptographic private keys that cryptoasset owners use to execute transactions – is a critical building block for crypto institutionalization. It is fundamental to earning customer trust in cryptoassets and allowing the market to scale. As cryptoassets proliferate, custodians have a tremendous opportunity to profit – both by earning management fees for delivering straightforward custodian services, and also by offering adjacent services only possible in the emerging crypto ecosystem.

For custodians trying to manage this regulatory complexity, an informed and detailed view of the changing regulatory landscape is paramount. Given the steep variation in the clarity and nature of different regulatory environments, decisions based on existing law and policy should be carefully calculated, weighing the risks and benefits of each course of action.

Regulatory aspects

Global regulators continue to debate governance frameworks and how to implement rules and regulations, which will allow a transparent and cyber free crypto trading market. The world of crypto branches minute by minute, and evolution of non-fungible tokens (NFTs) and De-Fi platforms continue to increase the gap created by crypto enthusiasts.

Positioning itself as a destination of choice for virtual asset investors and in response to global demand from the industry, the Abu Dhabi Global Market (ADGM) is the one of the first jurisdictions in the world to introduce a comprehensive and bespoke regulatory framework through its Financial Services Regulatory Authority (FSRA) to regulate virtual asset activities. The virtual asset framework focuses on robust governance, oversight and transparency. The rules cover a range of areas including anti-money laundering and combating financial crime, consumer protection, and technology governance.

The UAE's Securities and Commodities Authority (SCA), the local financial market watchdog, has issued a regulation on creation, issuance and marketing of virtual assets in the UAE. With this, the SCA aims to broaden its scope to include traditional financial markets, instruments and the alternative finance sector while encouraging market innovation and investor security.

The Dubai Financial Services Authority (DFSA) is also considering implementing a framework to regulate virtual or crypto assets. It is yet to be seen whether the Central Bank will
follow suit.

Accounting and auditing considerations

As recommended by the International Accounting Standards Board, each crypto asset organization is required to assess the applicable accounting treatment, considering the type of crypto asset invested; for example, a typical crypto asset like Bitcoin versus a stable coin or a token backed by certain assets (or even an NFT). Currently, a lot of institutions would prefer to list the traditional top virtual assets. These virtual assets could be held for sale or for appreciation, thus the accounting treatment would differ in each circumstance.

Generally speaking, crypto assets held for sale should fall under the scope of IAS 2 – Inventories, as the asset is held in the ordinary course of business. However, an asset held for capital appreciation would fall under the scope of IAS 38 – Intangible Assets, as a virtual asset is considered an identifiable asset without physical substance which will provide future economic benefits. Caution is required to when looking at the accounting aspects; each transaction or crypto asset could involve different arrangements or business purposes, impacting the accounting implications.

Auditors need to take particular care when getting involved with crypto assets; assertions to consider include existence, ownership and valuation.

The cryptoasset framework

0 Plan

- Product-market fit
- Strategy and revenue models
- Leadership and governance

1 Onboard

- Customer onboarding, KYC, and investor qualification
- Asset provenance
- Account creation and funding
- Crypto key provisioning and exchange integration

2 Service and deliver

- Crypto prder management, booking and settlement
- Transaction monitoring and anti-monet laundering (AML)
- Fork management and governance
- customer servicing

3 Protect

- Crypto storage and physical security
- Blockchain activity and threat monitoring
- Crypto key management & operations
- Privacy
- Cyber threat defense
- Resiliency and disaster recovery

4 Comply and report

- Regulatory compliance, integration, and reporting
- Finance, accounting and tax

Looking ahead

As blockchains evolve, there will continue to be new opportunities for asset owners to participate in consensus processes, governance decisions, and other rights afforded to them. Crypto custodians that support customers in exercising their rights as asset owners and using their assets in custody to the greatest economic advantage will gain competitive edge. They may also face requirements stemming from asset managers' fiduciary responsibilities to pursue revenue-generating opportunities on behalf of asset owners. Successful crypto custodians will focus on two fronts: building core capabilities for secure, resilient and compliant custody capabilities, and keeping pace with rapid technical changes that may drive new revenue and growth opportunities.

Banks looking to adopt crypto assets in the UAE will require careful consideration of the regulatory frameworks. Crypto is here to stay. It will keep evolving, day by day: the pace of change has never been so rapid – and will never be so slow again.

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