FINANCIAL SERVICES DIGITAL STRATEGY GROUP

# Crypto fear: An opportunity for banks

## Why the current scenario can be an opportunity for traditional finance to gain market share within the crypto landscape

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## Introduction

2022 will be remembered more for failure and market turbulence in digital assets than for the progress this nascent asset class has seen since inception.

FTX's collapse was the latest and possibly biggest blow to the crypto industry, pushing the crypto space further downwards into a deep bear market since December 2021. The third biggest cryptocurrency exchange with over five million active users[1], filed for bankruptcy in November 2022 in what was one of the worst years for crypto price-wise and probably the worst in terms of reputation.

2022 had a common theme throughout the year, a punishing bear market, with market capitalization falling from $2.8 trillion, at its peak in November 2021, to $0.8 trillion as of January 2023 and back to $1.2 trillion in July 2023. Obviously, this was not restricted to crypto: concerns on rising inflation, war in Ukraine and the energy crisis had a major effect on risk assets, with the S&P500 and NASDAQ falling from $4,800 and $15,800 in January 2022 to $3,800 (-21%) and $10,400 (-34%) in January 2023.

Although price action may be cyclical (similar scenario as 2018), the significant impact on the industry, however, has been the degree of inadequate management performed by industry players to grab market share or expand profits. Across the board have emerged the provision of unsecured loans to trading services with no clear liquidity measures; the use of customer funds for excessively risky investments or yield provisioning[2]; and suboptimal alternative collateralization measures among balance books, all showing the questionable behaviors of many industry players and how risk management measures seem to have room for improvement across most of the space.

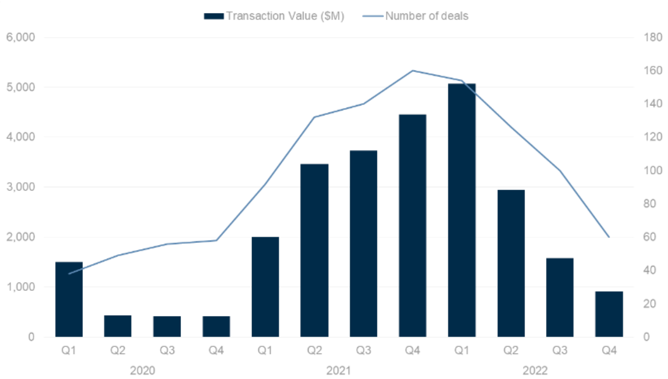

*Figure 1: Cryptocurrency, decentralized finance investments with PE/VC or institutional investor involvement[17]*

These actions had a major impact on industry sentiment, going from NFT being the "word of the year" for 2021 to the source of despair for most people in 2022. What once was the opportunity of a new financial system, with unheard of investment returns and exiting technology innovations, is now reduced to generalized criticism across the press and a general loss of interest by the public.

## What is the opportunity for traditional finance?

Be it from a conservative business view, fear of replacement or a simple lack of belief in cryptocurrencies, traditional finance was late to the digital asset space. Now, the reality is Coinbase, and crypto natives are the go-to solution for retail to enter the crypto space, where these firms have entirely seized market share, and with that, all the incoming revenues and profits from the now $1.2 trillion industry.

Tides, however, have changed, and the blockchain economy has provided another opportunity to jump on the crypto bandwagon for traditional finance. Insufficient risk management from crypto-native companies has notably damaged industry perception, and now companies are pressing for funding with a prevailing high bargaining power for those willing to invest in the space.

As depicted in Figure 1, crypto-related investments faded significantly over the course of 2022. The uncertainty and lack of trust, on top of the macro headwinds and monetary policy uncertainty, are dampening allocation to crypto VC funds, tightening results in declining valuations and stringent demands from investors, making for a challenging fundraising environment for entrepreneurs.

Banks, on the other hand, have shown significant strength during these tumultuous times. Contrary to 2008, liquidity amongst banks is properly sized and activity has remained constant with little impact on their business. Additionally, the rate hikes executed by the FED have posed an increase in profit margins from credit activity, with various banks such as Santander[3] or UniCredit[4] reporting record profits.

The argument for banks embracing and investing in crypto has not changed. Blockchain and its associated implementations (e.g., cryptocurrencies) have a large overlap with existing banking operations. Cryptocurrencies are essentially a new type of asset, which can be leveraged to improve certain activities. Embracing crypto as a financial asset can leverage synergies from existing infrastructure to provide basic custody and trading services, thus posing potential low investment requirements.

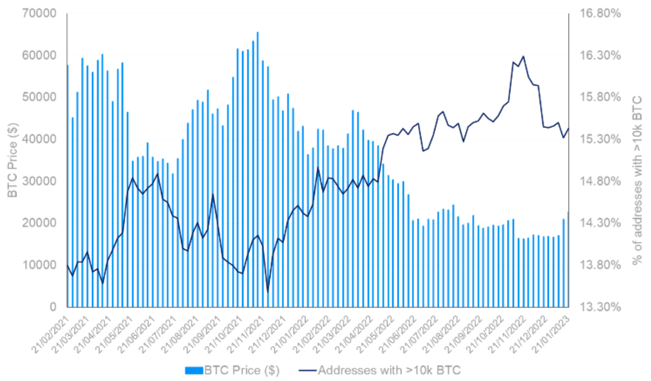


*Figure 2: Bitcoin Mega-Whale (Balance >10k BTC) address count vs Bitcoin Price[18]*

## Industry prospects

Whilst the price of BTC declined significantly, it did not collapse completely, indicating that investors retain faith in the fundamental concepts behind digital assets, crypto currencies and blockchains. Looking closely, as shown in Figure 2, crypto whales were actually buying and accumulating during this price downturn period. In fact, on top of Blackrock's Bitcoin spot ETF filing, major financial entities such as Goldman Sachs[5], BNY Mellon[6] and the Swiss Bankers Association[7] are leveraging this opportunity to acquire crypto businesses and embrace digital assets as a core business, driven by institutional "absolute interest" in digital assets.

The current downturn in valuations has not affected the rationale behind embracing crypto as an asset, and in fact provides an opportunity to invest at a discounted price because of the situation. As of now, investment by major financial entities in crypto poses a low risk/reward ratio, capturing lots of efficiencies in operations from synergies of existing infrastructure and procedures, whilst investing in platforms which can seize market share once the market follows a cyclical pattern and a new bull market potentially emerges with the next halving.

Quoting Nathan Rothschild, "Buy when there's blood on the streets, even if the blood is your own," the crypto ecosystem very much mimics the 2001 tech bubble burst, when a set of technology innovations led to an innovation bubble. Out of that crisis, however, the industry came out stronger and technology companies that changed the world we live in (Amazon, Apple, Google, Facebook, etc.) emerged and now contend to be the biggest companies in the world.

Banks have another opportunity to become major players in the crypto space and prepare for the next leg up in trading. Issues regarding poor risk and operational management are not so far-reaching in traditional finance, and as such, banks can attempt to capture market share based on three levers their crypto counterparts do not possess: an established and exploitable customer base, a robust regulatory environment against internal and external fraud and a perception of trustworthiness across the space.

## Existing Customer Base

By far, the greatest advantage traditional finance has over fintechs and crypto natives is its existing customer base and all the ecosystem in place to guarantee business continuity. Unlike fintechs or crypto natives, banks and other financial institutions do not start from scratch and can leverage their existing customer base to distribute and market crypto-related services.

Cryptocurrencies are another type of financial asset, and as such can be marketed like any other asset (equities, bonds, FX, commodities, etc.). Custody and exchanges services for other assets are already robust working services, which have been used and tested thoroughly, and currently operate as distinct business lines within firms, leveraging existing clients from traditional retail banking services (i.e., expenses and savings accounts).

Furthermore, financial institutions have expanded their operations, moving towards a more data-driven approach, extracting customer insights and developing profiling models to maximize potential revenue acquisition from cross-selling based on customer data. Thus, the opportunity to cross sell to existing clients is usual practice among financial institutions, leveraging robust and production ready models with minor adjustment needed to accommodate crypto specifications.

Although according to the Bank of International Settlements 81% of retail traders lost money with Bitcoin[8]; Coinbase, Binance, Gemini and Kraken reported 98.0, 28.6, 13.6 and 9.0 million registered users respectively in 2022. With 69% of retail investors unfazed by the 2022 Crypto Winter[9] and the percentage of Bitcoin held by retail soaring to a record 17% in 2022[10], how many of the 48 million Barclays customers or 30 million BNP Paribas customers would be interested in their bank providing crypto services?

Moreover, private banking is set to have a significant presence in the crypto space. Institutions and High Net Worth Individuals recognize cryptocurrencies as a hedge and diversification of their portfolios due to crypto's little resemblance with any other asset.

A Coinbase-sponsored survey[11] released in November 2022 found that 62% of institutional investors invested in crypto had increased their allocations over the past 12 months, whilst only 12% had decreased their crypto exposure. On top of this, investors outlined regulatory compliance, security, trust, thought leadership and data and analytics, in that order, as top factors to consider a crypto partner, areas where traditional finance has an edge, especially with private banking being such a relationship-intensive business.

## Robust Regulatory Environment

While regulators may feel relieved that major scandals did not occur under their supervision, these highlight that there still exists plenty of room for improvement by regulators across the globe toward crypto entities, many of whom would welcome explicit frameworks by authorities.

As the Coinbase CEO stated[12], distressed crypto companies were able to operate unfaithfully because they are based in countries with little regulatory oversight and ability to oversee financial services businesses. Out of the SEC and ECB's reach, crypto companies did not have to follow regulation guidelines and auditing procedures that traditional financial institutions follow, and which would have outlined most of the insufficient operational and financial risk management procedures these firms had in place.

Firms (including traditional institutions) operating under properly regulated jurisdictions are forced to comply with strict obligations (Bank Secrecy Act, Electronic Fund Transfer Act or Basel III) and thus were properly protected against the eventual downfall. The best example of this being FTX Japan, which expects local clients to recover funds thanks to assets being properly segregated as per Japanese regulation[13]. As a matter of fact, cryptoexchanges have recently been providing proof of reserves voluntarily to regain trust from customers and prove non-fraudulent operations.

Some firms, on the other hand, have simply been side effects of third-party mismanagement, executing poor risk management metrics and assuming too much credit risk, thus becoming another piece of the adverse domino effect. BlockFi filling for bankruptcy citing $275 million in obligations owed by former allied counterparts[14], or Genesis providing crypto loans to now bankrupt Three Arrows Capital and Alameda Research[15], remark the substandard credit risk management in place within the industry, and how lack of standardized regulation resulted in large exposure across companies, eventually bringing the industry down by virtue of the industry's interdependence.

After the 2008 crisis, this is unthinkable in traditional finance, as regulators have stepped in heavily within the financial system requiring stress testing and robust asset provisions to guarantee the health of the industry.

Basel III reforms, for example, presented a new capital charge for counterparty default risk of loss due to the deterioration in creditworthiness of counterparties to a derivatives transaction or an SFT. This potential mark-to-market loss known as CVA risk, captures changes in counterparty credit spreads and other market risk factors, which was a major source of unexpected losses for banks during the Great Financial Crisis.

Finally, if something has been common among all troubled companies, it has been pausing withdrawals upon unfavorable market conditions, showing how existing liquidity provisions and risk models are not fit for purpose against liquidity risk, given the volatility of the market.

In traditional finance however, the introduction of CET1 and CRR provisioning requirements has given the financial system a substantial safeguard against market fear and uncertainty. The EBA has a number of mandates on liquidity coverage ratio and net stable funding ratio stemming from the Capital Requirements Regulation, and all Eurozone banks are now expected to meet the minimum CET1 ratio requirements to their risk-weighted assets as outlined under Basel III, providing increased protection for retail customers with regards to their funds.

## Trust and Cybersecurity Expertise

Financial institutions are in a much different place when it comes to trust than they were after the 2008 financial crisis. Regulations align better with economic reality, the capital provisions are greater and central banks intervened quickly as soon as COVID-19 hit.

According to a survey executed by BIS[16], U.S. households are more likely to trust financial institutions than other institutions, including government agencies and fintechs, especially when it comes to safeguarding their personal data.

A lot of it stems from the resiliency the financial system has shown during the COVID-19 crisis, retaining more robust provisioning measures as well as improved risk management and forecasting models. For instance, on top of the federal Coronavirus Aid, Relief, and Economic Security Act, which made possible for homeowners with eligible home loans to apply for temporary mortgage forbearance, the financial system was key during COVID-19 lockdown, providing the tools and resources for companies and individuals to access the substantial liquidity provided by central banks, alleviating the sharp tightening of financial conditions associated with the pandemic.

On a separate note, traditional finance institutions have a more robust and tested technology infrastructure with regards to cybersecurity, the industry's number one concern. In 2022 for example, the leading crypto exchange, Binance, got hacked for $570 million and crypto market maker Wintermute lost $160 million after an attack.

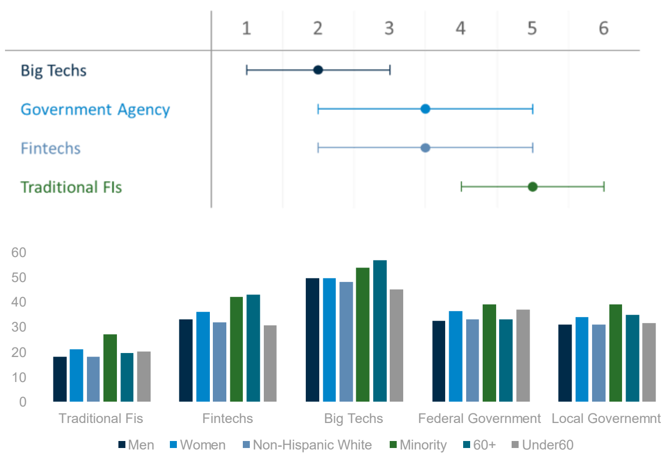


Figure 3: (TOP) Trust varies (1-10) by counterparty to safeguard respondent's data. (BOTTOM) Share (%) that became less willing to share data with counterparties due to Covid-

Unlike crypto natives, financial institutions have been on the eye of cybersecurity thefts for a long time, and as a result have developed resilient systems and performed full technology audits and stress tests regularly to protect their exposure.

In Europe for example, EBA's Cyber Incident Reporting system (2017) and Guidelines on information and communication technology and security risk management (2020), have helped stay aware of cyber incidents in banks that could potentially have a significant impact either individually or system wide, contributing to banks' understanding of potential cyberthreats and thereby to broader overall resilience.

## Final Remarks and Conclusions

During the 2022 crypto collapse, questionable behavior from crypto players damaged the industry's image among society. This, however, may be an opportunity for those willing to swim against mainstream tides, as the technology behind the industry has not changed and if anything has kept developing, with financial entities specifically seeing their business case unaffected operational-wise by recent events.

The dotcom boom and bust did not destroy the internet and web-based businesses. If anything, it led to greater rigor and better legal and regulatory structures, which have contributed to its ongoing and unparalleled success. If along with Bitcoin's next halving, another bull run comes, it's likely a similar scenario will play out in the world of crypto exchanges and digital assets. The technology and advances which they offer to business and the world in general are too good to squander.

The question to address is if traditional players will take the risk and embrace crypto as part of their innovation strategy, or will the space remain startup dominated, relying on government regulation to achieve market stability and robustness?

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