Digital Assets Industry Roundtable

Key takeaways

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Autumn 2023 Session

Foreword

At KPMG, we strive in our ambition to champion innovation, understanding from history that transformative changes do not unfold automatically, they require deliberate collaboration among a diverse group of stakeholders.

KPMG's quarterly Digital Assets Industry Roundtable series brings together industry leaders and experts to discuss the latest developments and challenges in the industry.

The purpose of the event series is to create a forum for leading institutions and digital assets market participants to engage in meaningful conversations that shape the industry, resolve challenges, and maximise opportunities – ultimately shaping the future of this dynamic and evolving sector.

Our latest Digital Assets Industry Roundtable involved stakeholders from across the market, including, buy-side, sell side, custodians, and financial market infrastructure (FMI).

The session covered a wide variety of topics including the global regulatory horizon for digital assets, digital assets use cases, the evolving role of market participants and key challenges and opportunities for the sector.

We hope these insights give industry leaders and stakeholders some valuable perspectives for approaching the future with confidence.

We would like to extend a special thanks to Zodia Markets, who co-facilitated the event with us.

Ian Taylor

Director, UK Head of Crypto and Digital Assets

KPMG

Executive summary

Our latest Digital Assets Industry Roundtable brought together leaders and experts from across the industry, from both leading digital assets and traditional finance firms, to explore the opportunities and challenges the digital assets industry faces.

KPMG intends to facilitate a forum for discussion and debate, and ultimately to allow market participants to engage directly with one another to find solutions and collaborate on opportunities.

KPMG's quarterly Digital Assets Industry Roundtables bring together industry leaders and experts to discuss the latest developments and challenges in the industry, with the aim of generating positive dialogue that can drive wider adoption.

Our most recent session – co-facilitated with Zodia Markets this autumn – examined the evolving regulatory environment in the UK, the maturity of - and opportunities in - the product and service landscape, and key challenges that the industry faces.

Further topics covered included: the global regulatory horizon for digital assets, specific digital assets use cases, the evolution of digital asset markets, the differing roles of market participants, and how to drive institutional adoption.

The output from the roundtable is summarised into 5 broad themes outlined in this paper.

The output from the roundtable is summarised into 5 broad themes outlined below:

- Digital assets terminology and market maturation
- Global digital assets regulatory landscape
- Digital assets opportunities: products and services
- Industry challenges
- Digital assets – the road ahead

Digital assets terminology and market maturation

The discussion started by highlighting the use of 'digital assets' as a collective term for activity in this area. The roundtable participants viewed this as a misnomer, as the term covers such a divergent range of products and services.

Digital assets may well be underpinned by similar technology, but a nuanced understanding and approach is needed – both from commercial and regulatory perspectives.

Some parallels can be drawn between today's digital assets industry and the dotcom boom of the late 1990s and early 2000s.

At that time, operating online was a point of differentiation – it is now ubiquitous. Despite scepticism, market fluctuations, and the critique that innovations were 'solutions looking for problems', the dotcom era fundamentally reshaped the world of business.

The move to digital assets can be expected to have a similar impact, especially within financial services. A digitally native, global financial system operating 24/7/365 with instantaneous settlement and programmable money would be truly transformational – and worth pursuing. Attendees agreed that digital assets will enable global financial services transformation – and broader financial innovation.

The majority of participants also agreed that digital assets will be the catalyst for a generational paradigm shift in our relationship with assets, money and ownership.

Participants envisaged the use of digital assets and financial services to create new investment classes for alternative assets, intellectual property, image, film and music rights; and increased financial engagement with brands through loyalty, event and fan tokens.

Global digital assets regulatory landscape

Though there has been much discourse and support for regulatory harmonisation across jurisdictions, participants were broadly in consensus that this will be difficult in a fragmented market – and in the current geopolitical climate.

Participants also suggested that some digital assets firms and traditional financial market participants may be less supportive of harmonisation as it would reduce revenue opportunities related to regulatory arbitrage.

However, regulatory clarity is increasing across a range of jurisdictions, including the UK. In this context, participants emphasised the need for regulators to strike the right balance between effective risk management, speed, and providing clarity.

Participants opined that the primary challenge for regulators was to anticipate and manage emerging digital assets risks. In particular, it was suggested that digital money, such as stablecoins, could present novel challenges in relation to their ability to enable 24/7/365 markets, with instant settlement and global reach.

For example, the risk of bank runs has increased as investors have the ability to move money more quickly in response to information spreading within markets. This would be even more challenging to contain with systems that run 24/7/365, without downtime beyond business hours to implement countermeasures.

The UK

Attendees agreed that the Finance Conduct Authority's (FCA) measured approach to the regulation of digital assets has proved prudent by recent digital assets business failures (e.g., FTX).

It was agreed that speed will be crucial to protect and grow the UK's digital assets market. In this respect, the participants felt that the FCA is moving in the right direction. However, some participants suggested that an even greater emphasis on proactive regulation would enable UK-based digital assets offerings to compete more strongly globally.

The FCA's principle of focusing on outcomes, rather than means, was well received by the participants. Similarly, the early adoption of the Financial Action Task Force's 'Travel Rule' - which is aimed at improving the transparency of digital assets transactions - was also commended.

Numerous 2023 UK regulatory developments - consultations, discussion papers, and other documents - have provided a clearer sense of regulatory direction, which has been well received.

Nevertheless, firms are seeking certainty before deploying significant capital. Participants also noted the potential for conflict with regulation in other areas, such as tax.

Participants observed that some other jurisdictions are taking a more pragmatic approach, even when their digital assets related regulation remains relatively unclear.

The EU

The EU's Markets in Crypto-Assets Regulation (MiCA), introduced in June 2023, was welcomed as a positive step for the industry. However, participants suggested that a broad, principles-based approach may have been a better starting point; and separately, that some Member States' registration processes would benefit from streamlining.

Participants debated about whether MiCA would accelerate the implementation of regulation in the UK or whether the FCA should take a measured approach to learn lessons from MiCA's implementation and the industry response to it.

The US

Participants felt that the US landscape was more challenging to carry out digital assets activity than the UK or EU. It was suggested that US regulators may be observing legislative and regulatory activity in other jurisdictions, while developing their own approach.

The Security and Exchange Commission's Staff Accounting Bulletin 121 was seen as a possible impediment to digital assets market activity in the US.

The participants observed that the impact of regulatory uncertainty could harm smaller firms in particular, hampering innovation and making it difficult to operate, while in effect protecting incumbents.

Innovative jurisdictions

Participants noted that some smaller, innovative regulators are taking the opportunity to differentiate their jurisdictions.

Participants highlighted the UAE as a notable example. Abu Dhabi's Global Market, and Dubai's International Financial Centre and Virtual Asset Regulatory Authority, were seen as having taken a proactive approach to regulating digital assets.

Bahrain was also noted as a promising jurisdiction for digital assets activities, while Malta, Mauritius, Seychelles and Gibraltar were noted as having a disproportionate focus on digital assets.

In addition, the Monetary Authority of Singapore and Hong Kong Monetary Authority were viewed as leading innovators, participating in digital assets projects, and coordinating efforts to develop global standards for digital assets.

Participants believed that ultimately, the best jurisdictions for digital assets will be those that proactively attract businesses and talent; help organisations to become regulated; and proactively invest to support the ecosystem.

Time will tell whether these early pacesetters can maintain their position of influence, now that traditional financial centres are adopting a more proactive approach.

Digital assets opportunities: products and services

The majority of participants noted their interest in the tokenisation of debt instruments, such as bonds. The broad consensus was that tokenising bonds can bring several benefits, by:

- Lowering barriers to entry for investors.
- Increasing the size of the market.
- Reducing costs through simplified issuance management processes.
- Enabling real-time book-building.
- Improving communication and investor management.
- Streamlining the monitoring and reporting of performance-related products, such as green bonds.

However, there was acknowledgement that the market for such products is nascent, and there isn't a dynamic secondary market yet.

Tokenisation of private assets

Participants echoed broader consensus on the benefits of tokenisation, going beyond the use case of debt and highlighting the benefits in relation to private assets, funds, and other asset classes.

Particular emphasis was placed on the benefits for private asset markets, due to the potential reduction in friction of accessing and exchanging private assets. It was also suggested that tokenisation could disrupt the traditional IPO market as a mechanism for smaller firms to access capital, cost efficiently, while providing greater access for investors.

Tokenisation of realworld assets

There were mixed views from the participants on the importance of tokenised realworld assets (RWAs). Some participants felt that tokenising RWAs (e.g., art, fine wine, classic cars) could help institutions access a more diverse asset mix. This would give the UK's listed companies and pension funds access to significant new asset classes.

But there was also scepticism about how this would work in practice – especially as disclosure rules would have to change for pension funds to invest in RWAs. Ultimately, participants were uncertain about the feasibility of this use case at scale.

Tokenised asset collateralisation

Participants discussed the collateralisation of tokenised assets as a key component of a functioning digital assets ecosystem.

There was a view, that without collateralisation, digital assets markets would be restricted by liquidity constraints, making it difficult to operate effectively. Parallel to this, it was noted that tokenisation would offer benefits to traditional collateralisation through automation and programmability which would enhance the movement of assets and reduce manual inputs.

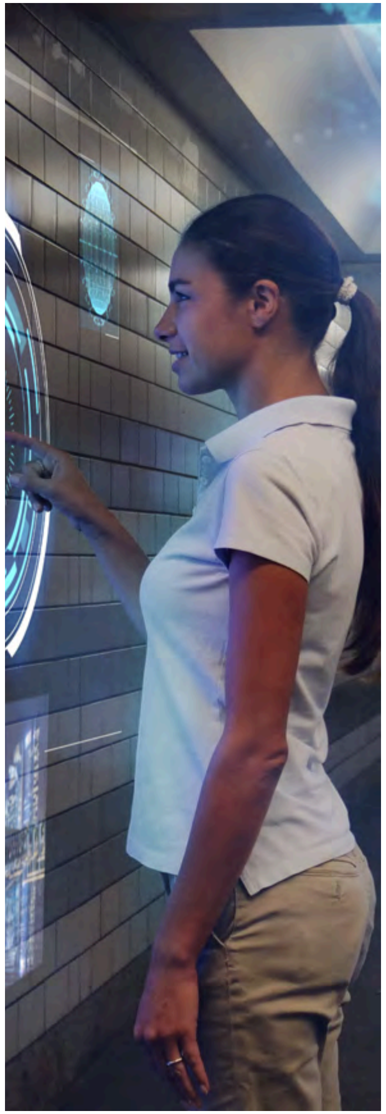
Stablecoins

Many of the perceived benefits of asset tokenisation rely on a cash leg which is able to move at the same velocity as the relevant tokenised asset.

Participants were therefore confident in the role that stablecoins will play in enabling digital assets markets to function.

There was also an understanding of the wider value that stablecoins could bring as an independent asset, driving new products and services.

It was noted that without a tokenised cash leg, tokenised asset exchange may suffer from the same lag currently experienced in legacy settlement systems.



Participants identified two compelling use cases for stablecoins:

1. **High-speed digital assets transactions**
The tokenisation of assets coupled with the tokenisation of cash (stablecoins) enabling both asset and payment instruments, to exist natively on the same platform. This could enable near instantaneous settlement, reducing risks and creating commercial benefits. For example, reducing counterparty risk and capital requirements while increasing liquidity.

2. **High-speed, low cost, cross-border payments**
In cross-border payments, the use of stablecoins could reduce transaction latency fees and capital requirements – and thereby improve liquidity. Participants further observed that stablecoin usage could limit a number of risks, including settlement risk and some operational risks.

Central bank digital currencies

Participants noted that the supremacy of traditional fiat currency is being challenged by digital assets, with the possibility of systemic stablecoins being contemplated by regulators. As such, central banks are exploring how their role and responsibilities may shift within the changing ecosystem.

Central Bank Digital Currencies CBDCs) were seen as a logical step in this exploration.

However, there was debate as to whether a CBDC was required if a systemic stablecoin, backed by a local fiat currency, was in existence.

There were also some concerns regarding privacy and control of CBDCs and broad agreement amongst the participants that the design and governance of CBDCs would require robust scrutiny and debate. Some participants viewed this as a possible catalyst for the use of 'privacy coins' to obscure transaction information.

Digital custody

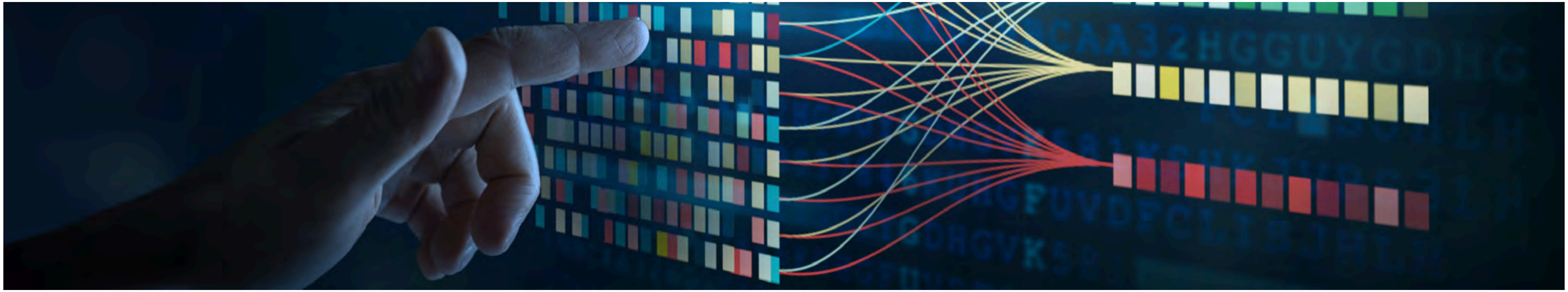
Digital assets custody was perceived as one of the most important components of the digital assets market.

However, participants observed that increased custody activity would likely only follow demand.

Prime brokerage

Participants were of the view that the prime brokerage value proposition for digital assets needs to be clearer. They also observed that prime brokerage for digital assets could be hampered by a lack of appropriate regulation; restrictions of the Basel Framework, including the amount of capital required to hold digital assets; reputational risks; and the credit intermediation model.

Participants generally felt that a pushback against prime brokers could be expected unless they deliver a clear value proposition for digital assets. There is already some limited evidence of pushback from digital assets exchanges.



Industry challenges

Despite the broad agreement from the participants on the revolutionary potential of digital assets technology, there was also consensus on the numerous challenges still to be faced.

Some of the key challenges and barriers raised are outlined below:

Interoperability

There was a strong sense among the participants that the development of interoperability is essential for the ecosystem to achieve scale. Interoperability is crucial to facilitating institutional adoption by offering an alternative to current traditional financial services siloes.

Participants predicted that a network of permissioned private chains – and possibly some public chains – will emerge. However, it was acknowledged that to allow such a complex network to interoperate, widely accepted token standards would need to be created.

Infrastructure and technical challenges

In 2022, the Basel Committee on Banking Supervision published rules on the Prudential Treatment of Cryptoasset Exposures seeking to address a perceived increase in resilience risk of blockchain and other distributed ledger technology related infrastructure.

However, participants did not fully agree that this kind of infrastructure necessarily carried more risk than legacy systems. It was highlighted, for example, that in the UK, the Clearing House Automated Payment System and Real Time Gross Settlement (RTGS) systems have both experienced failures, with the latest incident occurring earlier in 2023, when the RTGS system was offline for around 6 hours.

The participants did agree, however, that regulators should look at systemic resilience and infrastructure risks. Some believed that more focus should be afforded to this type of risk, rather than at asset-level, which financial institutions are experienced in managing.

Additional challenges highlighted included the common use of offchain settlement and associated risks (e.g., counter-party risk), storage challenges, private key management, and adequate insurance policies and coverage limits.

Liability

Participants suggested that the integration of digital assets use cases into traditional financial markets would require a shift in the accepted delineation of liability between institutions, service providers and FMIs.

This was seen as particularly pertinent for digital assets given the higher level of integration between market participants (e.g., through node hosting, smart contract development).

Skills and expertise

Most participants agreed that there was currently a lack of depth in expertise within digital assets functions, posing a risk across a number of areas, including fund administration, audit, compliance, and secondline risk functions.

Macro factors

The participants underlined a number of macro issues currently restricting digital assets markets:

- **Lack of regulatory clarity**
  Firms are largely waiting until regulation is in place before investing significantly in this area.
- **Limited liquidity** Secondary market activity for institutional-grade tokenised assets does not currently support business-case development.
- **Confidence in use cases**
  The lack of clear use cases is limiting successful business-case development.
- **Macro-economic environment**
  High interest rates are limiting investment in digital assets markets.
- **Reputation**
  The wider digital assets market has been unfairly tarnished by recent, high-profile, 'crypto' failures such as FTX.

Digital assets – the road ahead

Participants were of the view that institutional adoption must be a key focus for market participants and regulators alike. While traditional market participants, not yet actively engaged with the aforementioned innovations, should strongly consider the opportunities afforded by them.

It was noted that institutional adoption would be predicated on a number of factors:

1. A range of clear practical use cases, products and services, with proven benefits.
2. Diverse market participation from a spectrum of investor types, with various risk appetites and investment time horizons.
3. Regulation, standards, guidelines and frameworks to enable broader market participation.
4. Measures to drive active, liquid, secondary markets.
5. Robust financial market infrastructure.

Acknowledgement

We would like to thank all of the participants for attending KPMG's Digital Assets Industry Roundtable and for sharing their perspectives, knowledge, and insights on some of the key themes surrounding digital assets. We would like to extend a special thanks, once more, to Zodia Markets who co-facilitated the event with us.

We expect to focus on the critical themes and topics which emerged from this discussion during future sessions of our roundtable series, allowing for key issues in the industry to be deliberated on and debated further.

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