International Securities Services Association

Working Group Distributed Ledger Technology

Voice of the Customer Survey 2021

Background


Photo by Stanislaw Zarychta, Unsplash

The DLT Voice of the Customer Working Group (WG) recently conducted a survey of Asset Owners and Investment Managers to highlight where they are on their journey towards DLT based investments (tokenised assets, Crypto currencies). The intent was to validate what they want and need from the Securities Services industry.

This work was initiated as a result of the 2020 Survey "DLT in the Real World" where it appeared that the investors were focused more on Crypto currencies rather than tokenised securities, which was the opposite of the capabilities that ISSA members were building.

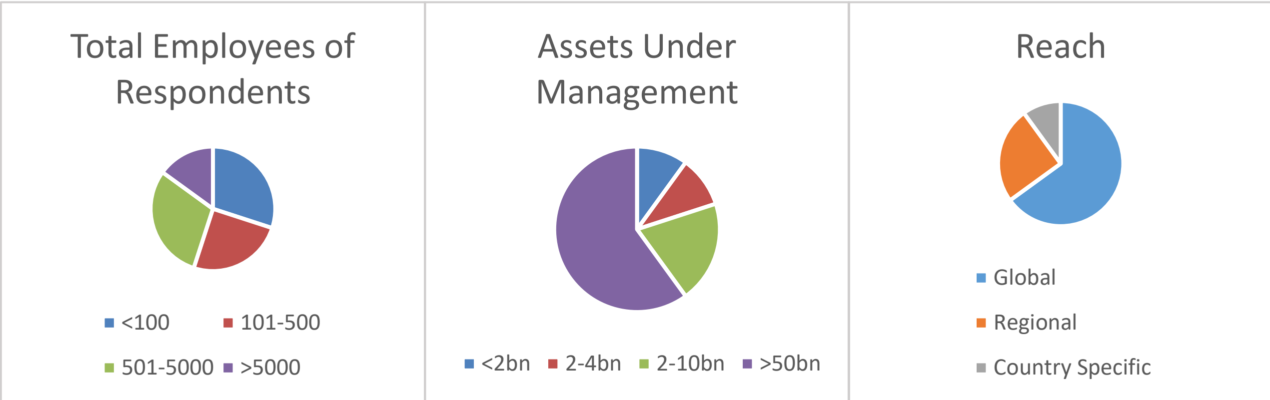
This new survey was broken into a quantitative part and a qualitive part to gain not only data, but also an understanding of the unquantifiable elements of the digital asset story.

The number of responses that were received was less than the normal base line of responses where ISSA believes it has enough data to issue a report. This led the WG to provide this article as the WG thinks that the data is in line with the WG's expectations and useful to the Membership despite that caveat.

August 2021

1. Introduction

The first questions established a baseline of the firms who had responded. Here there was a good spread of respondents, based on size – including both Assets under Management (AuM) and employees - and geographical spread:



The WG also saw that while the innovation or strategy teams were leading the assessments and driving the digital asset adoption they were doing so in partnership with the front office and operations teams. In the majority of cases, Compliance, Legal and Regulatory affairs were playing an active but supporting role.

2. Timelines and Proportions of AuM

The second set of questions focused on whether the firms were already actively engaged with digital assets, planning to be (and over what time-period) or had no plan to be active in these asset classes.

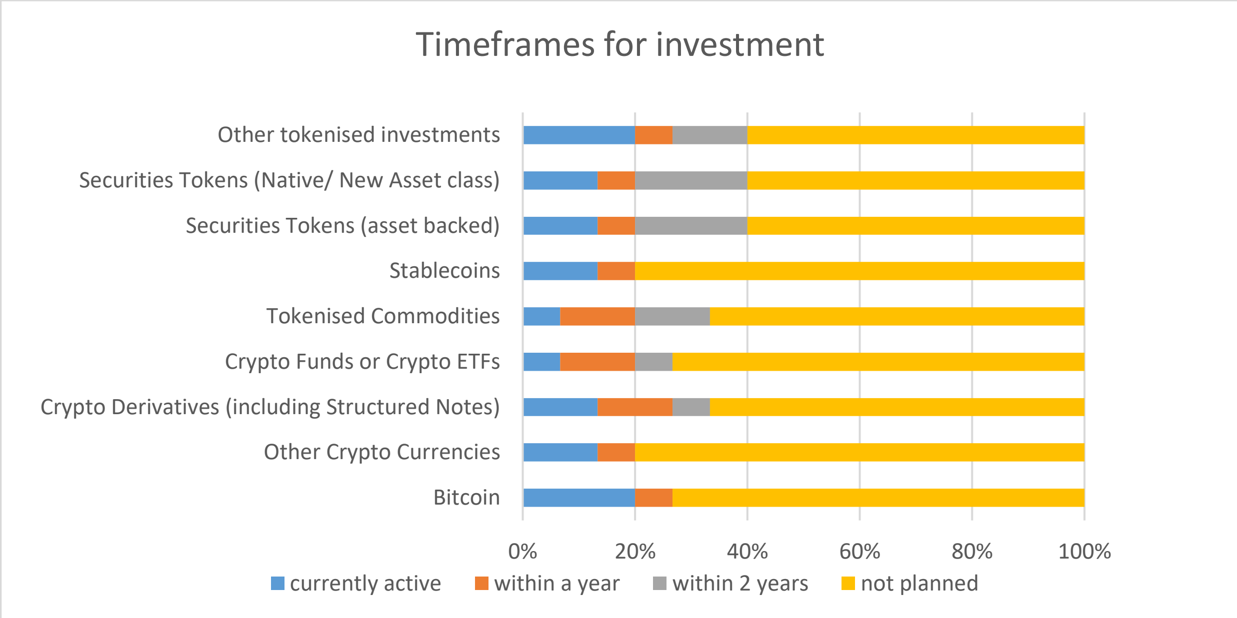
27% of respondents stated that they were already active in digital assets and another 13% thought that they would be trading them within the next 6 months, i.e. 40% of the respondents are engaged or soon to be engaged. Of the remaining 60%, roughly 50% (30% of the whole sample) had no plans to invest in digital assets and the remaining firms have a strategy to invest but no plans to do so within the next two years. There was no specific attribute of a firm which correlated to whether they would be actively engaged or not. There was positive engagement from firms of all sizes, AuM brackets and different geographical reach.

To drill into what DLT based products the firms were investing in, or intending to invest in, the survey asked about specific assets. The responses showed that the spread of assets that firms were invested in is wide. Bitcoin, as the WG expected, continues to be the asset preferred by the respondents with the highest 20% of them currently actively invested in Bitcoin. 13% also have exposure to other currencies like Ethereum etc. and same for Crypto derivatives. There was a slight tendency towards "Other tokenised investments" where the respondents stated that these "Other tokenised investments" were in fact tokenised funds.

The WG was surprised that Crypto Funds or Crypto ETFs were not more represented in the portfolios, as earlier studies had suggested that they were being more widely utilised as a methodology to gain exposure to the asset class as they also in some cases are regulated, such as CFTC regulated Bitcoin futures.

The responses of "not planned" for other Crypto currencies and stablecoins may well have the basis in a number of the headlines on the volatility and liquidity of those markets and the questioning around the underpinning of some of the stablecoins.

Here is the breakdown of timeframes to investment per asset type:



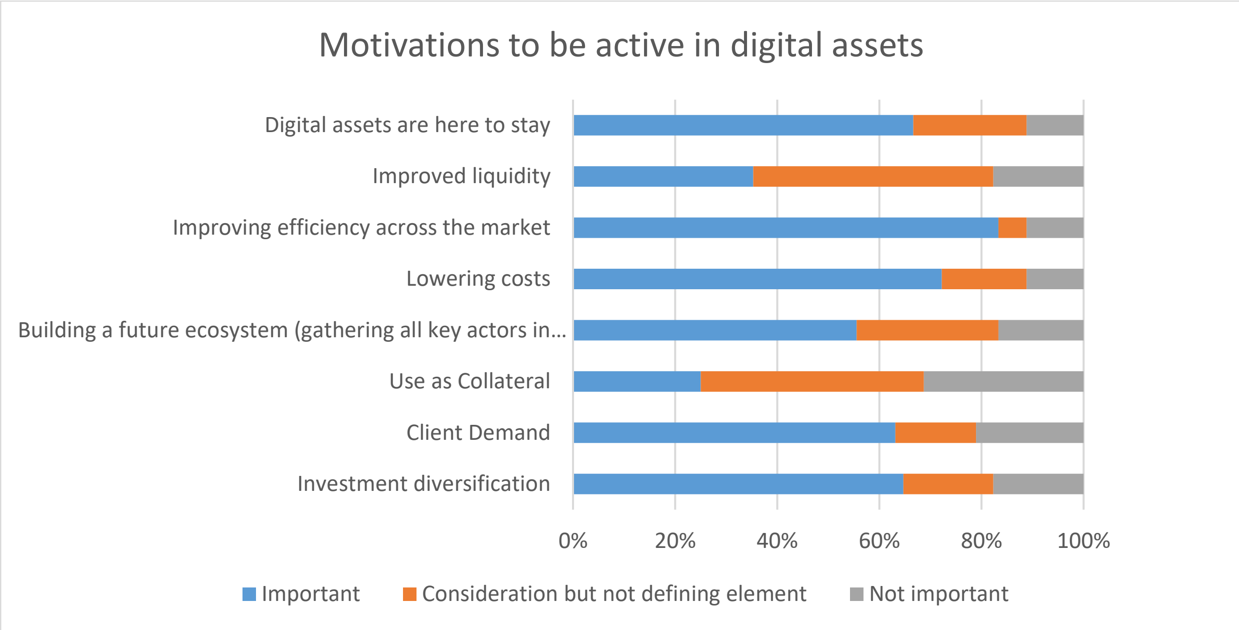
In response to the question on what percentage of the portfolio would be allocated to digital assets, a larger number of respondents than normal did not respond. Of those that did, just over a quarter stated that they will not allocate any of the portfolio into digital assets, which is aligned to the number of respondents who have no plans to invest. 40% of the respondents will invest less than 1% of the portfolio, 20% were bolder in an allocation of between 1-5% and 13% of the respondents felt that they would allocate >5% of their portfolio.

These higher allocation level responses were split between smaller firms (presumably with a Crypto focus) and global firms where it is presumed that the respondent has a portion of the firm's AuM but a mandate that includes alternatives. Low percentages of allocation envisioned by the majority points to a fairly conservative strategy that could give exposure to this asset class without damaging benchmarked financial returns in case that price volatility acted against them. The portfolio percentage allocation also correlates well with some of the other surveys such as hedge funds who invest in digital assets, the average percentage of their total hedge fund AuM invested is 1-2%, or many other institutional and HNI investors planning similar allocations over next few years

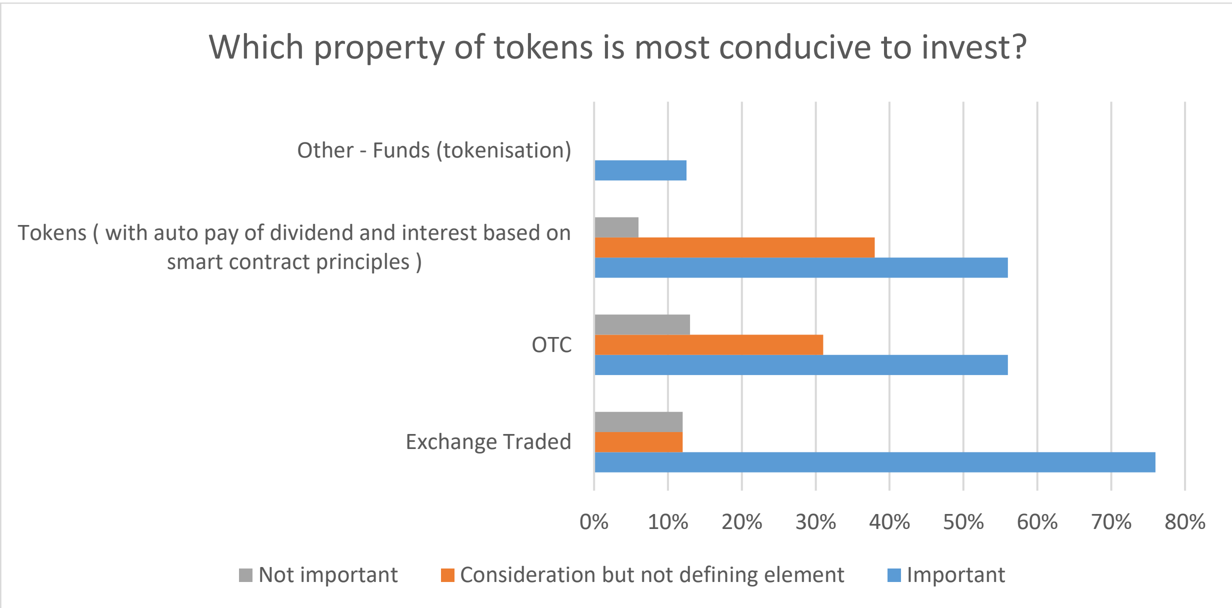
3. Motivations and Properties

The next question focused on motivations and this was the most surprising set of responses for the WG. The WG was expecting that diversification and client demand to be the highest drivers of why firms were investing in digital assets. Without doubt these were important considerations for the investment allocation, however, efficiency and lowering costs were both considered more important. The desire to use DLT solutions to drive to a better and more efficient market place showed that the margin pressure on the investment managers and assets owners is still significant and solutions to improve these by reducing costs are at the forefront of their mind.

This, in the WG's view, reflects on how asset tokenisation may deliver efficiency gains through the transfer of value with the need of fewer trusted centralized intermediaries and through the efficient automation of processes. It is the intent that this will result in faster, potentially cheaper and frictionless transactions driven by disintermediation and automation. The use of smart contracts and resulting automation may reduce the cost of issuing and administering securities, further reducing the cost of transactions and safekeeping, while increasing the speed of execution and streamlining transactions. Tokenised assets may also carry lower illiquidity premia allowing for the asset to trade closer to its fair value.



In respect of the properties of tokens, the largest response was that the tokens would be exchange traded, presumably as that allows both price discovery and implies liquidity of the asset.



4. Challenges

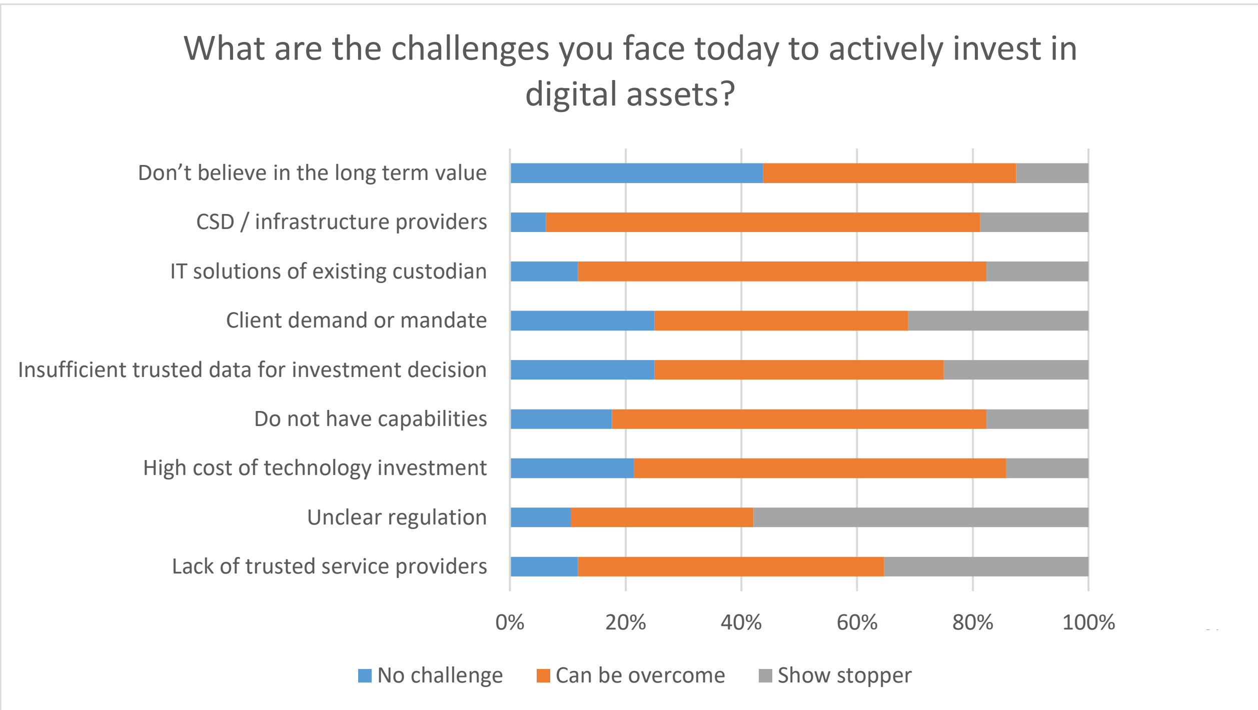
The challenges to actively invest in digital assets showed no surprises with roughly 60% of the respondents stating that "unclear regulation" is a show-stopper in respect of investing today. This has been a subject of many panels, papers and podcasts over the last three years and the regulators are engaged and thinking how the "same function, same regulation" principles apply in the digital asset environments.

The lack of trusted service providers was voted as the next highest barrier, with just over a third of the respondents saying it was a show-stopper. This shows that there is an opportunity for the Securities Services industry to address. In the present market for non-digital (although dematerialised) securities the number of trusted players is considered more than adequate and robust competition occurs. The perceived lack of trusted providers opens an opportunity for incumbents to show their capabilities and for new entrants to comply with the best practices around asset safety to prove their credentials.

The next two highest perceived show-stoppers were seen to be "Client demand or mandate" and "Insufficient trusted data for investment decision" and both were considered to be resolvable over time. These are quite understandable from an asset owner's perspective given the historic price volatility and how it impacts the investment decision and result, but there were many other concerns such as asset safety and regulatory concerns surrounding these assets.

Data problems are probably given the lack of clarity around pricing data, even deriving Volume Weighted Average Price (VWAP), establishing an End of Day (EOD) price given the 24*7 nature of the markets and also the challenges around fundamentals and fair valuation. But 50% of the respondents believed that this could be overcome and this points to a further opportunity for the industry players to build robust data and valuation services around these asset classes.

For the digital asset bulls, the view that there is long term value in digital assets came out strongly with almost 90% of the respondents feeling that there was no challenge or that the challenge could be overcome in respect to whether digital assets will be successful over the duration.



5. Services Required

The respondents uniformly wanted help in all aspects of their journey into digital assets. The services that are required include:

a. Technical services (keys management/custody, security, …)
b. Business services (consulting, brokerage, custody, ...)
c. Infrastructure/governance services (notary, DLT network governance, node management,…)

Given the novelty of the markets for digital assets and the regulatory frameworks in which the investment community functions, it was not unexpected that those that could provide trusted guidance and solutions in these areas would have their services in high demand. There were mentions around covering many services including fund accounting, asset servicing, reporting, middle office and the entire gamut of things that fall within the above business services. In this regard the survey was a positive story for service providers, both established and new players, pointing to the ample opportunity.

Also where asked if they were looking for existing custodians or other entrants to provide the above services, the majority (55%) responded that they were expecting their custodians to handle the key management and safe custody of keys, secure signing of transactions and associated functions.

Respondents were also looking for the service providers to play a bigger part in the network governance as 55% respondents wanted existing or new players to act on them. The WG's view is that it is expected that service providers as the governor and operator need to govern the behaviour of all participants in a distributed network, such as a tokenisation platform, and monitor adherence to the rules by members of the network.

Business services (consulting, brokerage, custody) was a little less at 45% - which the WG thinks points to the fact that there are already more providers who have started addressing the needs to consulting and trading services or other infrastructure developments.

6. Selection Criteria

At this point, the survey moved from numbers to comments, asking open ended questions and allowing a discourse on the subjects. Unsurprisingly there were a number of different criteria used to select the priority of the digital asset classes to select:

a. The most obvious and frequent response was that the decision was client led in the investment manager community, within the risk confines that the IM works under.
b. The second most commonly cited criteria was that the asset had to have an acceptable regulatory treatment within the jurisdiction. Again this is thoroughly understandable and rational as all the firms responding operated within a regulatory framework.
c. Two more of the comments were interlinked in that firms were making a decision based on the risk return profile, but also the understanding of the downside protection. To the WG this appeared to be the case that the respondents were willing to accept volatility in an asset as long as they could execute stop loss protection in all circumstances.
d. The final element mainly for the asset owners was whether the digital asset could be matched against their liability profile.

In line with the responses to the "timelines to invest" in Crypto currencies responses, when asked "What risk / return expectations do you have for Crypto currencies? And how are you managing the risks of liquidity, hedging etc.?" the majority of the respondents for this question were not ready to invest in the asset class as they viewed the asset as "high risk and high reward" and that the transparency and governance were lacking around the asset class. On a more positive note, it was felt that one of the drivers to invest in Crypto currencies was the diversification and less correlation to traditional markets, the potential of a new gold.

Asked the same question in respect of Security Token Offerings the responses diverged from the view that they will be highly volatile to the view that they would be low risk. All respondents thought that they would prove to be highly liquid and efficient. Again this suggests that the market professionals expect Tokenised assets to be a feature of markets going forward.

In respect to "How does investing into digital assets interact with your existing investment strategy?" there was an understanding that - where people were engaged - the addition of digital assets needed to be an integral part of the investment strategy. There was also the hope that digital platforms could make clearing, settlement and reconciliation a concurrent set of activities and hence less expensive.

7. Service Providers

This was an area instilling hope for all securities services providers, incumbents and new entrants. The most common response was that a mix between the traditional players and the new entrants would be the model adopted. This alludes to the fact that a partnership model was considered to be the key, with both of the sets of providers bringing their strengths to provide the optimal client service experience.

However as always there were outliers. One manager stating that they would be "relying entirely on traditional players and did not have the capacity to due-diligence new entrants" and a counter view that "Newcomers with new business models and systems that can be easily interfaced with current systems" would prevail.

8. Atomic Settlement and Liquidity

The WG asked two questions around this topic "Are you expecting atomic/instantaneous execution and settlement and by implication 'all or nothing' execution?" and "If so, do you have opinions and an approach for the resulting need for a cash pre-funding model?". Without doubt this was the hardest set of questions for the respondents. In summary one of the answers encapsulates the situation "Very good question... still needs to be figured out".

The industry, including ISSA Members, should take the lead in explaining the implications of both "on DLT" execution and settlement -in particular- atomic settlement to the users, and educating the investment managers and asset owners on the impact for how they conduct business today. That is not to say that all the effects are negative but there are some elements that appear to be a surprise to the client base. A good source of information is the ISSA paper "Crypto Assets: Moving from Theory to Practice" from November 2019 which can be found at: https://www.issanet.org/e/pdf/2019_11_ISSA_Report_Crypto_Assets_Moving_from_Theory_to_Practice.pdf

9. Collaboration, Standards and Regulation

The vast majority of the respondents are collaborating either within a consortium as an active participant or via their own industry bodies to improve their knowledge and ability to execute.

As the WG would hope, the investment managers and asset owners are standing behind the adoption of industry standards as an imperative to accelerate adoption of digital assets and to allow the smooth functioning of the markets going forward.

As mentioned before, they are also craving regulatory certainty as this allows them to invest in confidence that they are complying with the regulations. The WG did not gain any understanding of the exact frameworks that they needed and sought, so the WG lacks the ability to assess which elements need to be tackled as a priority by the regulators.

10. The Way Forward

The WG's final question was "Why do you think digital assets are here to stay (or not)?". The responses were extremely positive with the belief that digital assets are going to be part of the future. There was an interesting aside from one respondent that "digital currencies are not here to stay".

The reasons that digital assets are going to be part of the future varied from the access that they may provide to invest in Small Medium Enterprises (SMEs) and early stage companies, the efficiency that they could bring to the market, the promise of the underlying technology and client experience and the belief that digital assets are the future.

ISSA will take the findings from this survey and apply them to the other DLT WGs thinking on the subject. This survey will not be repeated.

The DLT Voice of the Customer Working Group would like to thank the respondents for their time and input as, without them, this paper would not have been possible.