2021 Roadmap to Institutional Adoption in Crypto Markets

LIQUIDITY ⊶ SECURE CUSTODY ⊶ CLEARING & SETTLEMENT

4 Think Ahead.

"Get Ready for a DeFi and Technologically Innovative Future"

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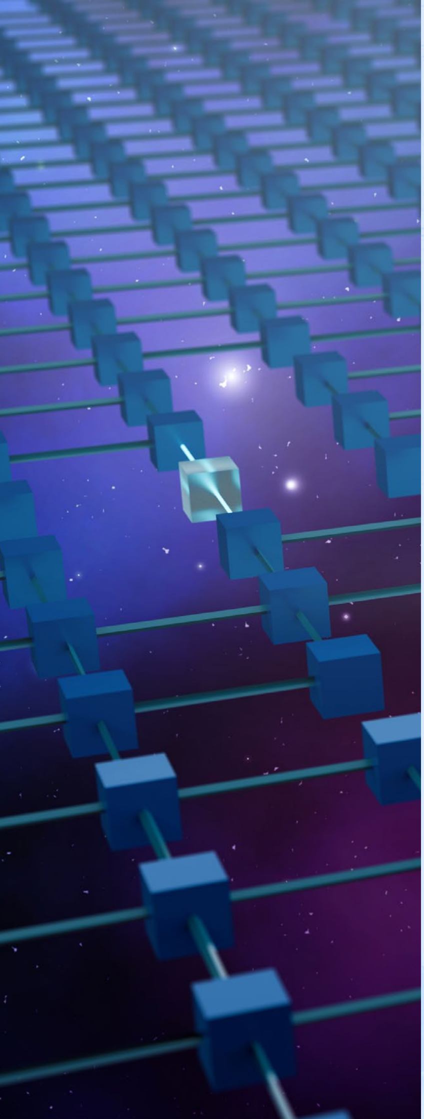

How Brokers Can Gain a Competitive Edge with DeFi

The crypto brokerage industry has been rapidly changing over the past few years, especially more so today due to the influx of forex brokers and fintech companies into crypto markets. However, to succeed in the fast-changing world of cryptocurrency trading as a brokerage platform, you need services that will be able to adapt quickly to changing market circumstances and demand, and you need services that are differentiating. In our final blog article to **The 2021 Roadmap to Institutional Adoption** series, we explore how brokers can embrace DeFi today to unlock opportunities and gain a competitive edge.

According to tracking service DeFi Pulse, the value of digital assets locked into DeFi services grew from less than $1 billion in 2019 to over $15 billion at the end of 2020, and over $80 billion in mid-May 2021 before falling to under $60 billion as a result of the recent crash. That's quite a substantial growth record in a relatively short time frame that no one anticipated. It's a clear indication that decentralised finance (DeFi) has a place in the future of finance.

Whilst DeFi promises lower costs and deeper liquidity, the infrastructure is still nascent, and working with the protocols can be inherently complicated and non-user-friendly. There is also a big AML/KYC question to solve for institutional participation in DeFi. In the current DeFi landscape, interactions are anonymous, making compliance tricky. The lack of custody solutions and an ecosystem composed of decentralised autonomous organisations or DAOs with no single entity in charge, further compounds the situation as it can be very difficult for users to navigate with no means of customer support and heightened security risk.

Ultimately, brokers exist to facilitate a variety of financial transactions for their customers in the simplest manner that vary in degrees of complexity. Differentiation amongst brokers comes in the form of providing value-add services such as support and user-friendly interfaces to best pricing and access to trading venues and more asset types for best execution. Whilst DeFi touts the mantra of 'no middleman', there is still plenty of utility brokers can bring to the table that isn't rent-seeking.

Improving Best Execution - A Wider Range of Access

What makes crypto assets different when it comes to best execution? The first major distinction is the market structure. The crypto asset market has no commonly accepted principal exchange in each jurisdiction or territory and no one venue can do it all. As a result, sourcing liquidity can be extremely difficult in today's crypto markets as it's massively fragmented across 100s of exchanges, market-makers, traditional FX LPs, and boutique offerings. Brokers often have to work across multiple exchanges or OTC liquidity providers just to fulfil an order at the best price. DeFi presents as the next evolution in this regard. It serves as an extension to the current repertoire of centralised exchange venues, OTC providers with more ways to source liquidity through decentralised exchange (DEX) venues and access to new asset types not available through traditional means. However, DeFi is inherently complicated and lacking in fundamental services institutional traders value and need such as customer support, compliance and custody. Brokers, therefore, have a real opportunity to offer a superior user experience whilst leveraging DeFi liquidity in the backend.

Leveraging and Hedging

With DeFi derivatives, brokers are not limited to offering spot trading. Protocols like dYdX, DDEX, Nuo and Fulcrum facilitate margin trading. Whilst trading synthetic assets created with protocols such as Synthetix, Opyn and UMA on DEXs like Kwenta, DHedge or Paraswap, opens up hedging. Using such protocols, brokers can add margin trading and hedging solutions to their clients.

Earning yield on deposits

Funds sitting idly in trading accounts are very capital inefficient. Lending yield in DeFi is superior when compared to traditional financial products, offering interest in the range of 8-10%. Brokers, therefore, have an opportunity to move idle assets onto relatively low-risk protocols like Aave or Compound that allow crypto holders to earn interest on their assets. Alternatively, staking protocols offer another means to earn passive returns. Brokers can then look to pass on the interest earned on deposits to their customers or offer them better spreads as a result of yield earned. In return, customers are more likely to put more flow through the broker.

Institutional DeFi

Perhaps the most powerful aspect of DeFi is the crowdsourcing element – the ability to frictionlessly aggregate almost unlimited third-party balance sheet. This diverse balance sheet can support unlimited-scale Prime Services without reliance on any one firm, which has the added benefit of reducing systemic risk and broadening the spectrum of credit provision to market participants. Bosonic's lending marketplace, where collateral stays in lender and borrower accounts at their own custodians, means that crypto, fiat and other assets at any custodian can be used as collateral for a loan or loaned out for a yield without the movement of the assets. Margin and leverage financing, as well as short lending, are facilitated with repo transactions in real-time and executed as an atomic exchange of collateral for borrowed assets on custodial Layer-2 blockchain ledgers.

Because there is no asset movement and no direct onboarding or paper agreements between individual borrowers and lenders, this intra-day financing is programmatically available, elastically, on-demand in real-time. Execution as a repo transaction between a borrower and lender (1st leg) that is performed atomically with the primary trade execution between two trading counterparties (2nd leg), means that powerful asymmetries between two trading counterparties can be supported. For example, a large market maker that trades primarily on credit can repo in assets to be legally fully funded intra-day against counterparties such as regulated fiduciaries who cannot take credit risk to the market maker. The credit risk is then shifted to any number of yield-seeking lenders who know how to price this credit risk, all in a single real-time, multi-leg trade execution, i.e., the trade and the repo are one atomic transaction completed in milliseconds on-chain. This has profound implications for institutional trading volumes as well as the highly intermediated lending markets in digital assets.

Conclusion

Brokers wishing to enter crypto markets today should consider embracing DeFi rather than view it as a perceived threat. The allure of DeFi today is its modularity. It provides for a host of financial services delivered via composable protocols that users can tap to find yield. However, it does so at the expense of usability with interfaces that are more often than not awkward or poorly thought out. Under this guise, brokers can be the saviours of the day rather than rent-seeking villains. The system-design nature of DeFi protocols enables brokers to easily build interfaces on top of them to offer their customers superior offerings that are simple to use, eg trade on leverage, accept fiat then convert fiat to cryptoassets such as ETH or convert crypto to bespoke token using a DEX and so on. The opportunities, therefore, are limitless, putting brokers in a position to become experts in choosing what's best. Think of DeFi as a financial symphony. If you string together the right transaction movements, it's music to the ears or in the case of DeFi its best execution achieved, yield earned, more customers onboarded, etc. What's more, all the transactions performed can now be done safely and quickly backed by secure custody with the right partner.

A fully programmatic, regulatory compliant custodian like Trustology can take the pain and burden away from brokers managing the risk and complexity of DeFi on their own. It's become prohibitively expensive to build out wallet infrastructures in today's crypto markets and applying for a license can be time-consuming (up to a year or more). Partnering with custodians who can effectively support and facilitate an ever-growing variety of assets and transaction types whilst maintaining policies and controls necessary for regulatory compliance can help further bridge the usability gap in DeFi for brokers.

Need a 1:1 discussion on DeFi?

Why not book an intro call with Trustology and we'll answer any queries you may have. Or, join the upcoming Founder and CEO Q&A discussion in June and we'll address all your queries on liquidity, custody, settlement and DeFi.

I'M IN!

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