

Virtuelles Investmentforum 2020: Blockchain und Crypto- Custody in Financial Services – wo geht die Reise hin?

Break-Out-Session
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25. Mai 2020



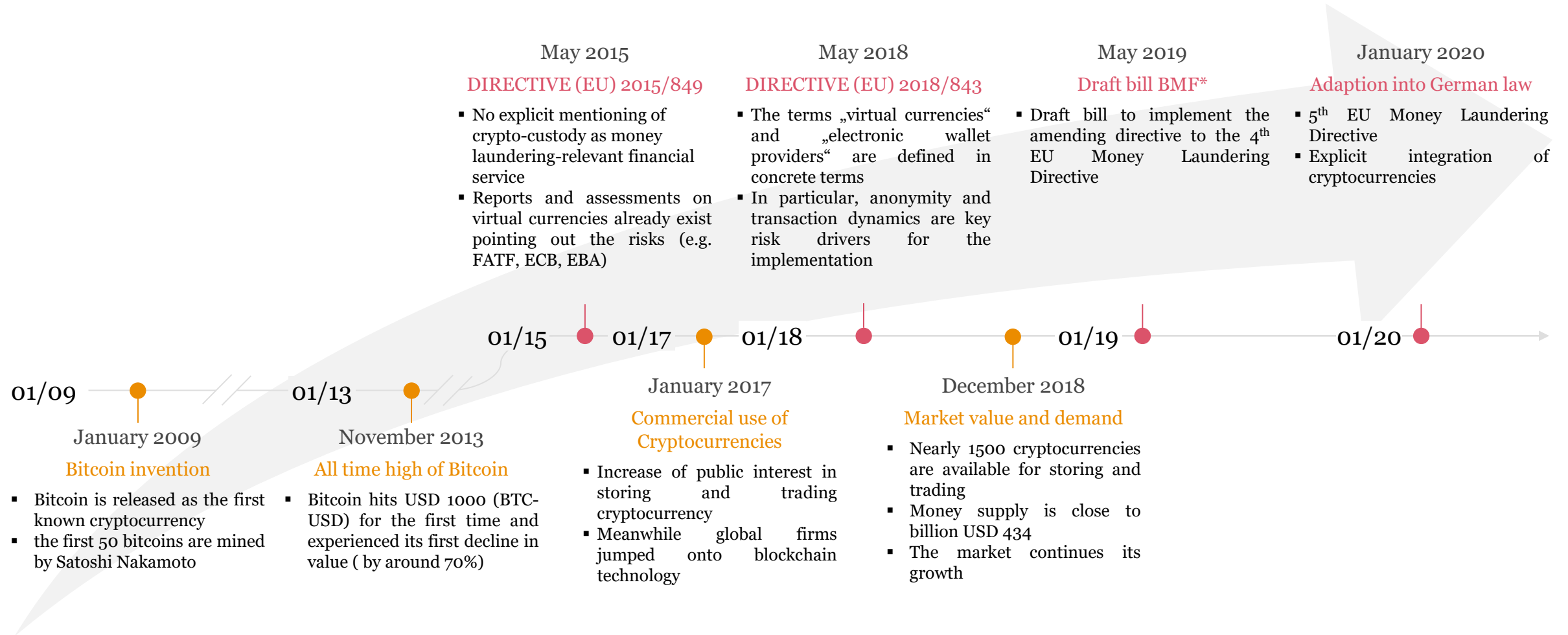
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Digital Asset Trading – Recent Regulatory Developments

The boom in the cryptocurrency and crypto asset market is years ahead of regulation



Now securities trading on Blockchain will soon be an option – subject to regulation since January 2020

- Corner points “Eckpunktepapier” of German Federal Government lines out Blockchain strategy
- This strategy includes the intention for issuance of bearer bonds (“Inhaberschuldverschreibung”) without paper-based authentication
- While equities are explicitly referred to a later stage, this opens the market for Blockchain based issuance and trading of securities – in particular since bearer bonds already today have a wide range of application
- While this opens the doors to securities trading on the Blockchain, there is no such commitment yet to also establish a digital Euro – which would however be the final element for complete Blockchain based securities trading
- Lacking a Central Bank issued Euro, there are mean-while private initiatives to enable an inclusion of Euro based payments on the Blockchain – although regulatory this is not Central Bank money.
- Blockchain Regulation with BaFin (German Banking Act – KWG) – including AML prescriptions
- Incumbent providers receive grandfathering until 30 Nov 2020, but must indicate their intentions by 31 March – new entrants to this business must receive the BaFin permission prior to the start of their business
- Licensing in the past was never a pure paper act, but always implied a proof of the relevant organizational and processual structures, including the respective staff base and operating models – this should be assumed as the minimum requirement also in the case of crypto custody

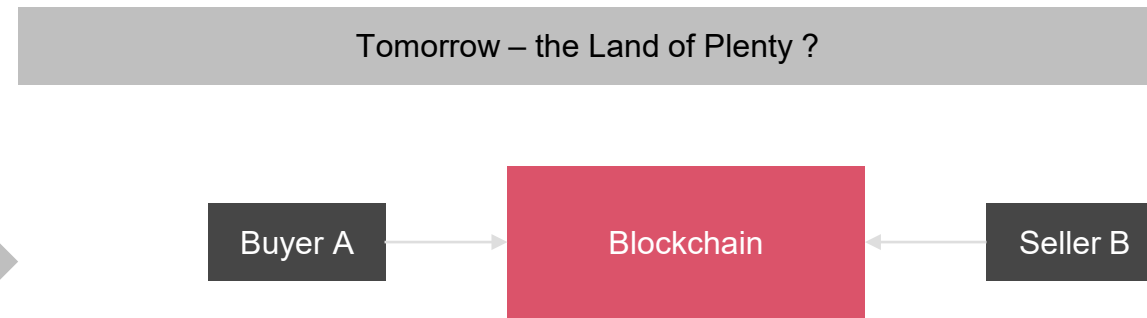
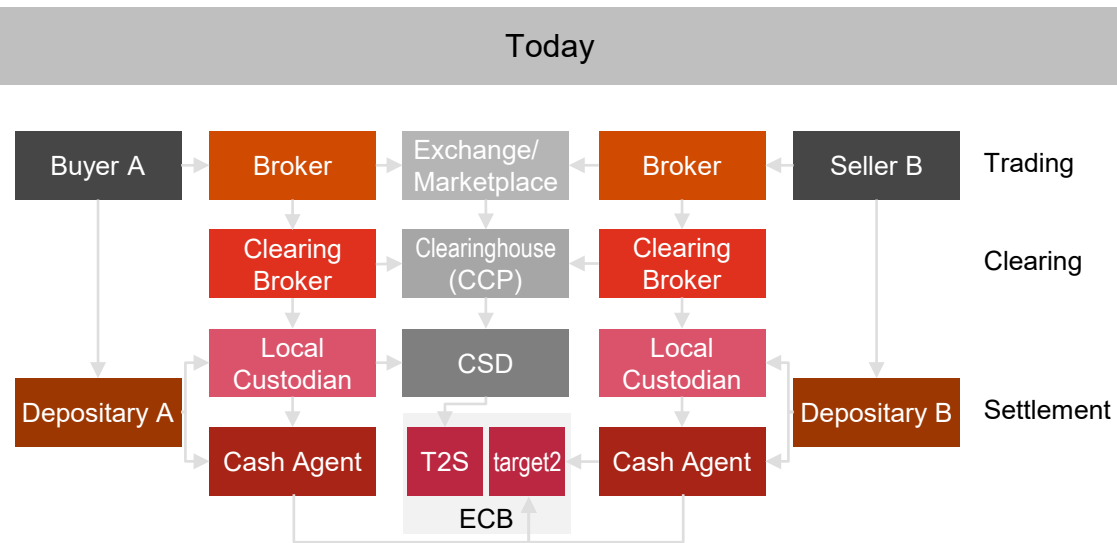


What on first sight might seem to be a restriction (no activity without licensing), in reality is THE enabler: licensing is possible – thus if achieved, the business is allowed from a regulatory point of view!

2

Securities' trading and
settlement on the Blockchain
– don't forget the ecosystem!

Moving today's complex process to the blockchain seems like the Land of Plenty – until we look at the details!



But:

1. This sketch covers the pure settlement process only
2. It neglects a number of major needs that the market players have in this context:
 - Trade management and netting
 - Risk management, collateral management
 - Liquidity, credits, repo, settlement facilitation (sec borrow & lend ...), ...
 - Market data, research
 - Tax services
 - ...

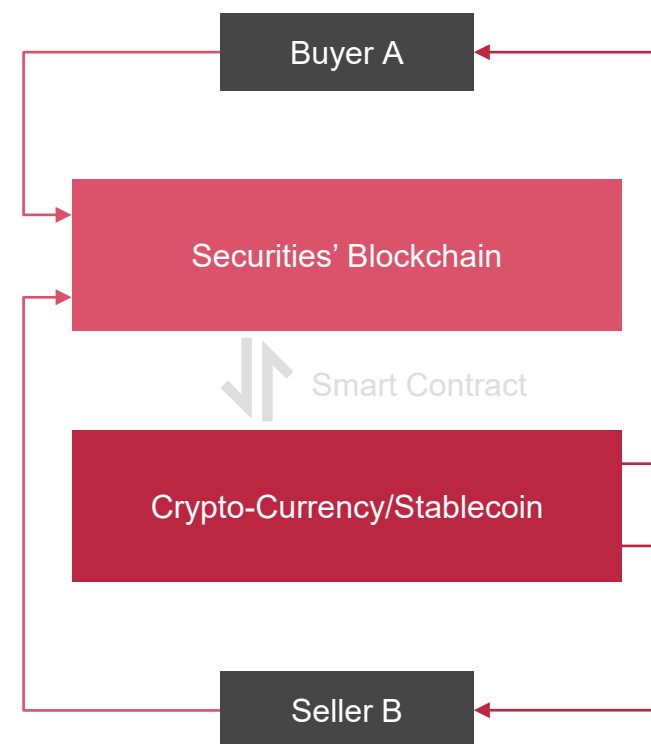
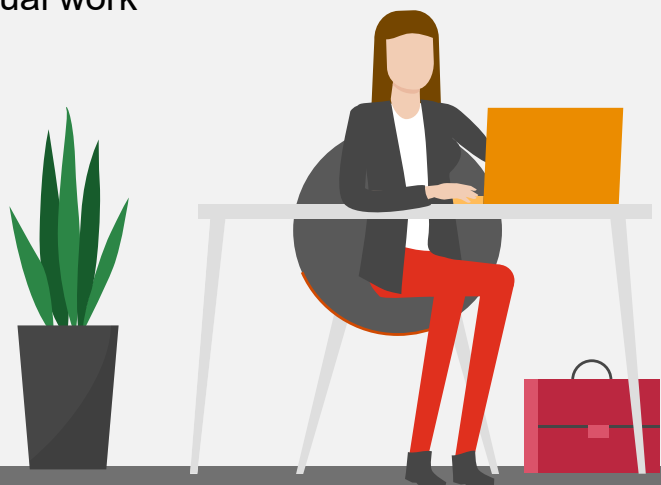
1. Duration from conclusion of the trade until final settlement with the parties is 2 days ("T+2")
2. In the standard case already, a number of service providers besides buyer and seller are involved
3. Workflow is thus distributed and each of the involved parties impose fees for their services



Many of these services will not become obsolete just because of Blockchain!

Delivery vs payment will be achieved by smart contracts that concatenate securities and payments in the Blockchain ...

1. While today, securities' delivery and payment are process-wise concatenated, yet they are still running in different systems (CSD ↔ ECB)
2. In the crypto-world, there is the chance to technically concatenate them with a smart contract, thus guaranteeing their mandatory synchronous execution
3. In addition to increased process security, this will also enhance process efficiency and reduce manual work



... and a few process elements will become obsolete ...

1

There will not be any central counterparty clearing any more, since immediate near time settlement does not leave room for the netting processes, nor is it necessary to provide risk management against the default of the counterparty overnight, if there is no open position overnight as a consequence of this near-time intraday settlement.

2

This includes that there is no settlement netting, which would require to collect executed trades as a basis for any netting process. Immediate resp. near-time settlement make any netting impossible but also obsolete.



3

As long as there is no digital Euro, there will neither be Central Bank money (CeBM) settlement, which in the classical world is the standard payment mechanism to avoid the counterparty default risk during the settlement run. The near-time settlement based on (ideally automatic and smart-contract triggered) payment in crypto-currencies however eliminates this risk to the greatest possible extent.

4

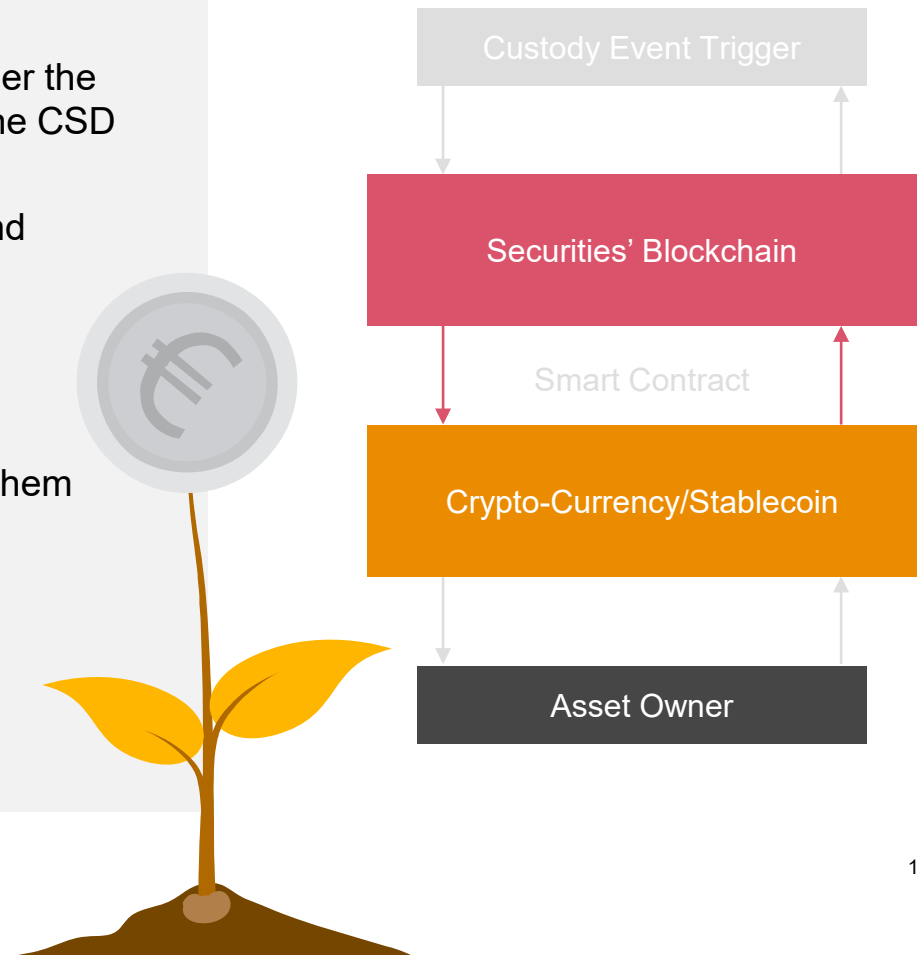
Blockchain does not have any position keeping. Rather, there is the storage of the complete transaction history of any token back to its first creation. Positions must always be calculated based on the transaction history. Service providers (as e.g. wallet providers) may (and do) of course perform these calculations regularly and offer position reporting services thereupon. This is however not comparable to the legal status of the positions kept and reported from classical CSD custody statements.

5 ...



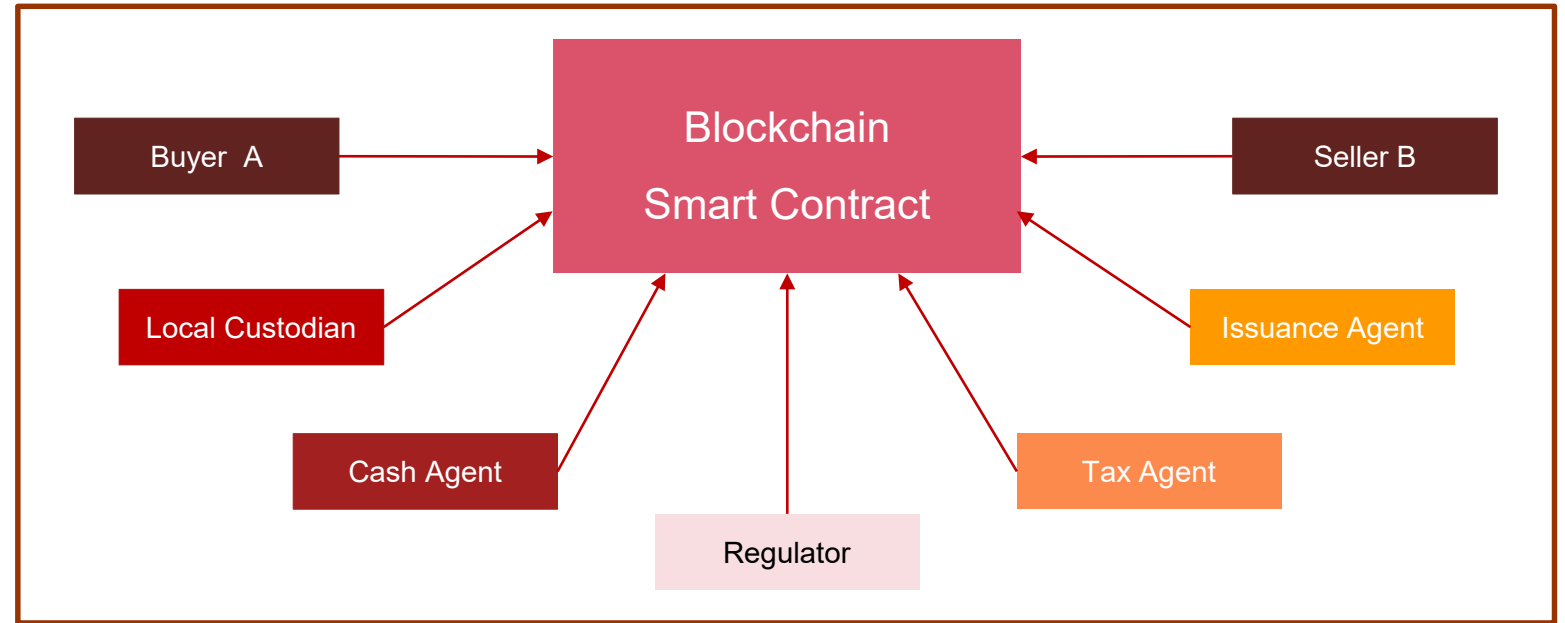
... but, as with classical securities, investors will still expect e.g. income or corporate actions from their tokenized investments

1. Today's income and CA processes are intrinsically asynchronous: the event is triggered by lead manager who provides cash on a dedicated account with either the CSD or via his Central Bank account – cash distribution is then organized by the CSD and the custodians
2. In the crypto-world, there is the chance to technically trigger both, payments and token splits with smart contracts triggered by an external trigger (fired by the issuer/lead manager), which then automatically triggers
 - the distribution of the funds via the associated crypto currency in case of income events
 - the generation of new tokens according to the split conditions and transfers them to the right owners according to their holdings
3. Voluntary actions need a separate mechanism to collect the token holders' instructions and feed them back to the securities' tokens Blockchain



The Ecosystem will thus be a decisive factor

As with most disruptions in the
Tech world, the existence of a
corresponding ecosystem will
make the difference



- The “land of plenty” is not as plentiful as thought in the first view, if not a number of “extras” are provided
- Blockchain based security settlement will work only, if these services are addressed in the Blockchain world, too
- Today’s use cases often focus on the pure basic transaction

➔ Market players don’t need technology, they need solutions!

3

Finally, do not forget the regulatory obligations that come along with securities' trading

The new crypto regulation is in place since January 2020

On 1 January 2020, the German Banking Act (KWG) was amended to extend its scope to crypto custody services.

What changes?

- Firms which provide *crypto custody services* must now obtain a license from the Federal Financial Supervisory Authority (BaFin).
- After declaration of existing services by March 2020, full licensing with BaFin must be achieved by 30 Nov 2020
- Otherwise the BaFin license must be achieved prior to starting the services

Who is affected?

- The regulation concerns *any* entity that services the German market, not just German firms.
- Similar rules are expected to be soon implemented in other EU Member States.

What are the implications?

- The Licensing obligation as a financial services provider in Germany triggers organizational requirements and further regulatory obligations as well as adequation issues in several areas.

1 January 2020

- Law is amended to cover crypto custody services

31 18 May 2020

- Deadline for letter of intent for provisional license to incumbents

30 November 2020

- Deadline for complete application for BaFin License

Ongoing Compliance

This year onwards, the term “crypto value” has officially been defined in German law for the first time

Crypto values were first regulated at European level before they were transferred into German law



European level

In 2014, the European Banking Association had already defined virtual currencies as a digital representation of values that are neither issued by a central bank or a public authority nor necessarily bound to a fiat currency, but [...] are used as a medium of exchange and can be transmitted, stored or traded electronically.

For the first time, Directive 2018/843 of the European Union (the so-called 5th EU Money Laundering Directive) includes virtual currencies and providers of electronic wallets in its definition.



German law

In May 2019, the German Federal Ministry of Finance (BMF) presented a draft for the implementation of the 5th EU Money Laundering Directive, which is incorporated into current law with effect from 1st January 2020.

This specifically includes the providers of depository, administration and security services of crypto assets (crypto-custody business) as financial service institutions.

Equally, the term crypto value is defined as a financial instrument.



Crypto-currencies or virtual currencies are increasingly moving into the focus of law enforcement authorities due to the money laundering abuse risks they entail.

Your next steps should focus on legal filing and TOM readiness

Additional implications should be considered in the meantime.

Operational Integration

You must prepare your firm for new regulatory compliance requirements.

- Target Operating Model Design
- Compliance Processes Development
- Implementation of TOM and Compliance Processes

Tax and Legal Considerations

New regulatory classifications means potential tax and legal implications.

- Impact Overview of Potential Tax-Related Regulations
- New or Adjusted Applicability of Work Place Regulations
- Advisory for TOM and Compliance Processes

Complete Application Submission

To continue operations without penalties, one must submit a complete licensing application with BaFin.

- Preparation of License Application/Set up of a regulatory compliant business structure
- Licensing **by end Nov 2020** for incumbents, otherwise prior to starting the service
- Ongoing Regulatory Compliance Support

40+ financial institutions have already expressed interest for a license from BaFin – there are clear benefits with the licensing



Providers of Crypto-Custody services are confronted against a catalogue of requirements by the GWG* (excerpt)

1

Risk Management

- Effective risk management that is appropriate to the nature and scope of the business
- Involves a risk analysis and internal safeguards
- A member of the management level is responsible for the risk management and for the compliance according to the German Money Laundering Act

2

Risk Analysis

- Identify and assess the risks of money laundering and terrorism financing regarding transactions
- The risk analysis must be documented and must be regularly reviewed and updated as necessary
- The current version of the risk analysis shall be at disposal to the supervisory authority on request

3

Safeguards

- Establish adequate business and customer-related internal safeguards to manage and mitigate the risks of money laundering and terrorism financing through policies, procedures and controls
- Measures are adequate if they correspond to the risk situation and sufficiently cover it
- The functionality of the internal security measures must be checked regularly and updated if necessary

4

Customer Due Diligence

- Obligation for identification of contractual partners
- Information on the purpose of the intended type of business relationship must be obtained and evaluated, and the status of Politically Exposed Persons (PEP) must be clarified in addition to other risk-relevant aspects
- The obligations include the implementation of Enhanced Due Diligence (EDD) as well as respective measures

5

Transaction-Monitoring

- Continuous dynamic monitoring of the business relationship including the transactions executed in its process
- In this context, customer profiles must be compared with the respective transaction behavior
- Where appropriate use of an automated monitoring system

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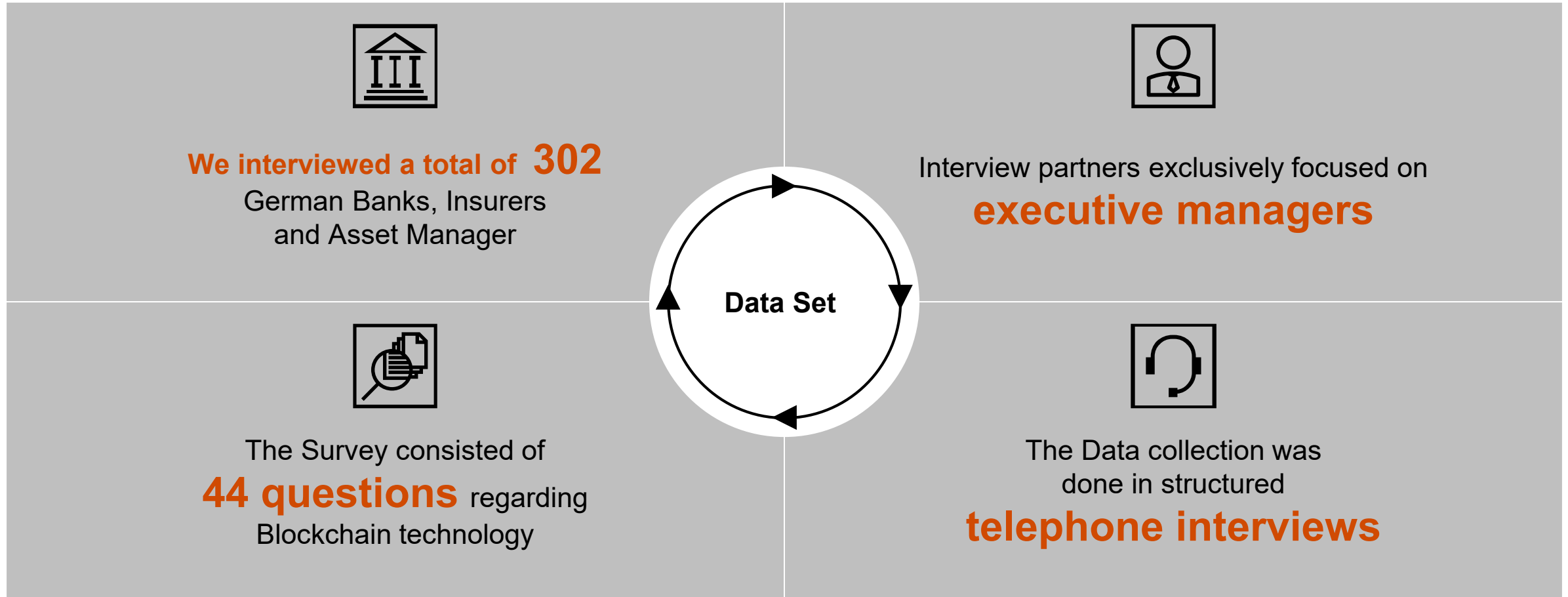
Suspicious Activity Reporting

- Suspicious activities must be reported immediately to the Financial Intelligence Unit (FIU), independently of the value of the asset or the amount of the transaction
- The report must be submitted electronically via the platform “goAML”
- The execution of a reported transaction is only allowed if, after 3 working days, no prohibition issued by the FIU or the dept. of public prosecution

4

Current Status of Blockchain
in the Financial Services
Industry

For the third time in sequence, we have asked decision takers in the financial markets industry on their view on Blockchain



Our continuous market surveys show that many players in the industry lack behind most current blockchain developments

As PwC there are various ways in how to support companies, for example educating them on the technology, finding blockchain strategies or identifying individual use cases. In order to evaluate how we can best serve our customers, we keep a close eye on the market developments, for example by conducting annual surveys.

As an example, recent studies in the German market show, that ...

- 100%** have at least basic knowledge of the technology
- 75%** consider blockchain to be relevant in the industry
- 79%** believe that cryptocurrencies are not relevant anymore
- 97%** of the companies do not have significant spending power for blockchain

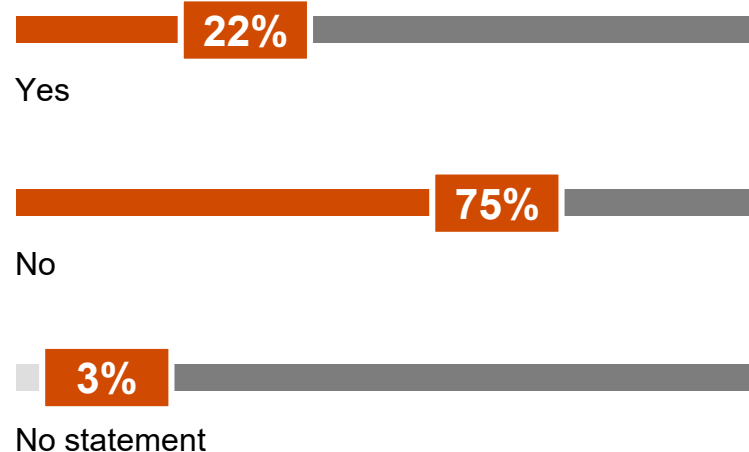
The results in combination with PwC's market expertise in blockchain lead to these implications

- 1 Despite the potential of blockchain, companies do not feel pressed to act
- 2 Many blockchain applications have not been implemented in a target-oriented way
- 3 The true value of blockchain for financial service is not with cryptocurrencies
- 4 A lack of regulation does not excuse the delay of activities anymore

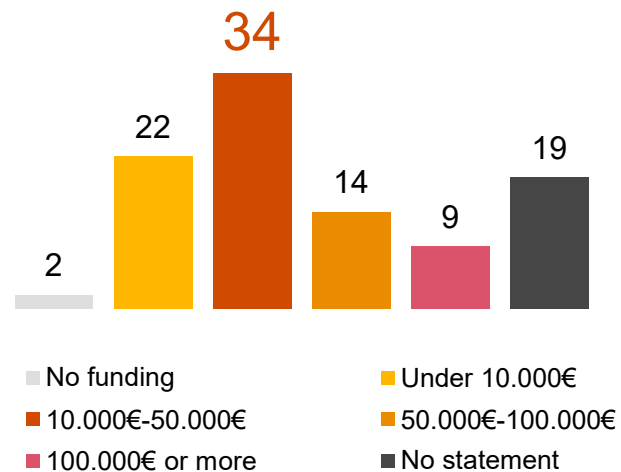
Positive image in the Blockchain environment, but limited activities – still the necessary funding is missing

Despite the positive overall image currently only slightly more than 20% of the interviewed venues actually deal with the technology. An obvious explanation is the missing funding, which was the case already in the last years.

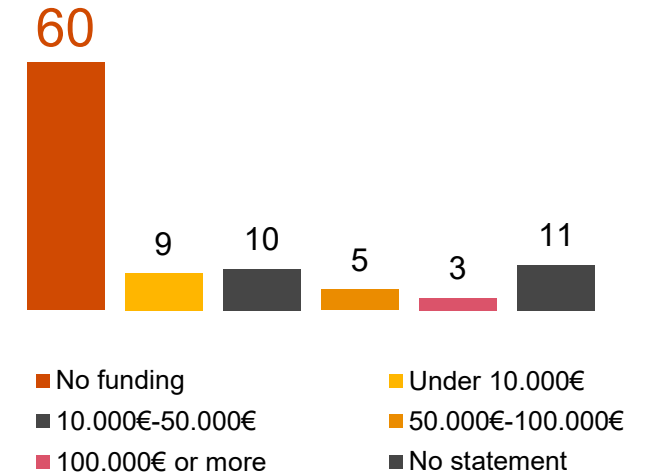
Are venues having Blockchain activities?



Funding for Emerging Technologies In %

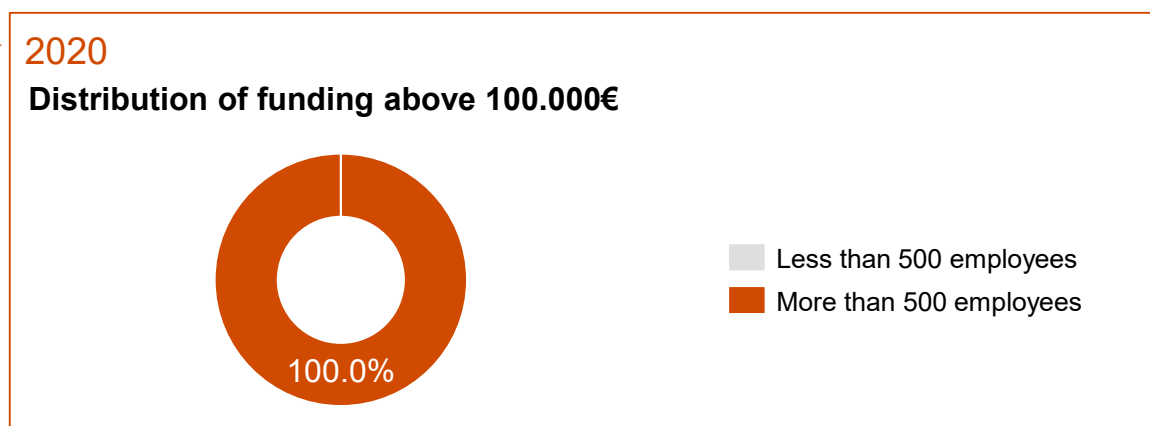
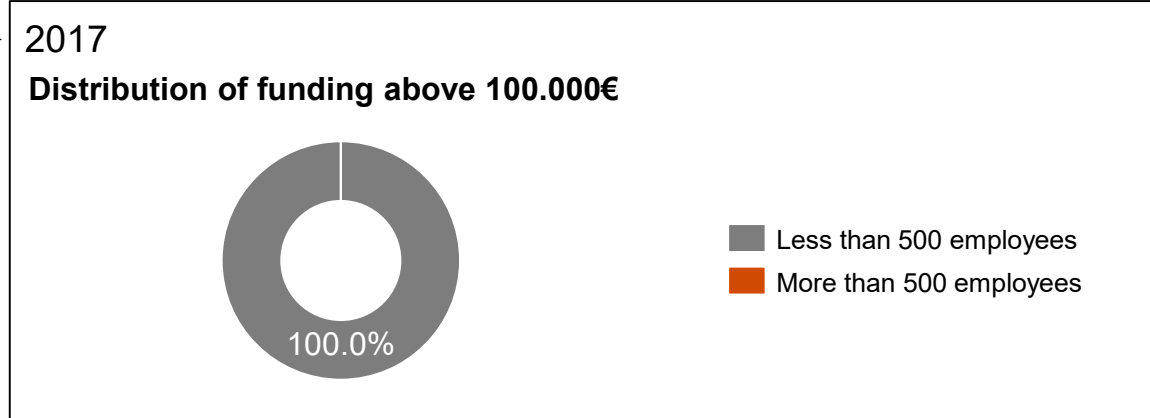
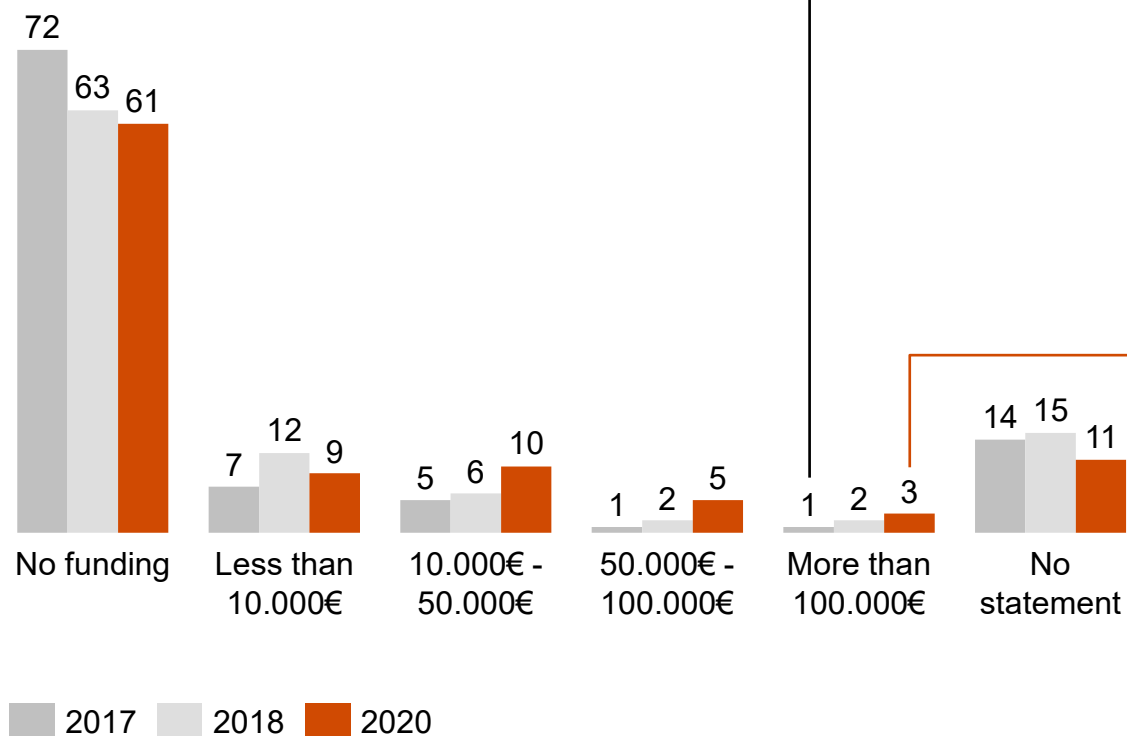


Funding for Blockchain In %



Different from 2017, now the significant funding is more with the larger venues

Which funding do you have secured for Blockchain activities?



The **urgency** to deal with Blockchain technology is in competition with the inherent efforts

As the study shows,

75% of the interviewees see the potential of Blockchain technology, ...

... but ...



... for **97%** of the venues there is no significant* funding.

*more than 100.000€

Why does Blockchain not receive funding?

- 01 Impression of a still immature technology** – Although a majority is in favor of the idea behind Blockchain, the technology still has to face some challenges (e. g. scalability, storage consumption, speed).
- 02 Discomfort re/ disruption** – The potential disruption enforces co-operation. Such co-operation discloses strengths and weaknesses of the individual partners, causing discomfort with the affected persons.
- 03 Too many „emerging technologies“** – Blockchain technology must compete with a variety of other new technologies (AI, IoT, etc.) for limited overall funding.

The Gartner hype-cycle does not reflect the reality of implementation and development of Blockchain technology



Basics of the technology are sound and stable

Blockchain is no longer an unknown. All have at least a basic understanding of the technology and can develop their opinion on it.



Hidden progress

Externally there is the impression that the Blockchain technology has moved back-stage. Nevertheless, the technology has achieved great progress.

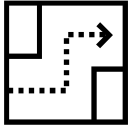


Relevance of perspectives

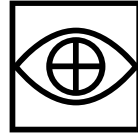
The different use-cases of different Blockchain applications bring along individual advantages and disadvantages. Depending on the business model this leads to differing judgements of the Blockchain technology.

Our message to the financial services industry:

Regulatory prerequisites have now been provided



Avoid procrastination.



Risk a view outside the financial services industry.



Blockchain is more than a crypto currency.

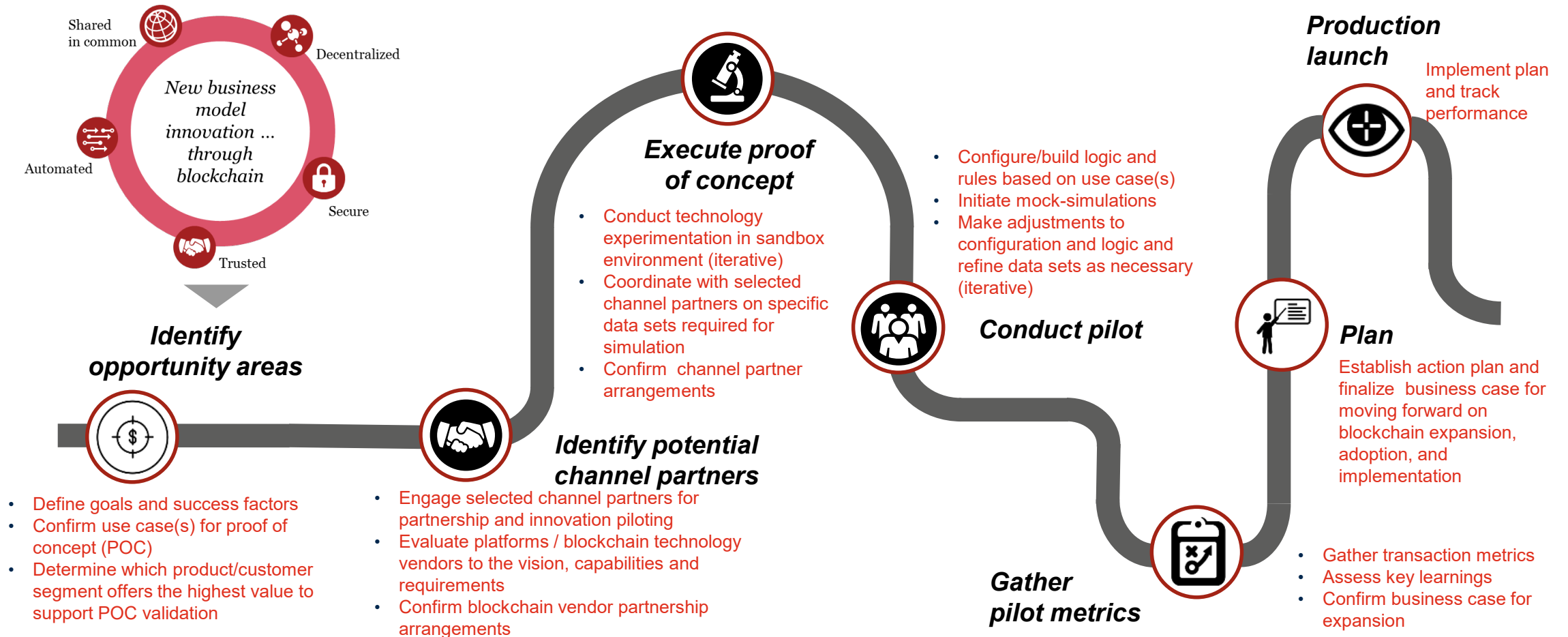


Open up co-operative business models.

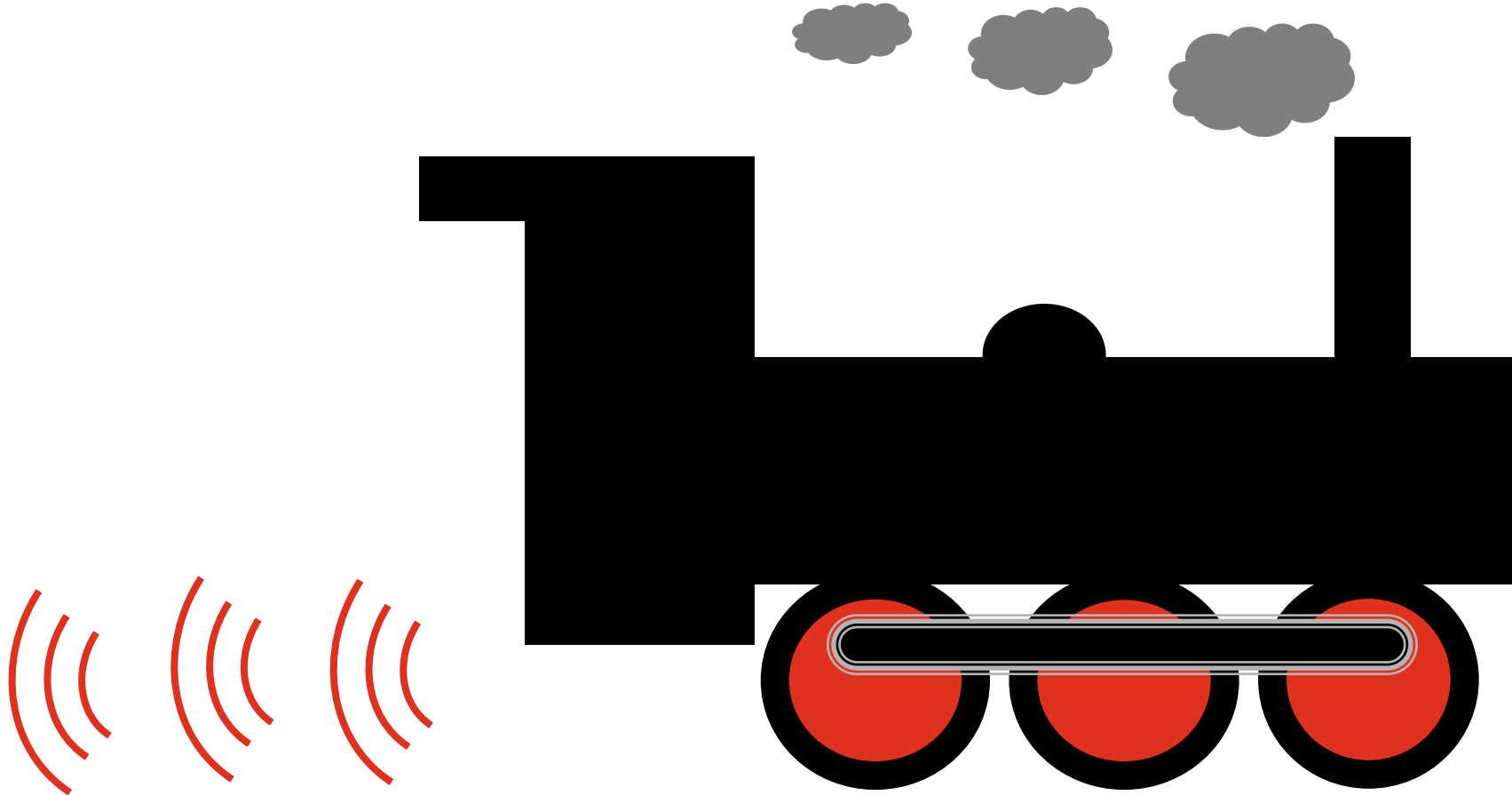
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Next Steps

The Blockchain Journey will have to start ...



... and it should start now, if you don't want to miss the train!



... and remember: the stokers are not needed any longer ...

Wir verabschieden uns und hoffen, Sie werden auch bei den nächsten Webcasts dabei sein! Bei Fragen oder Anmerkungen sprechen Sie uns bitte jederzeit an.

Vielen Dank für Ihre Aufmerksamkeit!



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