

Bitcoin and Financial Markets: Challenges to Full Integration and Practical Solutions

Retail investors often associate Bitcoin-related news with mainstream financial markets with many individuals accepting that Bitcoin and eventually cryptocurrencies will eventually fully integrate into mainstream financial markets. However, the rapidly growing cryptocurrency industry still faces hurdles to integrating fully with traditional financial markets.

Many traders and industry executives have emphasised that cryptocurrencies are currently lacking the efficient mechanisms which are essential for market functions such as netting; netting mitigates risk by offsetting positions in different currencies or securities. In cryptocurrency trading, transactions must be pre-funded which calls for investors to commit upfront the full amount rather than just a margin. This pre-funding requirement cascades across the system which affects market makers, brokers, and asset managers. Market participants must allocate capital to cover the total risk exposure, leading to significant capital requirements. Additionally, asset managers face the hurdle of selling out of one position before funding the next trade. Pre-funding stands out as a formidable obstacle in scaling crypto spot trading, according to experienced traders.

On top of the pre-funding requirement, the Bitcoin blockchain still presents flaws. Chief among the flaws are shortcomings in payment security and proof-of-work systems, as well as the inability of the blockchain to definitively establish ownership. Industry experts note that the current legal infrastructure necessary for establishing trust and recording ownership accurately is lacking. The issue of asset ownership has come under scrutiny due to incidents involving vulnerabilities in open, permissionless blockchains, exploited by early tokenized funds. The use of bridges to transfer tokens between different blockchain networks introduces further vulnerabilities, exemplified by the \$600 million hack of Ronin Network. Addressing these challenges will likely require considerable time and effort with reliable technology, commercial incentives, and regulatory frameworks paramount to instilling confidence in blockchain-based systems.

However, ClearToken, a startup based in the UK, is currently developing a clearing house for cryptocurrency assets aiming to tackle issues such as netting, custody, and payment discrepancies. Companies like ClearToken will set out to change and revolutionise the industry in what could be a second huge wave of development in the industry. Additionally, the Financial Conduct Authority in the UK has indicated the possibility of using regulated stablecoins (pegged against fiat currency) to streamline the trading and borrowing of cryptocurrencies, although regulatory efforts are still in the early stages.

Nevertheless, BlackRock chief executive Larry Fink still regards the developments in the cryptocurrency industry as a first towards a much larger outcome. This has come amidst fund in-flows of USD10b into the US spot Bitcoin exchange traded funds (ETFs) since their launch in January. A comprehensive shift across all aspects of the cryptocurrency ecosystem will likely take time and gradual changes much like the development of our modern day financial markets. However, with an increasingly robust cryptocurrency industry coupled

with heightened attention and anticipation from investors, the industry will likely overcome the aforementioned challenges in a similar vein to the modern-day financial markets albeit at a gradual pace.

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