Cryptocurrency could get physical to deliver the stability it needs

The option to settle futures contracts physically with cryptocurrency, rather than receive a cash equivalent, would give institutional investors the transparency they desire in this emerging market

Cryptocurrency has progressed enormously in recent years as an alternative form of value exchange to "fiat", which is backed by central banks that can control its value through mechanisms such as interest rates and other fiscal policies.

The decentralised, distributed and algorithm-driven structure of cryptocurrency has partly driven its rapid growth in popularity, as well as interest in the secure architecture behind its underlying technology, blockchain, which enables exchange of value without intermediaries. However, this has also contributed to a lack of price stability.

The centralised nature of fiat currencies, such as sterling and yen, could lead to a central point of failure and what some people see as too much power for banks. But it also provides vital stability for the markets, something cryptocurrency needs to master to overcome the price volatility that has defined its development to date.

"The solution is to introduce market-based alternatives that provide the same effect or at least replicate most of it," says Obi Nwosu, chief executive and co-founder at Coinfloor, a group of cryptocurrency exchanges for institutional and sophisticated investors and traders. "One of the best ways of doing this would be through a reliable and transparent futures offering."

Futures contracts, which allow assets to be bought at an agreed price today, but delivered and paid for at a later date, have been around in the cryptocurrency space since 2011. They gained particular attention last year when both the Chicago Mercantile Exchange and the Chicago Board Options Exchange launched their own bitcoin futures.

Purchasing cryptocurrency in this way provides a greater surety of cost by locking in a price. Today all futures contracts for cryptocurrencies are settled in cash. This means, at the point of settlement, parties receive the cash equivalent of the underlying asset, exposing them to risk of market manipulation and price slippage.

For people who require cryptocurrency for more than speculative purposes, such as institutional and sophisticated investors and traders with business use-cases, as well as miners who must convert it to fiat regularly to cover their costs, there is a growing desire to receive the underlying asset at the point of settlement, not the cash equivalent.

To achieve this with the current futures offerings available, they have had to take the cash settlement to the spot market and convert it back to the underlying asset, adding extra steps, but also exposing them to the risk of the price increasing.

"As they start placing their orders, people on the other side of the trade can see there is a large buyer coming," says Mr Nwosu. "If you know a settlement is going to happen at a particular time on a particular day and somebody has to get the cash equivalent of the underlying asset, you have a target to focus price manipulation around."

To tackle this issue, Mr Nwosu suggests a physically settled cryptocurrency future is needed to enable investors to receive the underlying asset at settlement, as well as the ability to convert crypto assets easily to fiat at a later date.

"Physical delivery obviates any risk around price manipulation at settlement, in terms of your returns," he adds. "You would receive the actual underlying asset at the point of delivery, so it wouldn't matter if the price was temporarily being manipulated; you would just wait for it to recover to its natural price."

It's clear that the more futures contracts are adopted, the more stability they will bring to the cryptocurrency market. However, this relies on institutional investors adopting them as entities that can deliver the volumes required to increase the amount of trades needed to move the market. Physically settled futures could finally provide the transparency that institutional players crave to manage their risks better.

"The waves of the cryptocurrency market are being rode in a dinghy; you're tossed around without much control because of the small amount of liquidity and volume being traded," says Mr Nwosu. "If you're on a cruise liner, you'll feel slight movements, but they'll be reduced because you have far more mass – that's the equivalent of far more volume going around the cryptocurrency market.

"The regulatory, social and technical issues holding back cryptocurrency's ultimate potential are being considered by policy-makers and are being addressed. The remaining piece in the puzzle, which is stability and transparency, would be greatly improved by physically settled futures."

Founded in 2013, Coinfloor is the longest-established group of cryptocurrency exchanges designed for institutional or sophisticated investors and traders. We offer stable and liquid platforms to trade and invest in cryptocurrency.

For more information please visit coinfloor.com

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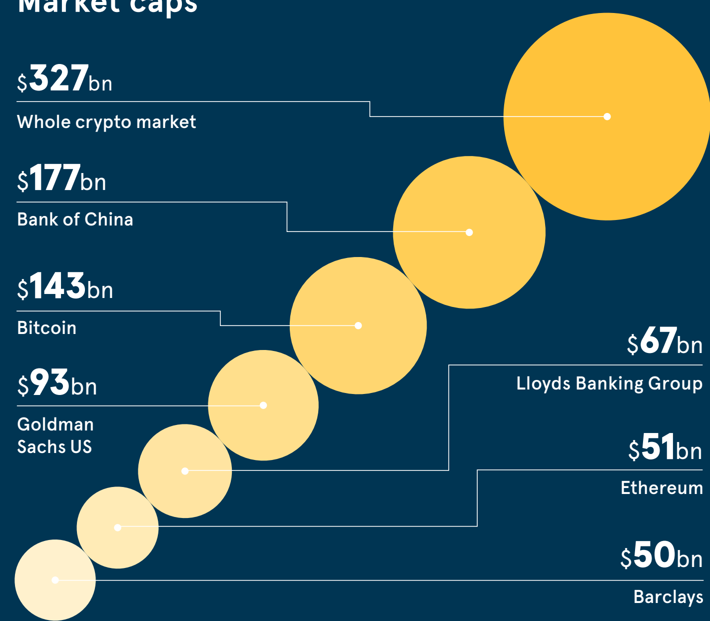
Market caps



Figures as of March 26

CoinMarketCap 2018

Bitcoin potential

44%
bitcoin share of the total cryptocurrency market

16.9m
circulating supply of bitcoin

21m
total bitcoins that can ever be mined

CoinMarketCap 2018

Investor considerations

Institutional investors

- Need to offer a wider range of high-performing assets to their clients
- Can benefit from long-term price stability as more institutionally focused products come to market

Professional traders

- Need access to breadth of asset classes to diversify their trading strategies and portfolios
- Benefit from access to a more comprehensive market with institutional liquidity

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Governance
Coinfloor group maintains strict governance practices including robust KYC and AML policies, modelled against regulatory industry standards

Secure
Coinfloor exchanges are the longest-established group of exchanges offering 100% multi-signature cold storage custody

Trust
Coinfloor group is led by an experienced team of financiers, technologists and cryptocurrency specialists with more than 150 years' collective experience in technology and financial services

Transparent
First cryptocurrency exchange to publish monthly Provable Solvency reports

Hedge funds

- Need to balance portfolio performance against risk for their clients
- While volatile, cryptocurrencies have huge potential for future growth compared to traditional asset classes

The miner

- Need to hedge their future bitcoin revenue to match their fiat denominated costs
- Need to forward sell large amounts of bitcoin in a liquid market to receive fiat currency to settle their costs
- Need market price and liquidity information to forecast future operating expenditure investment