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TOKENIZATION OF ART AS A NEW SUSTAINABLE REVENUE GENERATOR FOR BANKS AND FINANCIAL INSTITUTIONS

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Art objects have been a highly valued asset for centuries, attracting high net worth individuals and institutional investors alike. Many large banks have a sizeable art collection that they consider to be a part of their corporate culture.

In recent years, the art market has been undergoing a digital transformation, with blockchain technology and tokenization allowing for new ways of buying, selling, and investing in art. This transformation allows investors to part-own art items, by purchasing tokens which represent a stake in a famous painting, for example, thus making investments more liquid and accessible.

This article discusses a feasible use case for tokenization of art as a sustainable revenue generator for banks and financial institutions, and why these institutions should consider this use case seriously. Banks that possess an art collection already have the infrastructure to safekeep and maintain it. They are therefore in a position to act as an intermediary to offer investment services for tokenized art objects. This use case will also be relevant to retail and institutional investors as well as suppliers of art like museums, art galleries and private art collectors.

WHY DO BANKS INVEST IN ART?

Art collections owned by financial institutions contain numerous pieces of modern and contemporary art created by some of the most well-known artists of our time. The collections include paintings, sculptures, works on paper, photographs, videos, installations, and digital art. Visitors can usually get a close-up look at the collections during regularly scheduled public tours that take place in exhibition halls, foyers, and offices of banks.

These banks recognize the value of art not just as an investment but also as a way to enhance their brand image, foster creativity at work and create an attractive work environment for their employees. Furthermore, there is substantial value in the art collections of these banks.

From a financial perspective, banks invest in works of art for the purposes of alternative investments or investment diversification as well as enhancing their cultural profile and attracting wealthy collectors.

Some banks have specialized departments dedicated to art investments that focus on expanding the bank's art portfolio and cater to collectors and high-net-worth individuals, offering them opportunities to invest in art as part of their overall wealth management strategies.

HOW CAN TOKENIZATION OF ART BRING VALUE TO BANKS?

Given their involvement in and appreciation for art, tokenization of art represents a use case that aligns with banks' interests and expertise. The substantial number of art objects owned by banks and currently sitting as passive objects in lounges and exhibition rooms can be used for investment purposes, thanks to the concepts of tokenization and blockchain.

Tokenization refers to the process of converting real-world assets, such as art pieces, into digital tokens on a blockchain. This allows fractional ownership and trading of these assets, making art investments more accessible and liquid.

Benefitting from safekeeping measures already in place for their existing art collections, specific use cases that banks can implement include:

1. **Tokenization of art collection:** Tokenizing art objects and allowing customers to own these tokens for a price, while safekeeping the actual art objects within the bank and allowing the public to visit the collections. By doing this, banks can still provide their clients with opportunities for investment diversification beyond traditional asset classes and, in addition, have a new income generating business arm. Banks can implement a fee structure for the safekeeping whereas investors will expect to gain from the price appreciation of the art objects.

2. **Trading platform for tokenized art:** Banks, with their extensive financial expertise and networks, can facilitate the trading of art tokens and provide a platform for art investors and collectors to trade them. This increased liquidity benefits both artists and investors, allowing for greater participation and access to a bigger market.

3. **Value-added services (advisory, rewards program, etc.):** Banks can offer additional value-added services to their clients, including art valuation, advisory on art investment strategies and curated experiences such as exhibitions for token holders. Furthermore, banks could integrate tokens into their loyalty programs where customers can buy or receive art tokens as rewards or as part of special events.

MECHANICS OF TOKENIZATION AND REGULATORY FRAMEWORK

At this point it would make sense to understand the concept of tokenization. Tokenization converts financial instruments like equity, funds and bonds or non-financial instruments like infrastructure projects, cars, patents, and artwork into (tradable) digital tokens on blockchain platforms.

Figure 1: Digital asset types

From a technical and regulatory perspective, tokenized art will fall into the category of non-fungible tokens (NFT). NFTs represent unique digital assets and serve as proof of ownership on the blockchain for non-fungible assets whereas security tokens represent proof of ownership for financial instruments.

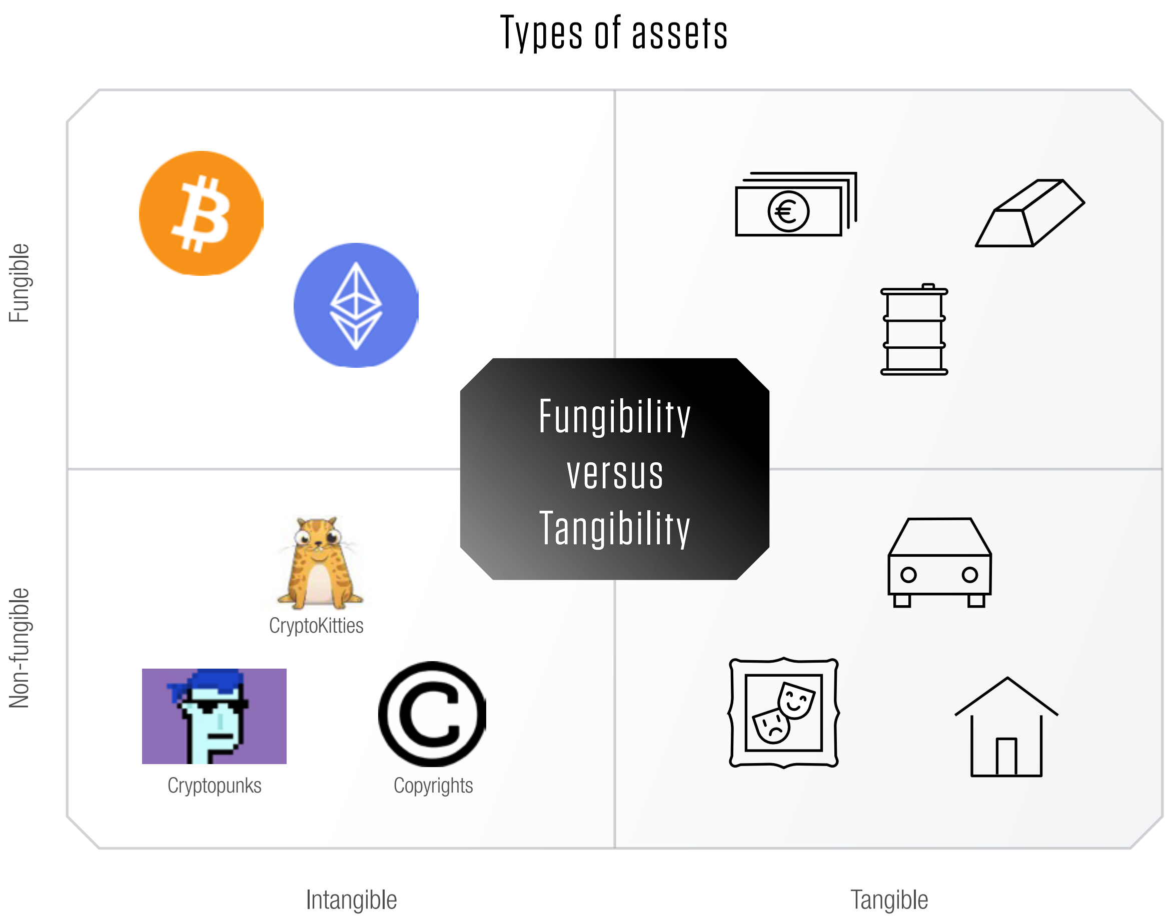

Figure 2: Fungibility versus tangibility

Security tokens that represent financial instruments must be handled following the current regulations and laws applicable to them. Important to note is that the custody of tokenized securities differs from the custody of traditional securities. As tokenized securities exist in digital form on a blockchain, custody involves securing digital private keys instead of safekeeping physical certificates. This means that banks need to set up a technical and architectural infrastructure that supports the tokenization and safekeeping of the private keys as well as comply with regulatory frameworks for crypto asset custody based on the jurisdiction.

For tokenized art objects, proof of ownership will be stored in a blockchain instead of physical certificates and access to the blockchain will be managed through private keys that will be kept in custody of the bank in so-called “wallets” created for the customers.

In this context the question might come up is, “Are we asking banks to launch another NFT collection?” Technically speaking these will be NFTs; however, the curated art collections possessed by the banks are of a much higher quality and value than the NFT collections currently available in the market. The current NFT market usually contains random digital content like images, videos etc. and does not usually match up with the high value art collections of the banks.

As per the EU's Markets in Crypto Assets (MiCA) regulation, non-fungible crypto assets are outside the scope of the regulation unless there are reasons for them to be considered as fungible assets.

According to the German Financial Supervisory Authority (BaFin), NFTs cannot be considered to have the status as securities. The officials claimed that these have not yet shown characteristics that would allow them to be classified as securities in a regulatory sense, such as stocks or debt instruments. It is expected that the European Securities and Markets Authority (ESMA) will provide guidelines regarding when NFTs may be classified as financial instruments in the second half of 2024.

SUCCESS FACTORS

To make the idea of art tokenization a reality, a number of key factors need to be considered:

Compliance:

- Ensure compliance with relevant securities laws and AML regulations in the respective jurisdiction.
- Conduct a thorough evaluation of the art collection's value and legal documentation to ensure clear ownership rights.

Technology and infrastructure:

- Create well-defined and secure smart contracts that outline the terms of ownership, transfers, and potential revenue-sharing mechanisms.
- Understand that a necessary blockchain infrastructure to tokenize and safekeep assets is needed. Select a suitable blockchain platform that offers security, scalability, and the necessary features for tokenizing assets. Ethereum is a common choice, but other options may be more suitable depending on the needs of the bank.
- Implement a secure custody solution for private keys to ensure safe storage and strong management of the digital tokens. Once a custody structure is set up, the infrastructure can also be leveraged for tokenized assets other than NFTs.
- Security risk considerations must include robust security protocols, encryption, and multi-factor authentication to safeguard sensitive information.

Management and resources:

- Secure appropriate senior management level buy-in to ensure sufficient budget and internal support for implementation of this use case.
- Scan the market for appropriate talent and resources, as such implementations require subject matter and implementation expertise that is not easily available.
- Setup the relevant marketing activities for tokenized art objects. Additionally, a structure / department must be setup for the management, care and curation of the art objects in custody.

CONCLUSION

Tokenizing art collections owned by banks will provide a new opportunity for banks and financial institutions to expand their service offering and foster innovation. This intersection of banking and art can be mutually beneficial through expanding access to and engagement with the art market for a wider segment of customers.

Contact us to discuss in detail how your institution can benefit from exploring the potential of this new business opportunity.

Capco has deep experience in the areas of asset tokenisation and custody of tokens and has already supported many banks and financial institutions in the end-to-end implementation of crypto tokenization, custody, and trading. As a trusted partner to our clients, we simplify complexity and bring expertise in the areas of project and program management, business analysis, regulatory compliance, transformation, and technology.

AUTHORS

Arindam Bhaumik,
Managing Principal

Christopher Graf,
Consultant

CONTACT

Dr. Christoph Ruth,
Executive Director,
M +49 172 986 8082
christoph.ruth@capco.com

ABOUT CAPCO

Capco, a Wipro company, is a global technology and management consultancy focused in the financial services industry. Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its award-winning Be Yourself At Work culture and diverse talent.

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