A Detailed Introduction of Crypto Custody

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The cryptocurrency industry has no shortage of horror stories about stolen funds, hacked attacks and lost passwords. This is why crypto custody is needed.

Crypto custody is a term used to describe the process of securing assets from theft. Custodians – third parties that can be hired to look after your crypto for you – act as safeguards of your money, be it cash, securities, gold bars or virtual assets. Custodians have been around since the 1960s and are one of the pillars of the traditional banking system.

When it comes to crypto custody, it works a little bit differently. Digital asset custodians do not technically store any of the assets because all data and transactions exist on a public ledger called the blockchain. Instead, what they guard are users' private keys – the important part of a crypto wallet that grants access to the funds held in it.

Crypto custodians are essential for the widespread adoption of digital assets. To this day, many institutional investors stay away from buying digital assets because of the lack of security. Institutions that manage large amounts of money such as hedge funds, pension funds, investment banks and family offices, are required by regulation to have a custody partner to keep their clients' money safe.

As more institutional investors started to dabble in digital assets and companies like MicroStrategy began to place large amounts of cryptocurrency on their balance sheets, the demand for crypto custody services skyrocketed. A report by Blockdata shows the size of digital assets under custody grew sevenfold between January 2019 and January 2022, from $32 billion to $223 billion.

Two Types of Crypto Custody

Simply put, crypto custody means securing the private key that proves you own of the funds held within your crypto wallet. In traditional banking, all custodians are financial institutions, as required by law. With crypto, however, holders have the opportunity to become their own custodians. Using gold bars as an analogy, you can either store them under your bed to keep them safe yourself or pay a third-party custodian to lock them in a vault protected by security guards.

With that in mind, there are two main types of crypto custody for you to know.

Self-Custody

As discussed, self-custody is when you personally hold the private key for your own wallet. This means you are the only one who can prove ownership of your funds and access your holdings. With great power, however, comes great responsibility. Being your own custodian means having complete control over your wallet, but it also means you bear all the risks too. If you lose access to your physical device (cold wallet) or forget the private key, your crypto will most likely be gone forever.

Third-Party Custody

Those who do not want to take the responsibility of managing their own accounts or find it too intimidating to deal with the tech might want to turn to a third-party custodian. These are registered, regulated financial institutions that have acquired a state-level or national license to act as a custodian.

This type of crypto custodian holds clients' private keys to their wallets in a safe manner and ensures the security of their holdings. From the user's point of view, it is similar to having a checking account with a bank. When you register to open an account, you must undergo know-your-customer and anti-money laundering checks. When you store crypto with a third-party custodian, you'll be expected to complete the same sort of checks to make sure your cryptocurrency was not acquired through illegal means.

There are three different kinds of third-party crypto custodians based on the financial institutions:

Digital Asset Managers

As cryptocurrencies have matured as their own asset class there has been an emergence of digital asset managers that act like banks for crypto holders. These institutions, like banks, are regulated and licensed to offer crypto custody. Most notable native crypto custodians include Anchorage, NYDIG and Paxos.

Exchanges

All centralized cryptocurrency exchanges take care of their customers' crypto custody. Some crypto exchanges and platforms outsource their security needs to an external custody provider that safeguards the assets under management. In any case, it's worth knowing that when you set up an account and hold assets on a centralized exchange, you do not hold the private keys to your exchange wallet. This exposes you to potential losses if the exchange is hacked or disappears with users' funds.

Custodial Banks

Starting in July 2020, every custodial bank in the U.S. can custody cryptocurrencies, too, after the Office of the Comptroller of the Currency (OCC) cleared the way for all nationally chartered banks to provide crypto custody services. This opened the door for custody giants such as BNY Mellon, Citibank and Fidelity to enter the crypto custody market.

Note that some of the third-party custody providers (Fidelity, BitGo, Bakkt) are only available for institutional investors. Others may require a minimum balance so high that it excludes most everyday holders from accessing their services. For example, Coinbase's dedicated crypto custody service, Coinbase Trust, requires a whopping minimum balance of $500,000 in digital assets to qualify for its custody system.

Don't fret if you don't have that sort of money invested in cryptocurrency. Some custody providers have made their services available for retail clients, too. A few examples include:

- Gemini
- Nuri (formerly Bitwalla)
- Blockchain.com
- Casa

How Much Fees Does Third-Party Crypto Custody Charge?

As with any type of service, providers typically charge a number of fees for safekeeping your money, just as regular banks do when you have a checking or savings account. Moving crypto in and out of your account also can incur fees. These costs usually fall into one of the following three categories.

- Custody fee: Custodians ask for a certain percentage point based on the value of the assets under custody every year. This is usually less than 1%.
- Setup fee: a flat rate for opening a custodial account. It’s worth noting some crypto custodians waive the fee and let users open an account for free.
- Withdrawal fee: You might pay a fee every time you take crypto out of your account. This can be a flat rate or a percentage point of the value you withdraw.

As an example, U.S.-based Gemini has a 0.4% annual custody fee. The company waives the setup fee so you don’t have to pay to open an account but any withdrawal from the account costs $125, which is deducted from the crypto asset you withdraw.

If you choose to go with self-custody, you save on the custody, setup and withdrawal fees, but do not expect it to be free. The user has to take care of the wallet and buy a storage product to keep the private key safe.

Advantages And Disadvantages of Crypto Custody

When you’re weighing which crypto custody solution to choose, first consider your needs. The right option depends on what kind of investor you are, how much you hold and how familiar you are with technology.

Self-Custody

Pros:

- Your key, your coins: Only you have access to your account.
- No counterparty risk.

Cons:

- If you lose your key, you lose access to your coins.
- Your assets are not insured.
- If hacked, you can say goodbye to your holdings forever.

Third-Party Custody

Pros:

- The custodian takes care of everything.
- Easier access for beginners.
- Custodians have insurance on assets they manage.
- In some cases, you can earn interest from the crypto you deposit by pledging or lending from the third-party custodian.

Cons:

- The custodian controls your coins. It can freeze your assets, block your access to your wallet,or restrict withdrawals.
- Third-party risk: A custodian cango bankrupt or be hacked.
- Much higher fees.