THE TIME IS RIPE

Marcelo Prates, policy director, Stellar Development Foundation, spoke to OMFIF about why securities are ready for tokenisation and the benefits of public blockchains.

OMFIF: In which asset class do you think tokenisation could have the most transformative impact?

Marcelo Prates: After the tokenisation of money, notably the dollar, the time is ripe for the tokenisation of investments. Stablecoins in circulation have surpassed $200bn, and 99% are denominated in dollars. They effectively became the 'digital dollar' and are easily and instantly available almost anywhere. But although they can be used to protect against depreciating local currencies, their low-to-no-interest income makes them less appealing as an investment.

Securities are therefore the natural next step in the asset tokenisation journey. Contrary to assets that cannot be fully brought on-chain because of their physical presence and complex ownership rules, like real estate and vehicles, securities can be more easily tokenised with immediate benefits for issuers and investors.

For issuers, the reduction in bookkeeping and reconciliation costs is real. With its on-chain money market fund on the Stellar blockchain, Franklin Templeton, a global investment firm, cut its reconciliation costs for every 50,000 transactions from $50,000 to $120. With that, they could reduce the initial investment required for the on-chain fund to $20, greatly improving financial access.

In turn, investors not only gain increased access to investments not typically available at the retail level but can also trade shares instantly, 24/7. For some on-chain funds, like Franklin Templeton, institutional investors can even transfer fund shares directly between them, peer-to-peer, facilitating liquidity management and reducing intermediation costs.

OMFIF: Are there technical hurdles that still need to be overcome for tokenisation to achieve more widespread adoption?

MP: The biggest technical hurdle for widespread tokenisation is interoperability. Converting rights to an asset into a digital token on a blockchain opens up a world of possibilities, giving consumers more options to invest their savings and issuers, public or private, more options to secure funding.

If, however, issuers are using different blockchains to tokenise assets that cannot be easily and securely traded on other blockchains, consumers are forced to have multiple blockchain addresses and wallets. The process gets complex and costly, leading to increased risks (such as numerous private keys) and fragmented liquidity.

The problem is exacerbated with private, permissioned blockchains. These closed networks are created and controlled by a single party that can unilaterally define the applicable rules and arbitrarily decide what can be built on it, who can do so and whether there is any degree of interoperability with other networks. Public blockchains, in contrast, favour openness and interoperability, guarding against entrenched forces driving out competition and interconnection. Much like the internet, public blockchains are based on standardised protocols that facilitate the interaction between different systems.

While more work needs to be done to improve the development of cross-chain communication solutions, using public blockchains like Stellar is still a decisive step towards a more widespread and seamless adoption of tokenisation.

OMFIF: What about regulatory challenges? How are these unfolding?

MP: The tokenisation of securities in the US is already happening in a regulated way under the supervision of the Securities and Exchange Commission. In 2023, Franklin Templeton launched on Stellar the first US-registered blockchain-based fund. WisdomTree also has 13 blockchain-enabled mutual funds running on Stellar.

All these funds are registered with the SEC and governed by the same rules and regulations as other SEC-registered investment products. Moreover, Staff Accounting Bulletin 121, which effectively prevented banks from providing crypto custody, was recently rescinded. Despite these positive signs, a significant regulatory challenge for widespread tokenisation is the international standards developed by the Basel Committee on Banking Supervision for banks' exposures to cryptoassets.

The standard is set to be implemented globally by the end of 2025 and explicitly applies to tokenised securities. However, the standard leaves a lot of room for financial supervisors in each jurisdiction to decide the risk profile of each cryptoasset based on a varied and subjective set of requirements.

Therefore, applying the standard could lead to some financial supervisors treating tokenised securities as riskier than their traditional (non-tokenised) counterparts and requiring banks to raise additional capital in the same amount of their holding of tokenised securities. So, for each $1 in tokenised securities held, banks would have to add $1 in capital.

The fear of facing this highly punitive capital requirement could force banks to avoid any exposure to tokenised securities until they have more clarity on how supervisors will treat tokenised securities. Holders of tokenised securities could then have trouble using them for basic financial operations, like posting margin or collateral. This regulatory threat could slow the pace towards broader tokenisation.

OMFIF: What is Stellar's role in this?

MP: Stellar can be seen as the 'batteries-included' network for asset tokenisation. From the beginning, it was optimised for asset issuance and payments. So much so that asset issuance is native to the protocol. Instead of needing to use smart contracts to issue assets, as happens on Ethereum, asset issuance is just a basic functionality of Stellar. In practice, this means shorter development times, lower counterparty risk and less room for error, allowing tokenisation to happen quickly, safely and at a lower cost.

The Stellar protocol also comes with built-in features and controls for approving, revoking and freezing assets, ensuring precise asset management and distribution. Again, without resorting to smart contracts or additional coding, issuers can use trustline configurations to add business processes into the life cycle of the asset – like requiring users to get know-your-customer or anti-money laundering clearance before they can hold an asset.

So, while Stellar is an open and public blockchain, issuers can fully customise their assets and choose the degree of control they have over them according to compliance needs and regulatory requirements. And this is all transparent to users, who can view the profile of each asset and decide which ones they are willing to hold or use.

Finally, tokenised assets on Stellar are added to a global network of exchangeable tokens with over 475,000 crypto-to-cash ramps in 180 countries, making assets on the network globally accessible and useful.