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Understanding the impact of the blockchain on traditional finance

AMBRE SOUBIRAN
Kaiko

"There are opportunities opening up in markets that have been tougher from a yield perspective in recent years. Just to give you an example, if you go back some 18 months ago, yields on investment-grade European assets were 12 basis points. Now, these are close to 4%. That's a big difference."

Many people get confused between Crypto Currency and Blockchain - What is the difference?

It's very important to understand that blockchain and crypto are not exactly the same thing. However, they are highly intertwined. The way I like to explain blockchain is that it's a tripod, where you have three important components. A blockchain is a database that is maintained by a network, but that network in order to maintain the database needs to be financially incentivised. The cryptocurrency is the unit of account that is going to incentivise the network to maintain the database. So there are three things: a database, a network, a unit of account. That unit of account is what we call cryptocurrency, is what we pay transaction fees in, is what we use to pay block rewards in. A block reward or a transaction fee is money that is paid to the network for the creation of new blocks. A blockchain is nothing else than a chain of blocks, in which every block is timestamped and ordered chronologically. And every block represents a state of the world where contracts have been executed between that block and the previous one.

Blockchain technology is very powerful because the network that maintains the database, maintains blocks and creates blocks has nothing to do with the parties that are involved in the transaction. If I do a transaction with you, the network is going to execute that transaction, and then input the update, followed by the output of that transaction into the new block which has nothing to do with you or me. And that creates trust. That creates executed and quarantined contract execution between parties. But in order to do that, the network, like everybody in the world, has to be incentivised financially. It has to be paid for, and the cryptocurrency is what pays the network to maintain the blockchain.

Why is automated, disintermediated contract execution so important? It's important because it's to guarantee the fact that once you and I agree on the definition of a contract, the execution of that contract is going to be done in a cost efficient, secure, transparent way. This matters in

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every industry that heavily relies on contract execution. We can obviously think about finance, where everything is about contracts between parties. But we can think about that also in shipping. We can think about that in trade finance. We can think about that in real estate. We can think about that in art with collectibles. There are many industries where that industry is heavily reliant upon the execution of contract between parties, but where we want to make that more secure, and cheaper where we don't necessarily need people involved in the transaction to be involved in the execution of that transaction, because that creates conflicts of interest. So blockchain removes that conflict of interest element between the execution of a contract and the parties involved in the contract.

Why will we tokenise traditional assets?

Going back to what I just said, blockchain is about contract execution. But contract execution on what? Most contracts that we execute have an underlying asset that is referred to in the contract, especially when we think, for example, of the financial industry, generally, you'll have what's called an underlying asset. That can be equity or a share of a company, it could also be debt security, and it can even be a government bond. It can be any type of traditional assets that we use that is going to be the underlying of that financial contract.

But in order to leverage blockchain technology to execute the financial contract, we need those underlying assets to have an on-chain representation, and that's what we call asset tokenisation. Asset tokenisation literally means giving a physical form of that asset a digital representation of that asset onto the blockchain, so then we can wrap around it a contract. And for me, not unlike back in the migration to electronic trading where we had to digitise assets, we're not trading paper securities anymore today. We all have a digital representation of shares, equities, bonds, debt, and real estate, owning everything. In the same way that we had to digitise assets in order to move to electronic trading and benefit from electronic trading, we will need to tokenise assets to benefit from blockchain-based contract execution. And that will apply to equities, rates, bonds, SMEs, securities, real estate, arts, collectables, and any kind of assets.

What does this mean for the way we do things now?

What it means for traditional financial institutions is that they have an opportunity today to disintermediate their own internal processes that have lower human value-added, but still high friction points. An example of that would be today, in the workflow of a traditional capital markets service, you have the front office that is going to be structuring a contract, agreeing with the client. Then you'll have the middle office, then the back office, and then settlement agencies getting involved for a T+2 settlement of the financial contract. The front office, the structuring of the contract, and the client-facing operations are still extremely important and will remain.

Where blockchain provides an opportunity for banks to disintermediate their own internal workflow and value chain of the middle to back to settlement agencies. This is actually costing a lot of money to banks to maintain this setup. This is actually where human errors come into play. There's a lot of friction here and this is what causes delays.

For me, the opportunity for the financial industry with blockchain is a lot about operational efficiencies and about maintaining the whole

structuring part of the financial contract and disintermediating the execution of those contracts. So it is an opportunity to cut costs. It is an opportunity to streamline the way contract execution runs in the financial industry in a more secure and transparent manner.

2022 had its challenges for this industry. What's next?

2022 indeed had challenges. However, I think it is, short-term painful, and long-term good. What we have seen is a bit of a cleaning up of the space. Very often when that happens, it has nothing to do with the blockchain as an underlying technology, and it has all to do with bad actors acting very often in bad faith or being a little bit too greedy with leveraging the asset class and trying to accelerate things faster. The problem with crypto is that it's a liquid, unregulated, 24/7 global market with a lot of emotions still involved in that because a big part of crypto is still very much retail-driven. Some people can leverage that and I think what we've seen in 2022 is a bit of a cleaning up of the industry where bad actors have been exposed. Because in a bull market, where prices go up, everybody's smart, and everybody can kind of free-ride a little bit. When the market crashes, where we're seeing bear markets, it exposes the bad actors. And I think that's exactly what happened last year.

I think it's good for the industry. We're seeing the good players being more involved in self-regulatory actions as well, and just becoming cleaner than the regulatory even ask them to, just to self-reregulate and prove the good faith in the industry. Also, all of the companies that are building and that is providing, especially on the institutional side, actors like us providing market infrastructure, and that is custodians, market data, tokenisation companies, people providing accounting services, audit services, all of these companies are actually trying to figure out, "How can we build more credibility into the space?" And that, I think, is positive for the industry.

2023 is a year where we're seeing high institutionalisation. There is not a single financial institution globally that doesn't have a digital assets team today, so that proves the interest in the technology. And then, all the actors that are addressing that segment of the industry are here providing services and building. 2023, for me, is a year of build and consolidation for the good actors that are kind of still standing today. ■