

The benefits of a token gesture

Paul Fisher explains what tokenisation is and how it might be used in the financial sector to improve liquidity and solve problems in trading transactions

Tokenisation is the new fashion in finance. Hardly a week seems to go by without a new asset being tokenised somewhere by somebody. So what is tokenisation and why would anyone want to use it?

The basic idea is simple. Suppose one wants to trade an asset that, in its pure form, might be awkward to buy and sell. Dining room chairs could be an example. Taking or making delivery would be inherently awkward, not to mention the risks of breakages. But one could get an exposure to chairs by trading the shares, and/or the debt, of chair manufacturers or retailers. Other options would be subscribing to a fund that invests in chairs, or buying an asset-backed security (ABS) that references underlying chairs, depending on one's level of risk management. One could even trade a derivative of the chair price.

But what if the chair-makers are not publicly listed and so not tradeable? And the problem with ABS or funds is that the chairs are all different and one doesn't really know what style or quality of chair is being held as backing. And derivatives are not within every investor's mandate.

Fintech offers a way around these problems in the shape of tokenisation. Tokens are not new – examples include casino chips and the data tokens used in payments that stand in for sensitive information.

What makes the fintech approach to tokenisation particularly useful is the use of digital ledgers. An electronic token issued on a blockchain can uniquely and legally represent an asset, in this case a chair. Then one can trade the tokens – and hence the specific chairs – electronically.

However, the blockchain is necessary but not sufficient. To make this market work, ideally the following also have to be in place:

1. The underlying asset is of a requisite standard to qualify for subsequent use as collateral.
2. There is a robust opinion that the token represents one-for-one legal title to the asset.
3. Proper investment screening, anti-money laundering, know your customer and secure onboarding are done.
4. There are no impediments to subsequent trading (secondary and [repo](#) markets).

5. The token is available, via public blockchain, for market participants to access freely after on-boarding.

These problems are all solvable with the use of new technology. Note that these tokens are simply a digital, one-for-one, representation of the tokenised asset; they are not a 'crypto-currency'. One might wish to pay for the tokens using either fiat money or crypto, but that is more a matter of preference for those on each side of the trade and the supporting payments systems.

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Regulatory underpinning also helps and, in the recent [Treasury Asset Management Taskforce Report on UK Fund Tokenisation](#), a Financial Conduct Authority executive director concluded “that there are no significant regulatory barriers to adoption in the context of industry's blueprint model for tokenisation”.

Liquidity gains

As with all new constructs, the fundamental question to ask is not 'what is it?' or 'how does it work?', but 'why do it at all?'. What are the unique benefits of tokenisation relative to other investment and trading methods?

Apart from our example of simply making chair-trading more efficient, the fundamental answer is in the liquidity properties of the token. Not only is it cheap to issue, and readily tradeable, it could also be used as collateral in a repo. As long as the chairs are of sufficient quality (for example, perhaps with an AAA rating) and the price is readily determined, not excessively volatile, and the token is easily traded or redeemable, there is no reason why any token of anything could not be freely used as collateral.

That is not true of many traditional, existing, high-quality financial assets where their construct makes it difficult to transfer ownership or pledge them in a standard repo, such as money market fund holdings.

This matters most in a financial crisis. In a liquidity crisis, cash becomes king. Downward spirals can occur because asset



holders have to sell their best quality assets to meet margin calls – and falling asset prices mean more margin calls in a vicious circle. In recent years, we have seen at least two such episodes: March 2020 globally amid the pandemic crisis, and in September 2022 in response to the UK’s [‘fiscal event’](#).

One way such crises can be minimised is if the relevant asset-holders can repo out assets, for cash, to banks. If the banks themselves feel liquidity-constrained, then central banks stand ready as lenders of last resort to the banking

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system, which they should freely do against good-quality collateral. At every stage in that process, the availability of good-quality collateral and the ability to use it are key. Not every big market participant on the buy-side is active in traditional repo. Many pension funds and others are limited in what assets they can hold.

Tokenisation could help alleviate these liquidity problems. If banks, and ultimately central banks, are happy to accept tokens representing high-credit quality instruments as collateral – and there is no reason why they shouldn’t be – then the universe of liquid assets could be rapidly expanded. While the set of assets recognised by regulators as high-

quality liquid assets is quite broad, not all of it turns out to be as liquid in a crisis as it should be.

In a real crisis, only the highest quality assets can be sold – that is high-quality sovereign bonds, gold...and not much else. Tokenised assets of good quality, including for example underlying AAA money market funds, should be acceptable either for outright sale or preferably as collateral.

A match with digital currencies

Markets welcome anything that reduces transactions costs, and tokenisation could also help with that. Not only can issuance be cost-effective for both investor and issuer, tokens could dovetail with new payment, settlement and custody systems that are equally efficient. And, although tokens do not rely on crypto currencies, they should be a suitable technology match for either private or centrally bank-issued digital currencies.

Whereas crypto currencies are sometimes described as a digital technology looking for a problem to solve, tokenisation has fairly clear immediate benefits in improving liquidity and market functioning. ■



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