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Tokenised securities and the future of settlement

Distributed, “tokenised” securities could be the future

For years, financial authorities have warned the general public about cryptoassets’ severe price volatility and consequential lack of safety. Yet the underlying distributed ledger technology (DLT) could have useful applications. Although cryptoassets and stablecoins focus on creating new types of money and means of payment, another area being explored is for securities and their settlement (Bech et al (2020)).

Today, most securities are book entries, with their ownership electronically recorded at some entities. The most common setup is an indirect holding system, where an intermediary (such as a custodian bank) holds securities on behalf of its clients with central securities depositories (CSDs). This arrangement, where securities are transferred through “book entries” across accounts at a CSD and intermediaries, minimises the management of information by CSDs, yet also fragments ultimate ownership records. This can add complexities and costs for end users.

The technology underlying cryptoassets could help through “tokenisation”. A number of projects around the world are transforming securities into digital tokens – representations of value not recorded in accounts. This would mean that, in the future, equities and bonds could exist on distributed ledgers held across flat networks of owners. This could make ownership records more transparent and settlement much faster.

Yet tokenisation is not that simple

If this sounds too good to be true, it is. Not only are there technological challenges to tokenising securities, but serious trade-offs in the management of risks. Although ownership records can be distributed with DLT and some functions automated with “smart contracts”, transactions still need to be validated and updated by all parties, rather than centralising these processes at CSDs and big intermediaries. Intermediaries do not just play a purely operational role either; they smooth trade flows and provide credit, making settlement more efficient overall.

Faster settlement is not without its challenges, or costs. A traditional settlement cycle (eg T+1 or T+2) allows more participants to trade and reduces the amount of securities that market-makers need to store in inventories. Faster settlement could also increase the likelihood of trades not settling, resulting in time and effort resolving disputes about failed settlements.

And the future is likely to see a transition, not a big bang

Tokens and DLT offer a number of benefits for securities, but they come with costs. It is therefore very unlikely that a large-scale coordinated move will take place any time soon, or simultaneously. Therefore, as new assets and securities become tokenised, they will need to interoperate with existing account-based cash and securities systems. The more open and interoperable a tokenised securities system can be, the better. ●