Corporate insights: why digital assets will level the playing field in global finance

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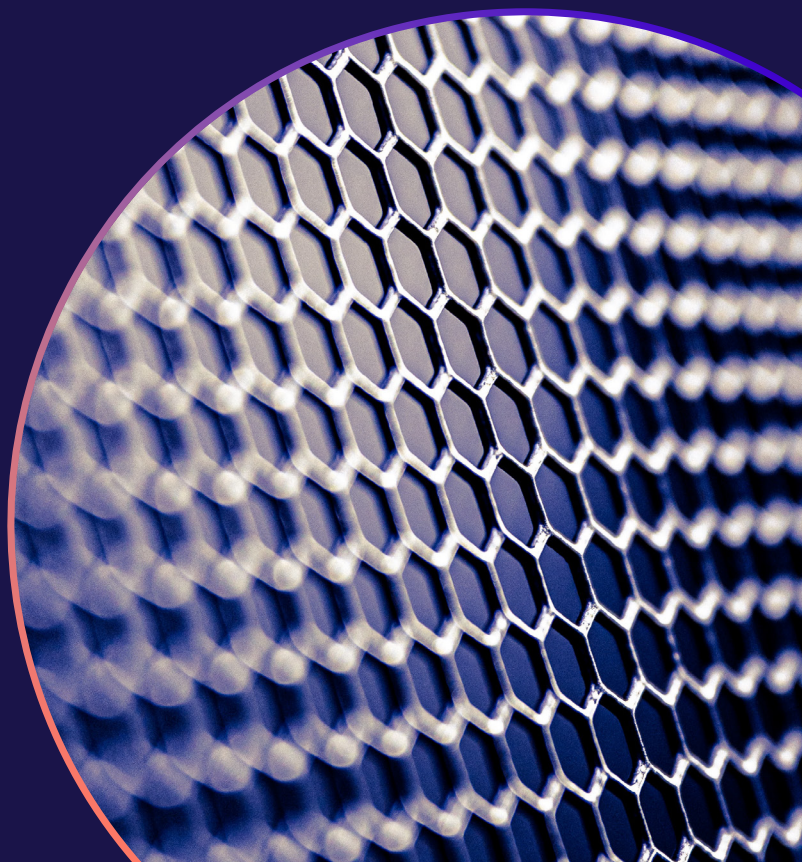


Ledgermatic

Seismic shifts: why digital assets will level the playing field in global finance

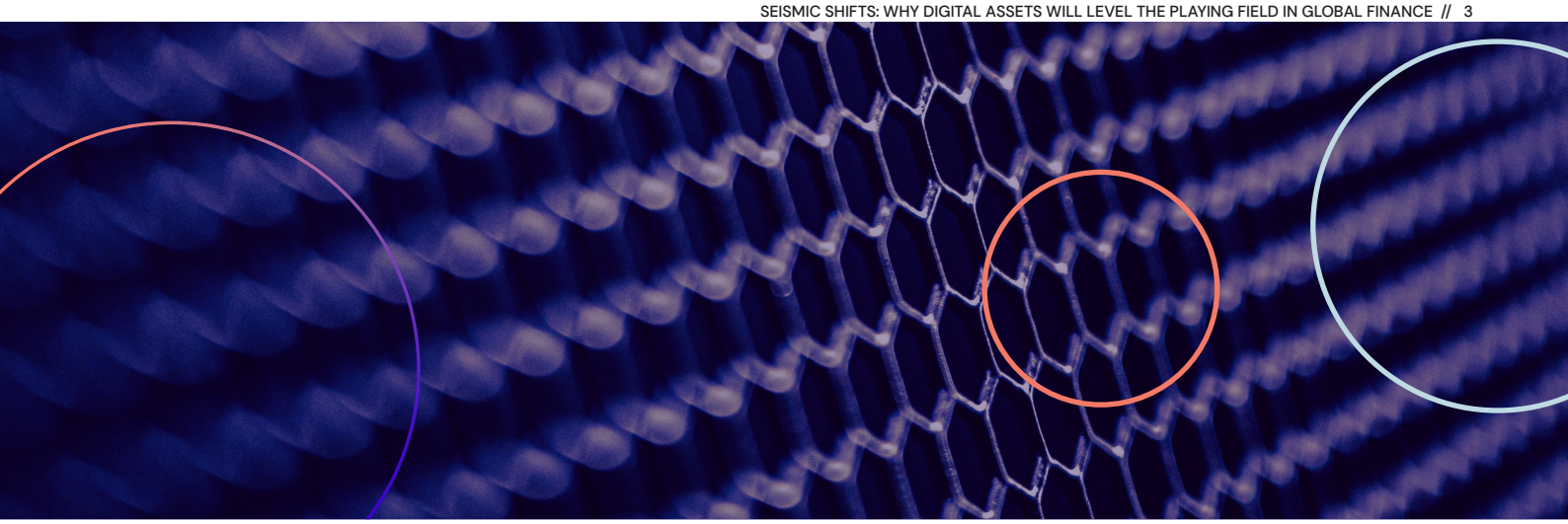
Executive summary

The new era of the monetary system is here—and the fastest businesses to embrace change will be poised to seize competitive advantage.

Finance is evolving towards a programmable, decentralized world, causing friction with traditional power centers. Regulations have yet to adapt, with outdated rules applied to emerging technologies.

This phase won't last for long. The inherent tension between these new technologies and the entities large enough to influence policy will soon resolve itself through the emergence of real-time access to markets, products
and services.

At the cusp of monumental change to the world's financial landscape, how can corporate America embrace the opportunity? The answer is blockchain-based peer-to-peer financial systems, which offer businesses the chance to create and deploy assets faster than ever before, find new sources of liquidity, yield and credit, and enable more effective approaches for managing risk.



Introducing a radical new paradigm

It has been 50 years since the US exited the Bretton Woods system—transforming the dollar into the global reserve currency and firing the starting pistol on a fundamental transformation of the global financial system. The last five decades have seen faith in the supply and price of the gold standard as the ultimate source of value cease, and in its place a growing reliance on central banks as the final arbiter of fiscal policy.

A new phase is emerging that has profound implications for global trade. The first signs of change are already visible: financial products and services are being decentralized away from banks, and programmable debt and liquidity is proliferating. In the same way that YouTube democratized content creation, blockchain and cryptocurrency networks are likewise disintermediating financial products and services. Algorithmically driven peer-to-peer markets are shifting control away from banks and into the hands of their clients. And because the cost of participating in these new markets is practically zero, the opportunities for financial inclusion are growing.

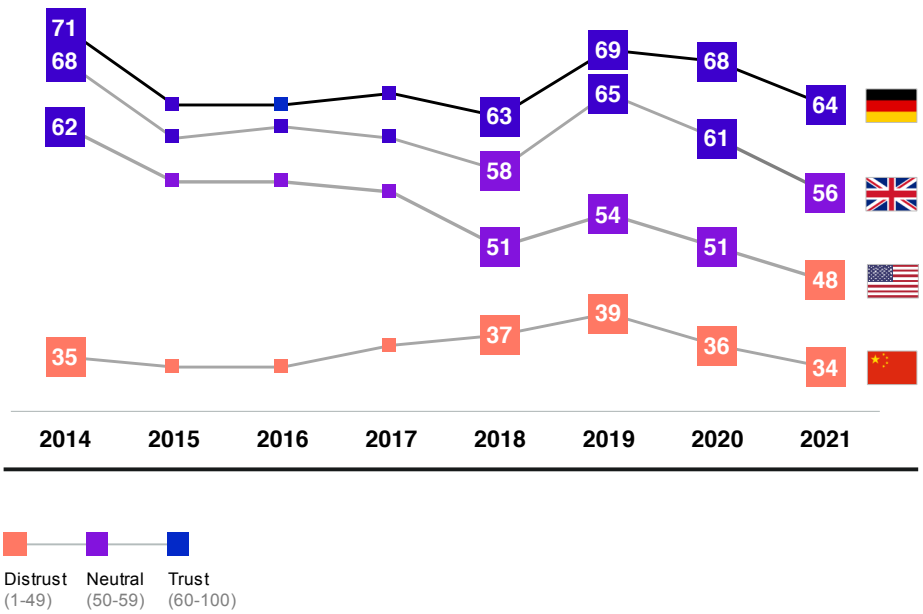
In the last 20 years, the number of banks in the US has halved from 8,200 in the year 2000 to 4,377 in 2020[1]. With banks now permanently on the decline, the democratization of banking and the emergence of alternative structures has begun. While regulators are still applying rules that assume that only banks control risk and are the principal regulated entities—they will ultimately be forced to adapt to the new reality.

Ledgermatic sees that over the next 20 years, successful businesses will all have something in common: they will have embraced this new wave of financial products and services early on, enabling them to engage directly with markets and constituents and to deliver value.

1 https://banks.data.fdic.gov/explore/historical?displayFields=STNAME%2CTOTAL%2CBRANCHES%2CNew_Char&selectedEndDate=2020&selectedReport=CBS&selectedStartDate=1934&selectedStates=0&sortField=YEAR&sortOrder=desc

The trend has already started. According to the Edelman Trust Barometer, companies headquartered in the most economically powerful countries in the world are losing the trust of their constituents[2]. In response, businesses all over the world are acknowledging progressive cultural, social and environmental discourse in their mission and vision statements—realizing that to do good and be good is instrumental to the financial success of their companies.

Percent trust in companies headquartered in each country



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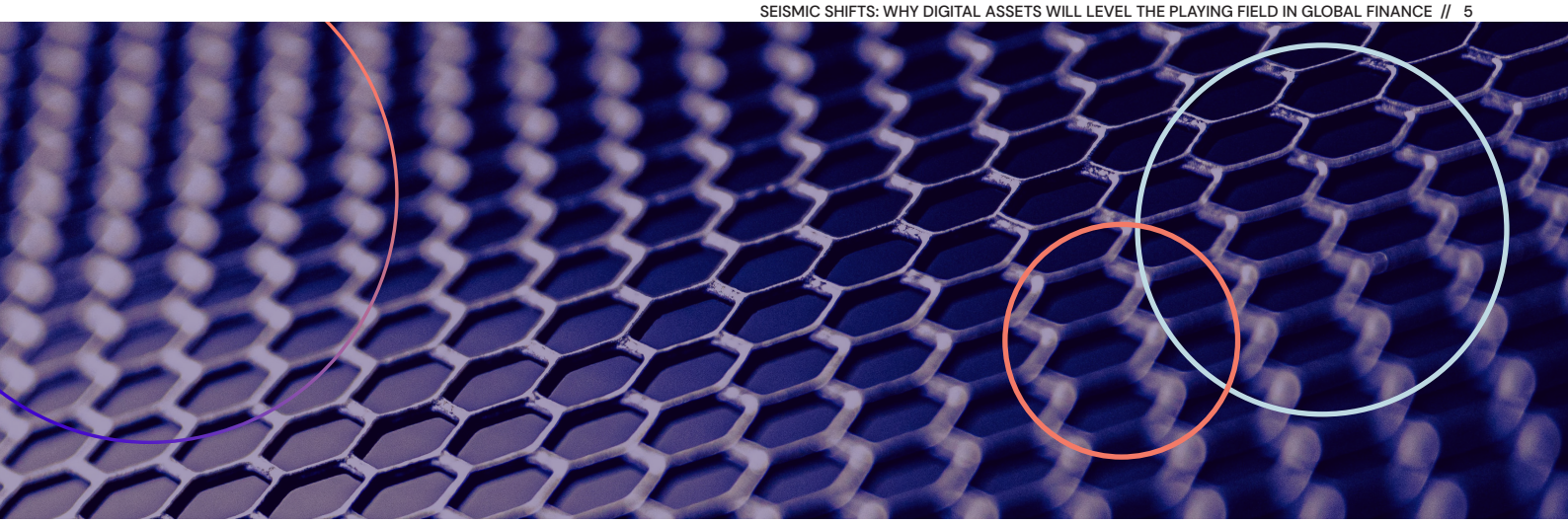
https://www.edelman.com/sites/g/files/aatuss191/files/2021-01/2021-edelman-trust-barometer.pdf



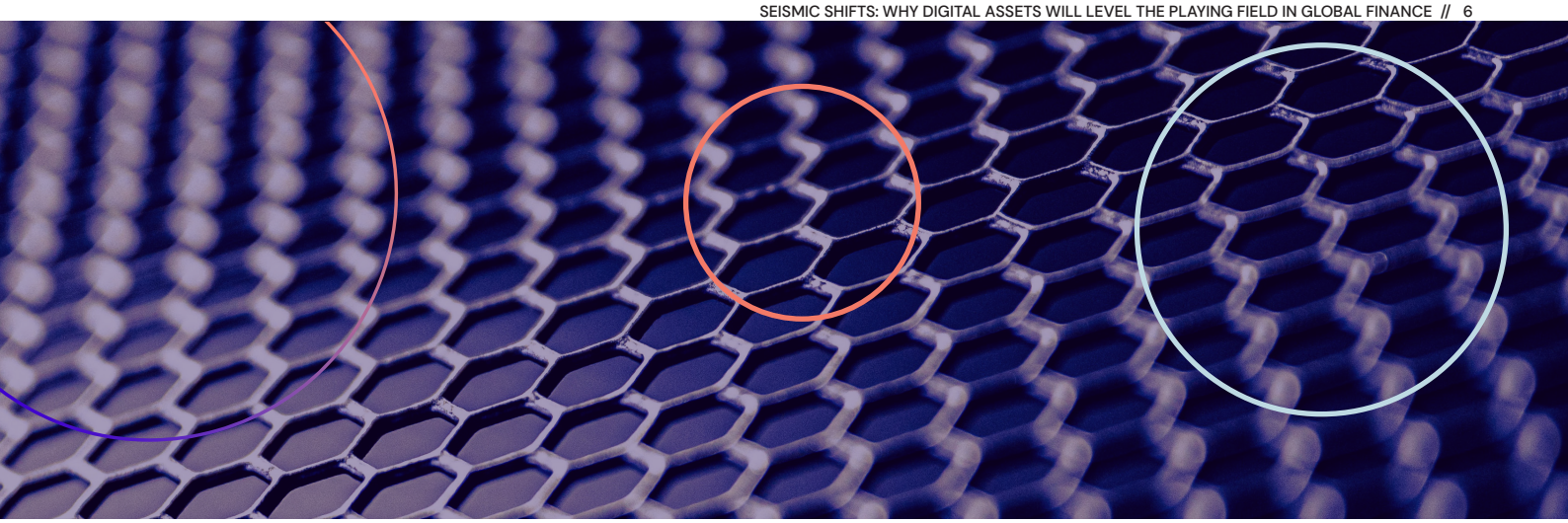
Digital asset infrastructure = transparent finance

Through digital asset infrastructure, companies have a unique opportunity to address trust problems through transparent finance. As companies adopt more sustainable practices and environmental, social and governance (ESG) criteria grow in importance, digital asset infrastructure can help businesses to measure and promote their positive impact on the world, inspiring greater trust.

Transparent finance equates to transparency of information, methods and services, leveraging the core facets of a peer-to-peer system for immutable data capture, fraud reduction and auditability on a real-time basis. This data can be captured, shared and reported on as a key business metric.

Organizations that leverage transparent finance will increase accessibility to their services, reducing economic inequity for a global audience.

Finally, transparent finance enables more effective risk management, helping organizations identify, unbundle and price risk more accurately.



Harnessing the asset creation economy

The global demand for assets is outstripping supply. However, until now, creating an asset has been a complex process, combining legal, accounting and finance expertise. Also, traditional safe assets (advanced economy, government-backed assets) are dropping as a percentage of global gross domestic product (GDP), from 70% ten years ago to an estimated 45% of global GDP today[3].

The growth of Bitcoin and its contemporaries, as well as extensive new tokenization initiatives, are democratizing asset creation by enabling the creation, pricing and transfer of assets in a fraction of the previous time and cost. As a result, the digital asset ecosystem is currently supplying new assets into the economy at an increasingly rapid rate.

Irrespective of the risk and quality of assets, liquidity is pouring into these markets. For example, according to a Goldman Sachs report, it is estimated that two new digital asset industries, the NFT and Defi market, have a combined value of USD 200 billion. This dwarfs the USD 80 billion in emerging market investment grade issuance in 2020.

Newly generated wealth, capital market flows and retail investors are all finding asset prices attractive compared to traditional safe asset classes. Companies have started to explore asset purchasing, diversifying their holdings with digital assets (Tesla, Microstrategy and Square are prime examples of the 'Bitcoin on the balance sheet' use case) and leveraging yield opportunities. Tokenization will allow companies to leverage assets that are traditionally deemed illiquid, since they do not have to rely on banks for valuations.

Ledgermatic believes that the larger opportunity for organizations, particularly where asset creation is bureaucratic and costly, is to also become asset creators. By taking advantage of the speed of value creation and transfer plus liquidity opportunities, these companies can drive growth and shareholder returns.

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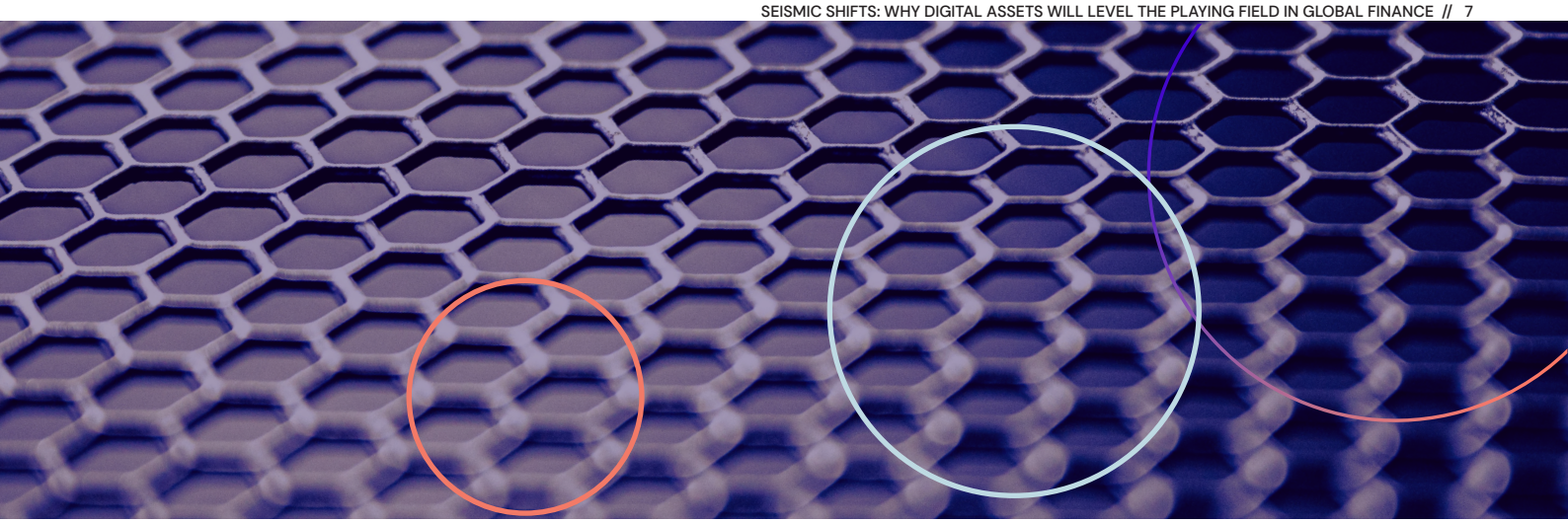
https://spe.org.uk/site/assets/files/7410/3_safe_assets_essay.pdf



Changing the game

Globalization means that there are no new markets in the world, only new financial systems. In a networked economy, Ledgermatic sees that blockchain-based peer-to-peer financial systems will emerge as the pre-eminent global value creation and transfer mechanism—and to gain a competitive advantage, companies must embrace the new way of working.

The advantage of a blockchain-based approach is that it offers the advantage of settlement finality through end-to-end transparency. Many companies are already adopting the concept of in-house banking, a newly devised service where organizations have a single bank account globally per currency, shrinking their banking relationships and reducing foreign exchange exposure. Peer-to-peer systems are the next logical step of this evolution.

Peer-to-peer systems will bring a wide range of benefits for early adopters. For example, organizations will be free to build more advanced treasury strategies, allowing them to use their balance sheet to build their businesses, rather than leaving assets depreciating. Since cryptocurrencies mirror the political neutrality of gold, they democratize access to value. By reducing transaction times with a peer-to-peer model, participants lower counterparty risk.

We explore some of the key use cases and options for asset creation below.

Balance sheet liquidity

Large companies can use cryptocurrencies and network tokens to conduct real-time, intercompany netting and settlement. Rather than setting up intercompany loans or liabilities with all the complexity that entails, companies can repatriate assets in different geographical regions simply and cost-effectively. They can do this via internal, fiat backed treasury tokens or in-house banking, payments on behalf of (POBO) and collections on behalf of (COBO) structures replicated with digital asset virtual, pooled or segregated wallet infrastructure. As a result, they can more easily meet month-end requirements, satisfy capital controls, or fulfil reporting purposes.

Companies can move to a just-in-time model for foreign exchange swaps, rather than processing these transactions in bundles. They can leverage crypto exchanges as a new form of foreign exchange conversions, yielding immediate liquidity.

Companies seeking yield

The explosion in crypto-yield products offers companies a novel product both to hedge against and repay US dollar debt. The mechanism offers attractive short-term rates (up to 90 days), leveraging an increasingly sophisticated and buoyant trading market to ensure such yields can be offered.

Typically, 5-12% yield is offered in US dollars (or the crypto dollar equivalent), often collateralized by Bitcoin. Bitcoin is globally accessible, highly liquid and can be held directly or indirectly, lowering the barrier to entry.

In this context, companies can buy Bitcoin with cryptocurrencies, US dollars or local currency to use as collateral to generate USD-denominated yield, with the option of returning the Bitcoin, holding it as a potential long-term investment or selling it once the yield has been secured. Companies that trade internationally can also receive payments in USD-denominated stablecoins to reduce their currency mismatch and funnel into short-term yield positions.

With a peer-to-peer approach, companies can conduct more dynamic price discovery with more parties. They can participate in syndicated on-chain lending, enabling better returns than traditional interest-bearing accounts.

Companies seeking credit

By embracing this new approach, businesses gain access to money-market type liquidity. With more tokenized assets on their balance sheet, companies can more easily leverage them as collateral. They can approach other lenders strategically aligned with their business and agree better credit terms.

Rather than waiting on banks for credit decisions, companies can access public data to find new credit opportunities at better interest rates. As peer-to-peer bond markets develop, this effect will increase over time.

Unbundling of risk

Via blockchain-based peer-to-peer financial systems, companies can unbundle risks rather than relying on the catch-all inaccurate approach favored by banks. Specifically, digital assets enable users to separate out risks and manage them programmatically. This enables organizations to identify and unbundle risk into its individual parts. When companies can accurately identify risk, they can price and manage it more efficiently, making them more competitive and profitable.

With digital assets, interest rate risk, foreign exchange, geopolitical risks, settlement and counterparty risk can all be managed programmatically and at a reduced cost. For example, you could tailor your strategy to a desired level of exposure to foreign-exchange volatility or supply chain fluctuations. Moreover, they enable companies to move away from service offerings available in a single geography to a globally accessible platform. In fact, political risk pricing is all but eliminated from digital asset pricing, as the sovereign spreads and subsequent discount rates do not apply. These two factors ensure that cryptocurrencies are relatively insulated from geopolitical risks, though not from regulatory risk which is not priced into digital assets.

The immutability of a blockchain-based financial system reduces risk by decreasing the possibility of fraud or errors. Companies can also conduct self-verification, eliminating the fees associated with third-party vetting of the authenticity of financial information.

Emerging markets, US dollar debt and the digital asset opportunity

In emerging markets around the world, restrictive local banking services limit private sector competitiveness. Payments are expensive and slow, further protected by capital controls imposed as regulatory measures to protect the position of domestic banks. Similarly, gaining access to credit is costly and complex. The treasury conundrum for companies operating internationally and facing this situation is therefore even more complex to manage.

US dollar debt is global debt

Increasingly, US dollar debt will be serviced with US dollar crypto equivalents. As the advantages of speed of deployment and settlement are better understood by companies, we believe this will be one of the key use cases for rebalancing regional economies towards digital assets. In 2018, the BIS estimated the total stock of US-dollar-denominated debt held by non-banks outside the US at $11.4 trillion. In 2020, that number had grown to over $12 trillion, 14% of global GDP, with the USD contributing to over 60% of the debt[4].

Turkey is a prime example of a country faced with dramatic USD debt. 40% of all Turkish debt is denominated in US dollars, borrowed by the Turkish Central Bank and passed onto Turkish businesses, which then converted that debt into lira.

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Source: BIS Global Liquidity Indicator

In the last five years, the Turkish lira has lost 65% of its value against the US dollar. In response, the Turkish Central Bank borrowed more US dollars to buy lira to stem the depreciation—making imports more expensive and creating a currency mismatch between inflows and outflows on companies' balance sheets. As the BIS noted in a 2018 study, corporates that issue US dollar debt and/or build cash balances using US dollar debt are vulnerable to local currency depreciation. Corporate distress, driven by local currency depreciation against US dollar debt, is now a consistent macro-economic theme.

For businesses in emerging markets faced with USD debt, short-term hedging is not always accessible, since it is predominantly used by large companies that leverage foreign exchange derivatives contracts and strong relationships with banks to negotiate rates. For small and medium businesses without that influence or infrastructure, much of their debt remains unhedged, offering significant opportunities for USD denominated digital asset services.

The ability to earn yield in USD to pay off or hedge existing US dollar debt will be a highly attractive value proposition for companies in emerging markets. In future versions of digital asset applications, we believe that the underlying technology and growth of the ecosystem will further stimulate more direct firm-to-firm lending. This will create a more dynamic, accurate and inclusive global market for short-term lending to fund business growth, particularly for unhedged assets.

Inflationary pressure and the impact on stablecoins

While the value proposition for stablecoins is certainly compelling—using the fast issuance and settlement times to transact globally—the underlying national currencies that stablecoins are pegged to are invariably subject to central bank influence. This exposes the asset to inflationary pressures which undermine its purchasing power and 'stable' value. The specter of inflation casts a shadow over this emerging asset class.

The challenge for the digital asset industry over the coming years is to identify a stable asset value that is politically neutral and out of reach from central bank influence. For those companies and institutions that are digital asset native, there is ever growing demand for this type of asset to underpin their operations.

Gold remains the obvious choice, but a digital version has yet to fully find its place in the digital asset arena. Ledgermatic posits instead that composite tokens, representing a basket of assets, is the closest representation to a stable value set outside of political influence. The asset mix could take many forms; from public network tokens to protocol tokens or commodity/crypto mixtures.

Ledgermatic believes this is the next most obvious step in the evolution of stablecoins and one that will grow in demand as native digital asset businesses grow in numbers and stature.

Conclusion

For companies willing to embrace technology and manage risk proactively, digital assets provide a once-in-a-generation opportunity for businesses to level the playing field. The rebalancing of many financial systems towards a direct peer-to-peer model can eliminate the cost and time involved in using banks as intermediaries, unlocking greater agility and choice. This paper has explored just a small fraction of the use cases for which this new approach can yield immediate benefits.

Inaction is not an option. As the world's financial landscape shifts, companies must take proactive measures to ensure that they come out on top.

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