THE EVOLUTION OF PRIVATE BANK TOKENS

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The future of money lies in decentralization and tokenization. The concept of digital currencies is not simple, however it is possible to categorize them into 3 basic groups; electronic money – which does not change the value of the fiat currency (eg. prepaid cards, electronic purses), digital money - which is issued by its developers, has intrinsic value and used in a specific virtual community (eg. bitcoin) and stable coins - which are privately issued by regulated financial institutions, exist alongside cash and have different measurable valuation methods (eg. bank tokens). The purpose of this paper is to provide a framework for issuing private bank tokens and integrating them into digitized trade finance platforms by outlining specific recommendations and potential challenges. The last section provides the key points that the prospective issuers should take into consideration regardless the tokens are issued only as a private currency or as an integral of a digital trade platform. The analysis was conducted by collecting a mixture of data through interviews with finance professionals and research.

1. Framework for Tokenization

a) Regulatory License

The primary step is to provide safety and credibility to the users and ensure that;

- the tokens meet the local and international legal claim standards of existing commercial money and other forms of payment types with regards to;
  - → money movement (Anti Money Laundering & Combatting Terrorist Financing)
  - → banking transactions (deposit taking, money transfers)
  - → investment trading
- jurisdiction about the cross-border payments are clearly identified
- token reserves are held at Central Bank to meet customer demands
- token reserves and bank notes can be swapped
- there is a protection scheme for token deposits
- privacy and data protection rules are clearly set

b) Design

The collateralization of bank tokens can be myriad, the major two of which are fixed (in one currency or a basket of different currencies) or variable redemption value (a share of a portfolio of underlying assets). <u>For the initial stage,</u> the author suggests to keep the volatilities associated with any private bank token at minimum and recommends to make a valuation by

- pegging the token to a single currency 1:1
- covering only wholesale payments and cross border payments
- commencing to operate in one country or selected countries
- being redeemable <u>at par</u> for customers & non-customers (free of any additional fees)
- being converted into fiat at any time

c) Governance

Bank tokens have the potential to allow a single financial institution to play multiple roles as market maker (issuing the tokens), trading platform (creating the platform on which tokens can be transferred) and custodial wallet (storing them). In order to provide maximum security and privacy, the author suggests the issuer to set a robust governance by;

- having its own blockchain infrastructure for tokenization rather than using an existing blockchain,
- using a private, closed and decentralized network
- outlining the recovery procedures (how the system reacts to large scale hardware / software failures such as outage of electricity and data networks, if there will be an offline payments functionality, etc.)

2. Integration with Trade Finance Platforms

Bank tokens can enable instant and secure payments, eliminate manual processing & intermediary costs and reduce counterparty & settlement risks for the clients. From the issuers' perspective, in addition to those advantages, they might offer the potential to create a closed loop for retaining customers and deposits as well as decreasing capital requirements.

Blockchain allows to combine trade finance and tokens with use of smart contracts and enables payments to occur according to certain conditions. The roadmap for integrating private bank tokens into a trade finance platform is not clear-cut. The benefits should outweigh the risks and costs whether the token is adopted by an operating trade platform or the issuer chooses to create a new trading platform. In this context, the author suggests that;

- Regulatory path must be clear and strategic decisions should be in place to provide answers to below questions;
    - → How will the issuer maintain the liquidity to convert tokens back to fiat any time? How are the funds allocated to tokens going to be ensured? Will they be placed in a separate account?
    - → Will the tokens be allowed to be extended as loans?
    - → Will the tokens bear an interest?
    - → Will the tokens be eligible for investment?
    - → Will the tokens be convertible to other coins / tokens?
    - → Will there be a preset number of tokens? Will the tokens be burned as they are converted into fiat or will they be replaced?
    - → Will there be limits on the number of tokens that can be held by a single client?
    - → Will the tax aspect be parallel to existing forms of payments?

- Creating a new trading platform would be costly, time consuming and difficult to scale. Existing trade platforms are composed of different banks, companies, and APIs thus having all members on board to use a private bank token might be challenging. In addition to benefits of using tokens stated in the beginning of this section, the users might seek to be incentivized with higher returns or tax advantages.

- The token transactions would highly involve the issuer's credit and liquidity risks therefore the issuer bank's B/S strength, rating, compliance policies and regulatory oversight would be key determinants for the users.

Key Points

Whether the tokens are issued only as a private currency or integrated into a digital trade platform, some of the additional key points would be as follows:

- If significant deposit balances are moved to tokens, it could have implications for shrinking the balance sheet of the bank as well as the amount of loans that can be extended.
- Large corporates are usually risk averse and most of them have slow decision-making processes. SMEs might be more adept to switch to a new form of money as they are more flexible, agile and decisions are taken easier compared to large companies.
- The demand for the token should be tested and the issuance should take place incrementally. As the transactions are adopted, multi-currency or variable redemption values might be considered.
- Central Bank Digital Currencies (CBDC) & Bank Tokens can be considered as substitutes. CBDCs could reduce the demand for bank tokens as they are able to provide better payment services and backed by risk free central bank money. Introducing bank tokens prior to the launch of CBDCs might would give issuers competitive advantage.

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