



## The art of the possible

*While not providing a silver bullet, the application of technology to specific pain points offers potential for major efficiency gains in securities finance. Carmella Haswell reports*

Distributed ledger technology (DLT) has been expanding in the financial marketplace and is making its way to the world of securities lending. The transactions that are being facilitated in the market today by DLT platforms are taking place between highly regulated institutions in highly regulated markets, and in very high value transactions.

DLT refers to the protocols and supporting infrastructure that allow computers in different locations to propose and validate transactions and update records in a synchronised way across a network. Market participants that took part in an Acuiti report in November expect the technology to bring the industry major efficiencies to trade settlement, trade reconciliation and custody.

Guido Stroemer, CEO and chairman of HQLA<sup>X</sup>, emphasises that DLT in itself is not going to be the “silver bullet” that provides a solution to all problems in the market. However, it will be the “very precise and well thought out application of the technology to specific use cases and specific pain points in the market” that is paramount.

### Fit for purpose

Market participants at IMN's 28th Annual Beneficial Owners' International Securities Finance & Collateral Management Conference came together to discuss the importance and benefits of DLT as it relates to the securities finance sector.

HQLA<sup>X</sup>, in particular, makes note of the headwinds that the firm has heard from its beneficial owner community. Stroemer elaborates that owners sometimes face restrictions around the ability to reuse collateral received in securities lending transactions. DLT can facilitate additional collateral mobility that allows beneficial owners the ability to, for example, reuse collateral received into onward obligations, such as variation margin exposures.

Stroemer continues: “Tokenisation, broadly speaking, enables the decoupling of ownership transfer from movement of assets, thereby greatly enhancing the ability for users of DLT platforms to get the right collateral to the right place at the right time, without the need to actually move the security physically. It is just a matter of transferring the legal title, or the ownership rights of those securities.”

During the “Exploring Digital Assets and Distributed Ledgers in

Securities Finance” panel, EquiLend's Gary Klahr, director of strategic initiatives within the client relationship management team, also found that DLT can be harnessed to address pain points in the industry for the firm and its clients.

After a discussion with a number of EquiLend's clients last year, Klahr says that there was a resounding focus from participants in eliminating reconciliation through putting securities lending transactions onto DLT.

In terms of DLTs of data versus value, EquiLend analysed a proof of concept (POC) to ensure that the solution would mitigate the risks. The POC validated 1Source's ability to solve complex business operations, scalability and interoperability. The firm then had a successful POC on DLT, Klahr says.

1Source was pioneered by an EquiLend-convened digital transformation working group made up of market participants representing a broad cross-section of the industry, whose goal is to solve key challenges facing the market. The initiative harnesses emerging technologies such as distributed ledger to develop a single source of truth for securities finance lifecycle events.

The first undertaking of the 1Source initiative is to eliminate the reconciliation of securities lending transactions, which the working group identified to be the most pressing issue facing the industry.

“Ultimately, the environment today, where everyone books entries onto their own system and has traders go in and reconcile those, is incredibly inefficient. With 1Source, you can have your traders doing more value added work. This is a risk mitigation tool that can add value onto a trading desk,” Klahr informs.

When it comes to the application of DLT, it is imperative that the operating model, as well as the design features of the operating models, is fit for purpose from a regulatory and legal perspective, explains Stroemer. This supports market adoption for DLT applications by bank borrowers, agent lenders and beneficial owners.

“When the music stops and there is a failure in the system — where the counterparty goes down or a service provider is unable to continue providing services — there needs to be complete legal certainty in terms of who owns what, at any given time,” Stroemer indicates.

On the regulation front, Stroemer believes that a great deal of progress is being made. He emphasises the need for additional regulation in the digital asset space, predicting that an increasing number of service providers and fintechs will likely become regulated over time.

### Reaching T+0

As market participants explore the uses of DLT platforms, some question the role that DLT plays in facilitating the transition to shorter transaction settlement cycles, and specifically to T+0.

T+1 has been a subject of much discussion in the industry as the Indian market transitioned to the shorter settlement cycle in January, with the US planning to implement T+1 in 2024. While the UK government explores this step with a new taskforce, participants of the IMN panel look further afield to T+0.

Reviewing the SEC's ambitious agenda and whether it will trigger a necessity for the entire ecosystem to rely on blockchain and DLT, Ed Blount, founder and executive director of Advanced Securities Consulting LLC, says: "We do not need blockchains and digital assets to get to T+1. We do need it to get to T+0, possibly." Admitting that it may be impossible to get to such a shortened settlement cycle without reengineering workflows within the market system, Blount says "everything that we do is essentially an automation of the manual processes that took place".

He adds: "In the past, we have upgraded, automated and written programmes, but shared ledgers were never available to anybody before. Shared ledgers will be essential to make it to T+0."

The industry needs to think of DLT as a "foundational base" and from that, participants can grow the chain further, adds Klahr. He believes that the "art of the possible" will allow for 1Source to link to additional activities well beyond the scope of securities lending contract terms.

He continues: "Ultimately, 1Source is a foundational product, and while we don't know everything that DLT can do just yet, we know that it can fit the purpose for making businesses much more efficient in terms of the interoperability and the future state, you can clearly see the industry getting to T+0, you can see ALD faster processing through DLT. In

theory, for 10c-1, you can even have your data in a reconciled ledger, where the data is shared."

Reviewing other opportunities in the securities lending space, the panel evaluated the trajectory for crypto assets and its possible interaction within the sector.

Stroemer indicates that from recent market developments in the crypto space at the end of last year — which led to the crypto winter — market participants are taking a step back and realising that crypto assets are one thing, but the underlying technology that underpins them is a completely separate thing. "We should clearly differentiate between the two," he adds.

"What we are seeing in the market today is that there are some DLT platforms that are helping issuers issue securities directly on a ledger," Stroemer continues. "I certainly think there will be plenty of opportunities for that market to further develop, which means it will also need to be supported by the securities lending market."

Stroemer hopes that this will provide a great opportunity for an intersection between DLT platforms that support issuance of natively-issued securities on ledger and DLT platforms that support securities financing transactions of both natively issued securities and existing legacy securities. "I believe we will see some meaningful examples of interoperability across DLT platforms in the near term," he concludes.

Blount suggests that the supporting systems for bringing this technology into mainstream institutions will depend on the interconnectivity between the two. After attending a digital asset symposium last September in Manhattan, Blount left the conference with the takeaway that the connectivities are the vulnerabilities. Beneficial owners should be reviewing application programming interfaces (APIs) when evaluating a service provider that is using a DLT, "because that is where the hacks take place, it is the bridge between one chain and the other", says Blount.

In conclusion, Blount adds: "The future is inevitable, we will have digital assets. Central bank digital currencies (CBDCs) are already in progress. We will have stable coins, CBDCs and there will be applications. I think that this is the way to go. You find that application and then you digitise it, put it on a chain, get a smart contract to control the bridges, and then move the business onto those smart contracts and shared ledgers." ■