

Going digital

Appropriate regulation of digital payment could pave the way for the issuance of securitisations in stablecoins. However, as **Corinne Smith** reports, further standardisation across the blockchain ecosystem is needed for the technology to reach a critical mass.

The regulatory attention that digital payment is currently attracting – as exemplified by the US Fed’s recent report on central bank digital currency (CBDC) and the US SEC’s examination of the stablecoin market – has been welcomed by the securitisation industry. It is hoped that appropriate regulation of this sector will allow for greater adoption by institutional investors and pave the way for securitisation issuance in stablecoins.

The size of the stablecoin market is estimated to be over US\$150bn, while the ‘unpegged’ cryptocurrency markets – like Bitcoin and Ethereum – are over US\$3trn in size. Digital currencies are important to the blockchain ecosystem, as they provide a way of representing cash in real time. However, digital currencies can also introduce counterparty risk to financial transactions.

One way of minimising cryptocurrency credit risk is to use stablecoins backed by bank deposits.

For example, blockchain securitisation issuer Figure Technologies is a founding member of the USDF Consortium, which launched last month and aims to further the adoption and interoperability of a bank-minted dollar-backed stablecoin assured by the FDIC (see separate box). The consortium currently comprises five community bank members, but plans to significantly grow the membership base by year-end.

Meanwhile, with Cadeia’s recent GreyPeak 2021-1 blockchain securitisation, payment was executed in a fiat currency (Swiss francs) instead of a stablecoin to avoid introducing counterparty risk to the transaction (*SCI 7 December 2021*). “We’re waiting for central banks to introduce central bank digital currencies – CBDCs – which would make transactions even more efficient. Depending on the set-up, CBDCs could enable settlement within milliseconds of execution and ensure direct transfer from one wallet to another within seconds,” notes Rolf Steffens, co-founder and md of Cadeia.

The Fed’s report on CBDC, which was published last month, examines the potential benefits and risks of CBDCs and identifies specific policy considerations. In the report, a CBDC is defined as a “digital liability of the Federal Reserve that is widely available to the general public.” The report notes that unlike stablecoins, a CBDC’s value would not depend on an underlying asset pool for its backing. ►



Rolf Steffens, Cadeia

Further, the report indicates that if a CBDC were to be created, such a CBDC would need to be privacy-protected, intermediated, widely transferable and identity-verified, according to a Schulte Roth & Zabel client note. “While the report does not commit the Federal Reserve to any action, the report demonstrates the serious attention that financial government agencies and regulators are giving to digital payments (and the potential desire by the government to create its own form of digital payment),” the firm observes.

The Fed is requesting public comment on more than 20 questions on the benefits, risks and policy considerations for CBDCs, as well as CBDC design. Comments are being accepted through 20 May 2022.

The report follows one published by the President’s Working Group on Financial Markets (PWG) on stablecoins in November, which notes that “stablecoins, or certain parts of stablecoin arrangements, may be securities, commodities and/or derivatives.” As such, the report highlights a number of recommendations to address the

associated public policy challenges, with the US SEC and CFTC noting that they will deploy “the full protections of the federal securities laws” to these products.

Fred Matera, md and head of residential at Redwood Trust, welcomes the SEC’s examination of the stablecoin market to evaluate what types of regulation are best to protect investors. “Smart regulation would allow for more adoption by institutional investors,” he suggests. “We would anticipate that the regulatory regime would provide clear guidance by the time we are ready to tokenise mortgages and issue securitisations in stablecoins. As with all of our new products, Redwood’s approach will be to work closely with our regulators to help inform what the ultimate structure looks like and to ensure support.”

The firm’s current approach to using blockchain in securitisations is as a tool running in



Fred Matera, Redwood Trust

becoming ‘tokenised’ – in other words, issued in a stablecoin – which would allow for more efficient tranching and fractionalisation of risk.

Steffens says that financial assets – such as loans – are more straightforward to tokenise

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parallel with existing reporting to assist with disclosures and transparency, all within the existing securitisation framework. But Matera says that eventually, Redwood foresees securitisations

because all of the documentation can be executed electronically. But real assets, such as cars and real estate, require more human involvement – due to there being less standardisation in those sectors – and therefore they will likely take more time to be tokenised.

Matera accepts that applying blockchain to the more traditional aspects of the wider economy, like the mortgage market, is still in its nascent stage. He suggests that by introducing blockchain technology into Redwood’s existing residential jumbo securitisation framework, the firm is giving market participants a chance to vet the technology over time in a way that is safe and additive to their ability to collect relevant information.

“Currently the blockchain technology is additive to our traditional reporting and not in replacement of it. Overall, we believe that the technology can be helpful to the industry and, at Redwood, we have created an opportunity for blockchain to prove that thesis while simultaneously benefiting investors and market participants,” he explains.

In collaboration with Liquid Mortgage, Redwood last year became the first issuer to price a securitisation that used blockchain to provide this data (*SCI 23 September 2021*). This involves loan servicers reporting borrower-level payment

TOKEN STANDARDISATION

Digital services platform Cadeia has partnered with several parties to improve its offering, including with the International Token Standardization Association (ITSA). Constantin Ketz, co-founder and head of business development at Cadeia, co-initiated the non-profit association for the development of digital asset market standards. The association has over 100 founding members and has grown since inception to around 200 members, comprising banks, stock exchanges, law firms, corporates and start-ups.

Currently, ITSA provides three market standards: the International Token Identification Number (ITIN); the International Token Classification (ITC) framework; and Tokenbase, a database for digital assets. ITINs are nine-digit alphanumeric technical identifiers for DLT-based fungible and non-fungible tokens

that allow secure and transparent identification of digital assets, while also referencing other quantitative and qualitative information.

ITC is a token classification framework based on economic, legal, regulatory and technological specifications. Over 200 tokens – covering 99% of the token market by market capitalisation – have so far been classified according to the framework.

The Tokenbase is a database that combines token identification and classification data with market and blockchain data from external providers. It currently holds data on over 5,000 tokens, with third-party data integrated and API access in development.

As part of the cooperation, the three token tranches of Cadeia’s securitisation GreyPeak 2021-1 have been identified by ITINs and classified according to the ITC. They can be reviewed in ITSA’s Tokenbase.

activity for each securitised loan every business day to Liquid Mortgage, SEMT's blockchain provider. Liquid Mortgage then makes that information available to registered users on its reporting site the same business day.

"We believe that this inclusion of enhanced payment and prepayment reporting within the Sequoia (SEMT) securitisation platform is the first step on a path to putting an entire RMBS transaction on the blockchain. By leveraging the speed and accuracy of distributed ledger technology, we believe we can drastically increase transparency and reduce the points of friction in the life of a residential mortgage loan, including legal documents and contracts, diligence, reporting and data. For example, we believe the loan level payment reporting introduced for this transaction may provide greater insight into borrower payment and prepayment activity on a more frequent basis than is traditionally available," Matera observes.

Given the potential for such a wide range of applications, there is an opportunity for all securitised asset classes to be potential beneficiaries of blockchain technology, according to Matera. "Redwood has been a leader in securitising loans

BANK-MINTED STABLECOIN UNVEILED

The USDF Consortium is an association of FDIC-insured financial institutions that seeks to further the adoption and interoperability of a bank-minted stablecoin (dubbed USDF), which will facilitate the compliant transfer of value on the blockchain. The consortium was formed to meet the needs of customers demanding greater access to blockchain applications for payments and other transactions.

The consortium's founding members include Figure Technologies, JAM FINTECH, New York Community Bank, NBH Bank, FirstBank, Sterling National Bank and

Synovus Bank. USDF is an alternative to non-bank-issued stablecoins, minted exclusively by US banks and redeemable on a 1:1 basis for cash from a consortium member bank. The aim is to address the consumer protection and regulatory concerns of non-bank issued stablecoins by offering a more secure option for transacting on blockchain.

USDF operates on the public Provenance Blockchain. As such, in addition to peer-to-peer and business-to-business money transfers, banks and their customers will be able to use USDF for a wide range of applications.

the less manual intervention there is, the more savings can be achieved by using the technology. "Blockchain technology has come a long way over the last four years and is now becoming mainstream. Figure has executed three HELOC securitisations via blockchain and transacted with 100 different counterparties – from small

system or, alternatively, a permissioned blockchain," he says.

The Cadeia platform, for instance, offers a two-level operating system – one level is a cloud application outside of the blockchain and the other is deposited on the blockchain of choice. In the case of the GreyPeak transaction, the firm used the Ethereum blockchain, but the platform is agnostic in terms of blockchain connectivity.

"The first level allows transaction participants to structure a securitisation, including the covenants and their trigger levels, as well as cashflow waterfall and changes in the way principal and interest is distributed. Once this is agreed, we release a series of smart contracts that represent these attributes onto the blockchain via the second level of the platform," explains Steffens.

He continues: "The smart contracts convert the attributes into blockchain language and execute them automatically. The platform enables users to speak blockchain language and use the blockchain environment as a trusted platform over the life of the deal – from the initial issuance down to the last payment on the refinancing instruments. The Cadeia platform can handle traditional, as well as tokenised asset and refinancing instruments, making the system future-proof."

Ultimately, further standardisation across the blockchain ecosystem would facilitate its up-take. "There are no specific structural barriers to the wider adoption of blockchain – it's available for anyone to use already. But the industry needs to get to the point where all banks/issuers and all investors are set up on blockchain – we need the buy-in of a critical mass of users," Milani concludes. ■

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for over 20 years and we view utilising blockchain for reporting as a safe and efficient way to provide end users with more timely reporting of loan level payments," he notes.

TJ Milani, general manager of Figure Marketplace, agrees that while generally any assets can be securitised on blockchain, the more streamlined the origination process is and

regional banks to the likes of Jefferies, Nomura and Raymond James," he notes.

He adds: "But to ensure that blockchain does what it's supposed to do, a strong IT system is necessary – including different nodes to validate transactions and implementing proper encryption. Further, regulatory reporting should be integrated with end users' general ledgers and compliance systems – so that they are receiving the information they need, but in a way that is compliant with their systems."

Many financial institutions are currently exploring whether to implement private or permissioned blockchain environments, with the aim of keeping information private and reducing costs. In this context, Steffens highlights the issue of data secrecy.

"Ethereum is a public blockchain, so do not deposit confidential information on there, unless access to it can be controlled. Keep such information in the first level, outside of the blockchain, and controlled by using an application permission



TJ Milani, Figure Technologies