Tokenisation unlocks illiquid markets

Real estate sector stands to benefit greatly

by Pierre Ortlieb in London

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Technology and liquidity are mutually reinforcing. Technological developments have smoothed the sale and shipment of assets across the globe, while more liquid and efficient capital markets accelerate technological innovation.

The promise of tokenisation lies in substantially reducing remaining illiquidity discounts by creating tokens that represent partial ownership rights to underlying illiquid assets. These tokens are easier to sell and transact on global exchanges than the underlying asset itself.

Tokenisation can expand the investor pool available to a seller by introducing an asset to a global audience and reducing what counts as sufficient capital to invest. This enables smaller investors, whether retail or smaller institutional groups, to participate in a purchase. This is particularly encouraging in the commercial and residential real estate sectors, where frictions and barriers to investment, including minimum capital requirements, can be high.

Tokens are therefore distinct from existing products such as real estate investment trusts, which remain inaccessible to most retail investors. Furthermore, the implementation of 'smart' contracts – self-executing contracts coded to automate the terms between buyer and seller – automatically standardises the issuance of tokens, further reducing the costs associated with the sale of an illiquid real estate asset.

By breaking up a larger asset into smaller portions in this manner, tokenisation has the potential to create liquidity in previously unwieldy markets. Earlier this year, a $30m Manhattan condominium development was put on the market in part through tokenisation, the first such process. At the same time, platforms such as Maecenas, which provides blockchain-based fine art auctions, have emerged, illustrating this technology's potential in connection with other illiquid assets beyond real estate.

But there are several caveats to consider. First, a successful tokenisation requires a reliable secondary market for its tokens. Fortunately, the associated technology makes this achievable. Tokens are by nature divisible and remove restrictions on investment size, meaning any investors can purchase a token, creating a more liquid market. This will also allow investors to exit their positions more easily. In addition, secondary transactions can be tracked through the underlying blockchain-backed tokens. These proof-of-asset tokens are immutable, fungible and transparent, and exchanging them on reliable third-party exchanges will further reduce the costs and risks associated with trading large, illiquid assets.

Second, real liquidity is legal. Investors – regardless of size – will want security of contract and legal certainty before committing to a token purchase. Without a robust institutional framework, no investor will have full confidence in the liquidity of their tokens, ultimately spoiling the process. Yet existing ownership frameworks are in many ways inadequately equipped to grapple with the legal implications of tokenisation. Defining who is legally liable for a property, for example, is one question law-makers and regulators must address in establishing guidelines on tokenisation. Resolving these issues will ensure that investors can reap the liquidity benefits of this technology.

OMFIF seeks to bring together market supervisors and industry representatives to ensure the most effective and efficient regulatory paths are taken. The recent joint London & Oxford-OMFIF report on the 'Global crypto-asset regulatory landscape' seeks to outline the current legal environment, examining how tokens are treated and regulated across jurisdictions.

Through a survey of potential investors, we discerned a budding interest in using real assets to back blockchain-based tokens. This emergence of tokenisation as a possible alternative is timely, as our research in collaboration with BNY Mellon has also clarified a growing appetite for real assets among global investors. Once the rules of this market are written, tokenisation could change the nature of liquidity in the investment universe, unlocking the global potential of previously illiquid properties.

Pierre Ortlieb is Research Assistant at OMFIF. The London & Oxford-OMFIF reprot on the 'Global crypto-asset regulatory landscape' can be downloaded here , and the most recent OMFIF-BNY Mellon report, 'Real Momentum: Global Public Investors and the Real Assets Market', can be read here .