

COMMENT

It's Never Gonna be Like it Was: Smart Ledger Futures for IFCs



By Professor Michael Mainelli,
Executive Chairman, Z/Yen Group, London

'Say a Prayer for the Falling Angels'

All right, it's not highbrow, but Meatloaf's lyrics from 'The Future Ain't What It Used To Be' provide solace for those contemplating the future of IFCs. On the one hand, the stresses and strains of increasing uniformity in regulation, combined with cries to reduce tax competition, reduce the attractiveness of some IFC products and services. On the other hand, the stresses and strains of international commerce lead businesses to seek new financial centre products, services and structures that reflect the realities of global trade.

Let's take an over-hyped example; smart ledgers and blockchain. Smart ledgers are based on a combination of mutual distributed ledgers (aka blockchain: multi-organisational databases with a super audit trail) with embedded programming and sensing, thus permitting semi-intelligent, autonomous transactions. Smart ledgers are touted as a technology for fair play in a globalised world. 'Blockchain technology' is certainly hyped, and the volatility of related cryptocurrency coins and tokens doesn't help see the underlying

robustness of a basic 'internet of record' technology. However, there are numerous projects building trade systems using this technology with announcements from governments, shipping firms, large IT firms and the like.

This technology advances slowly. Distributed databases and ledgers are an order of magnitude more complicated than a traditional database. Multi-organisational projects are also an order of magnitude more complicated than projects within a single organisation. Combined, smart ledger projects could be said to be 100 times more difficult than a traditional project.

It's Like a Shadow on The Land and the Sea

So why complicate things? To understand the deep interest in smart ledgers one needs to understand the most common approach people have used for millennia to handle multi-party transactions – 'central third parties.'

Examples of central third parties in action include lawyers holding escrow accounts, banks providing letters of credit, or exchanges trading and central

counterparties clearing. Often the central third party sits at the centre of a large network, for example SWIFT or credit card processors.

Central third parties are a well-known approach and often work well; sometimes earning the sobriquet 'trusted third parties.' Central third parties typically do three things in financial services: (1) they preserve the definitive set of market transactions. This raises the prospect of charging market participants to 'get their own data back.' (2) They safeguard the definitive set of market transactions against alteration. This raises the threat of being bribed or rewarded for falsifying transactions. (3) They validate new transactions and authorise their addition to the definitive set of market transactions. This raises the possibility of falsifying assets or admitting corrupt participants.

Further, central third parties frequently become 'natural monopolies.' A natural monopoly is a supplier whose costs are lower than the alternative of multi-firm provision. Natural monopolies are not inherently 'evil', but two aspects are clear. First, a natural monopoly creates at least the three temptations to cheat enumerated above. Before you find this extreme, remember the scale of the FX or Libor scandals just to get started. This is one reason monopolies attract social attention, and in turn regulatory attention. It is also the reason natural monopolists are often paid well by members. If they get caught cheating,

"The advantage of smart ledgers lies not in being cheaper or faster. The advantage of smart ledgers is that they allow organisations to work together without giving central third parties a strong natural monopoly."

they put a cushy life at risk.

The second temptation is to extract excessive 'economic rents'. Economic rents are payments to an owner or factor of production in excess of the costs needed to bring that factor into production.

This economics jargon means central third parties can charge much more than things cost. Banks, for example, have long complained about the charges of SWIFT, credit card processors and exchanges. Switching suppliers in financial services incurs the cost of changing processes for a new supplier, or finding a new supplier with the same level of connectivity, but one of the biggest switching costs is historic data. Often, only the central third party has the authoritative dataset.

The advantage of smart ledgers lies not in being cheaper or faster. The advantage of smart ledgers is that they allow organisations to work together without giving central third parties a strong natural monopoly. Smart ledgers do this by giving everybody an immutable copy of the data they need, while also reducing 'switching costs'. To switch to a new supplier, customers need to merely appoint a new central third party, not be hostage to a monopoly on historic data.

It's Like a Storm That's Never Ending

Great, but what has this got to do with IFCs? Over the 23 issues of Z/Yen's Global Financial Centres Index, IFC fortunes have risen and fallen. It's a gentle but downward slope. IFCs walk a tight-rope across a chasm of claims; on the one side that they are capable of rapid change, and, on the other, that they are havens of stability. For example, IFCs simultaneously claim that they can change legal codes rapidly when laws impede sensible decisions, yet also avoid hasty legislation when larger nations are senselessly reacting to domestic calls for action.

Unlike financial centres with large domestic economies, IFCs shouldn't take risks with their foreign finance and do something stupid, e.g. radically change the tax code or impose onerous regulation at short notice, because it will hurt them disproportionately more than onshore centres. Unlike larger economies, financial services are so important to IFCs that they must keep their balance.

A more integrated perspective of IFCs' comparative advantage emerges from

"IFCs should continue to find opportunities where onshore regulators have not created sensible wholesale finance and international trade regulations."

the argument that savvy IFCs enable longer-term financial planning. 'Long finance' structures, i.e. structures that can endure for a generation or two, benefit from avoiding the capriciousness of larger nations' domestic agendas. A large nation can change tax rules or ownership rules at short notice. Well-regarded IFCs have achieved a reputation for avoiding hastily-enacted changes that would harm their own self-interests.

Today's IFCs contain both the good and the bad; from money launderers and tax evaders to long-term planners and legitimate but complex wholesale financiers. There are 'mid-shore' solutions, solutions that facilitate international trade by avoiding conflicts among onshore jurisdictions' regulatory, compliance, tax and technical differing standards.

IFCs should continue to find opportunities where onshore regulators have not created sensible wholesale finance and international trade regulations. Onshore jurisdictions are subject to bouts of rapid regulatory change in response to domestic crises – and damn the consequences if it's inconvenient to pesky foreigners. Credible IFCs have moved well beyond primitive secrecy or tax avoidance to build reputations based on longer-term stability and regulatory simplicity.

Stem the Tide of the Rising Waters – Block to the Future

So, where do we find a need for longer-term stability and regulatory simplicity? Smart ledger hype can only be fulfilled if numerous groups of organisations want to work together mutually and decide that smart ledger technology will help them avoid much, or all the natural monopoly problems described above. These ledgers are immutable, thus inherently a long-term problem. Some of these ledgers are already planning for post-quantum computing encryption, while many current financial firms are asking what the issue is. These ledgers are frequently or mostly international, thus needing

regulatory simplicity. Some of the emerging applications that could create large mutual networks include:

- **Private or public-private international identity systems for both corporates and individuals:** Regulations around anti-money laundering, know-your-customer and ultimate beneficial ownership increase legal and regulatory costs and hassles. 90 per cent of businesses responding to the International Chamber of Commerce's 2016 Global Survey on Trade Finance pointed to anti-money laundering as the most significant impediment to trade. The 53 Commonwealth nations are exploring how this might be managed on a shared smart ledger system.
- **Trade facilitation infrastructure:** These trading systems can be almost 'unowned Alibabas or Amazons', or deep wholesale trading markets for specialist players in reinsurance or commodities, or other narrow but capital-intensive markets. Singapore already has a trade facilitation system for SMEs based on smart ledger technology.
- **'Internet of record' services:** IFCs are well-placed to offer independent timestamping services. The States of Alderney has been operating such a system, MetroGnomo.com since 2015.

IFCs will find sustainable strategies in long-term multi-organisational work, whether it's turning complex international tax structures for special purpose vehicles into a series of bilateral arrangements, or helping to stage profit recognition on complex deals. Smart ledgers are one promising area where the technology may facilitate an explosion of 'mutuals', all needing governance, regulation and reporting. Some, such as Gibraltar, Malta, and Alderney, have taken material steps towards welcoming such mutuals. There is a genuine opportunity for IFCs to grasp and it plays to their traditional strength — to be the world's home for central (and increasingly trusted third parties) that make international trade work. **IFC**