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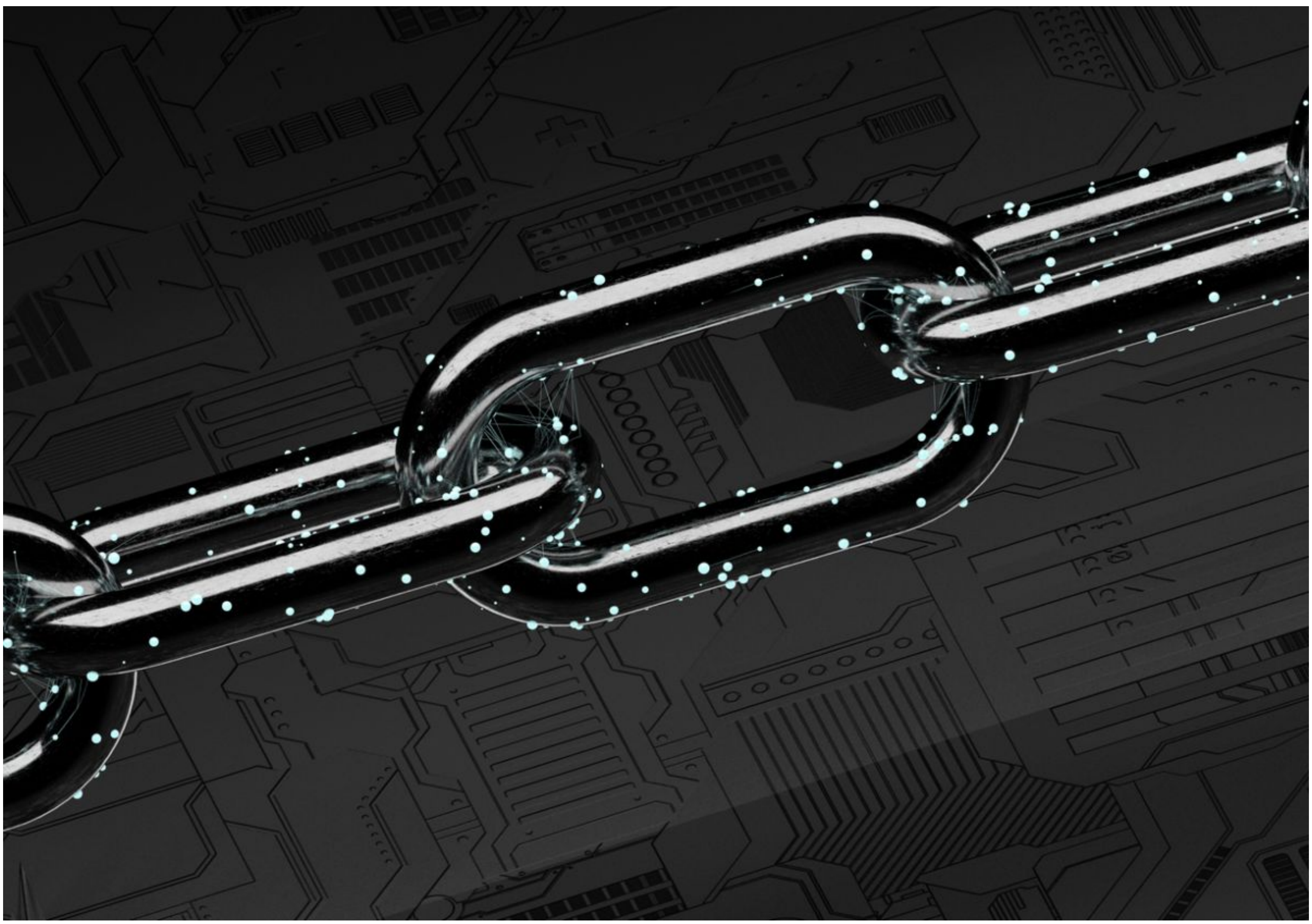
Unblocked

by Sam Birchall (/index.php/article/author/165) 11 March 2021



Blockchain technology has been sitting quietly in the shadowy periphery of the financial industry for over a decade. A secure ledger that allows participants to store and update information in real time, blockchain technology holds the potential for big efficiency savings in private equity. Despite this, it has been slow to gain traction.

This is partly due to confusion about what blockchain actually is. Even its beginnings are shrouded in mystery, with the first blockchain implemented by a programmer known only under the pseudonym Satoshi Nakamoto in 2009. "Many LPs and GPs are not yet informed about the advantages of blockchain. It's still abstract to them and they often confuse it with the application in cryptocurrency only," says Peter Soesbeek, director of funds and structured finance at IQEQ.

It's easy to see why; a quick google of blockchain pulls up a list of headlines focused almost exclusively around cryptocurrency or rather one currency in particular; Bitcoin. "When we explain our case for using blockchain, people ask: But where is the Bitcoin?" says Nivesh Pawar, business leader of IT at Partners Group, one of the early adopters of blockchain technology. Even now, Pawar said there is a lot of skepticism and mistrust toward blockchain within the industry, especially when it comes to money transfers. Afterall, it wasn't so long ago when Bitcoin was linked to the nefarious "dark web" and a series of scandals involving Silk Road, an online black market, selling everything from drugs to murderers-for-hire. Understandably, corporations with a reputation to keep clean might be reluctant to get involved.

It should be noted, however, that the public blockchains used in currencies like Bitcoin are different from the private permissioned ledgers that are used in the financial sector. 'Permissioned' or 'private' blockchains allow for different levels of permissions for users, so access can be restricted, and information can be encrypted to protect confidentiality. It is this use of blockchain that is worth a closer look...

Unlocking blockchain

First movers in the blockchain space have been large banks, asset managers and some of the bigger financial institutions, says Arvin Abrahms, a fintech lawyer at McDermott Will & Emery (MWE). "Here, we are seeing firms revolutionise their back office and front office by utilising blockchain. Anything that involves contractual documentation – you can do it more efficiently using blockchain technology."

Blockchains' "irreversible and immutable" nature is a significant draw, according to Chris Robinson, director of IT and digital services at IQEQ . "The way a blockchain works is you can't just go in and change a piece of information. You have to change it in every block, which is virtually impossible, so once you put something in a blockchain it is a record of truth." The distributed nature of a private blockchain, too, means it is unhackable if set up correctly, making it a more efficient and secure alternative to a classic server or cloud-based infrastructure.

So far, the 'classic use cases' for blockchain in a private equity context are for KYC (Know Your Client) and AML (Anti-Money Laundering). Partners Group was one of the first firms to start implementing blockchain for this purpose. In 2017, the Swiss firm launched a blockchain-based signing and verification service to aid fraud prevention by tracking deal cheques. Partners Group's Pawar says the idea came from a growing mistrust of the industry's ability to keep information secure. "At the time, our third parties were still using email attachments to communicate transaction instructions, which brings a huge risk of being hacked." Today, the firm's platform has been used in more than 40,00 documents entailing about CHf1bn of payments.

It is worth caveating, though, that permissioned blockchain does carry risk; the first being compatibility – A blockchain that is set up to pool capital into a fund is only worthwhile if the technology is compatible with the private equity firm's blockchain. Pawar questions the use of blockchain in this context but conceded that it can prove helpful in a mutual fund business where you can create a portfolio and use similar tokens. Secondly, Pawar notes that a permissioned blockchain still relies on the automatic consensus of each party involved to be approved – there is nothing to stop incorrect information being recorded. Cost is another consideration, says Pawar. "Over time we realised that the cost of using a third party for our blockchain technology was too much. To remedy this, we re-coded the technology in-house, insourcing our own coding and audit services."

Pawar admits this is not a good solution for everyone. "You have to look at blockchain in terms of: what is the problem you are trying to solve? For private equity, many of the problems they are facing can probably be solved in a much simpler and efficient way than blockchain." MWE's Abraham agrees with this outlook and pointed out that buyout firms are nimble and don't have the right infrastructure to make blockchain worthwhile. He did add, however, that once blockchain becomes more commonplace, "it would be a no brainer for private equity firms to piggy bank on technology being used by the likes of JP Morgan and Goldman Sachs."

Blockchain has been proven to help in other ways, however. Another example of an early mover of blockchain technology is Northern Trust who, together with IBM, developed a system based on the IT company's "hyperledger fabric", to monitor the administration of a private equity fund managed by Unigestion. The service allows the fund to transfer ownership stakes and be managed throughout the investment lifecycle on a transparent platform. This is where buyout firms could see real benefits. At a time when investors are demanding frequent reporting from managers on performance, blockchain offers investors the ability to see price changes in real time.

Just the beginning

The possibilities for blockchain, however, go far beyond basic operational and efficiency-saving applications. Used correctly, the technology can be implemented to help portfolio businesses meet their ESG targets. KPMG launched a blockchain Climate Accounting Infrastructure (CAI), a soltuion that enables a transparent disclosure to investors of ESG progress and helps to track greenhouse gas emissions. The ability to see real-time verified promises to fix ESG data gaps caused by inconsistencies, while unlocking significant value propositions and product opportunities.

From an investment perspective too, blockchain is huge. "It's one of the hottest sectors out there right now," MWE's Abraham says. "While the space is more active in VC than big ticket PE players, this is gradually changing as the technology becomes more mainstream, as we are seeing now. It's one of the most interesting areas of my practice right now because it's such a fast-moving field and there is so much client interest in it."

The wild west

Blockchain developments are progressing, but it has yet to reach a level of maturity where industry and regulators feel confident. James Taylor, an associate at Goodwin who drafts and negotiates agreements relating to blockchain, said industry adoption will require significant collaboration, new technical and security standards, as well as a solid regulatory framework. "There is more clarity on the horizon," Taylor says. "The EU is looking to regulate cryptocurrency and last month the UK announced plans to focus on the area too. When we have more clarity on these terms, that's when private equity will dive in." Arguably, innovations in decentralized finance will help to demonstrate how blockchain solutions can disrupt various aspects of the financial services sector.

Until then, a little perspective is needed. "When you think it took the internet 20 years to be adopted, so far there's only been 12 years of blockchain. In order to see the technology's full potential, we will need more concrete examples of how it works. Only then will it become more popular," Soesbeek says. "It's still a bit wild west at the moment," Robinson agreed. "With any new technology, there is a proliferation of alternatives. As such, there has not been an industry standard in the blockchain space that firms can look to as a safe bet. The closest one might be Hyperledger, which was launched by The Linux Foundation in 2015 and is backed by IBM, but this is still just one of hundreds of blockchain solutions.

This is a point raised by Partners Group's Pawar, who says blockchain agnosticism is a necessity for blockchain's future. This means when different business solutions can be operated from different underlying blockchain technologies. Most current applications are rigid, they are designed for specific uses and are therefore unable to adapt to changes that occur in such a budding ecosystem. "Once there are more solutions available to make it easier to switch between blockchains, this will invite more use cases," Pawar says.

People's knowledge of blockchain is still fairly superficial and there are not enough people at more senior levels in organisations who understand the technology well enough for blockchain to be widely used. There isn't a huge amount of development resources in the market, with the vast majority of all blockchain developers acknowledging one blockchain; Ethereum, the most widely used.

There are some areas where private equity remains reluctant. When it comes to moving cash through the blockchains, for example, Pawar said the trust is not there in the industry yet. "Many are still skeptical when it comes down to using blockchain for money transactions. We are keeping our eyes and ears open when it comes to tokens but we see it as more of a downside protection tool rather than an upside enabler…for now."

A key area where blockchain is successfully maneuvering its way into the financial space is payment verification. With its distributed ledger and ability to enable transactions with reduced fees, blockchain is challenging cross-border funds transfer systems like SWIFT, a consortium of banks that manages global transactions. For private equity, however, it's going to take some time. "Forget about the next level of blockchain, we are talking about an industry that is not fully on SWIFT," Pawar said.

Change will happen

Historically, private equity has been slow to digitalise, but the ongoing lockdowns have pushed organisations into looking at their dependence on technology. Soesbeek believes this could boost the rate of blockchain adoption."There's been a flood of money going into blockchain backend projects at corporates and we ourselves have done a lot more over the last twelve months in this space as part of a wider digitisation."

A recent study by Global Palladium Fund backs this claim up. It revealed that 50 per cent of investors believe there will be a "dramatic' increase" in the use of blockchain technology within the asset management sector over the next three years. Most (51 per cent) said this was part of a growing trend to provide more transparency around investments, while another 35 per cent believe it is due to investors increasingly wanting more information on the investment vehicles they invest in.

Already, players are taking steps to prepare for the further blockchain implementation. IQEQ, for example, has been looking at building out a digital asset custody solution for its clients down the line. While still in its early stage, blockchain has the potential for real, long-term impact.

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