HL INFLUENCERS: DIGITAL TRANSFORMATION

TRANSCRIPT

Luke Kovic
Applied Blockchain

Karishma Paroha	Hello, everybody, and welcome to another edition of *The Influencers*, our podcast conversation on digital transformation and law. I'm Karishma Paroha, a senior counsel working in the product and insurance sector at Hogan Lovells and the acting chair of the IUA's Developing Technology Monitoring Group, founded by my co-host Tom Hughes.
Tom Hughes	Thank you very much, Karishma. The DTMG is one of many groups exploring innovation and risks that we run at the IUA. We are an association and we represent many of the largest international insurance and reinsurance companies based in the historic London market. Day-to-day that means I get to work with risk specialists, with innovators and regulators on everything from marine and aviation to environmental and casualty insurance.
Karishma Paroha	Tom and I are hosting a special Future of Insurance mini-series on *The Influencers*, where we delve into exciting technology through an insurance lens and consider the risks and benefits of this cutting-edge world.
Tom Hughes	And I'd like to think that this world wouldn't be quite so cutting-edge without the support of the insurance community. A worthy moment to shout out IUA's members, I hope. Now, insurers have a vital role to play in giving innovators the comfort they need to do what they do best to innovate, whether that's covering rental e-scooter providers, GenAI developers, or automated vehicle manufacturers.
Karishma Paroha	In this episode, we're tackling a topic that's quietly becoming one of the most important pieces of modern financial infrastructure, even if it doesn't quite always grab the headlines. That's right - stablecoins are increasingly acting as the connective tissue between traditional finance and blockchain rails, powering payments, treasury functions and cross-border value transfer.
Tom Hughes	They promise speed, efficiency and, at least in theory, stability. But, they also raise some very big questions around trust, governance, risk and of course, responsibility.
Karishma Paroha	So, to help us unpack what's really going on beneath the surface, we're delighted to be joined by someone working right at the front of this

	technology. Luke Kovic from Applied Blockchain, an organization helping enterprises and institutions move blockchain from theory into a real-world financial infrastructure.
Tom Hughes	Luke works at the intersection of blockchain engineering, finance and regulation with a particular focus on stablecoins, how they're built, where they create value and what needs to go right for them to scale safely. Luke, welcome along to the podcast. It's great to have you with us.
Luke Kovic	Hello, guys. Thank you very much for having me on the show.
Karishma Paroha	Luke, before we delve into the pockets of stablecoins themselves, let's take a step back. What has your journey into blockchain been like? Was there a particular moment or real-world problem that made you realize this technology was more than just hype?
Luke Kovic	It wasn't really a particular use case. Like a lot of people, I heard about Bitcoin. I actually heard about Bitcoin quite early and dismissed it out of hand straight away without doing any kind of reading or research. That was in 2013, similar again in 2015. And then in 2016, I was working for a fintech startup, and the founder of the business just had "blockchain" written across the glass walls in the office in WeWork that we were in. So, I decided to sort of take the bite and do some reading, read some Bitcoin literature, became infatuated with it as an asset and then became incredibly attracted to the underlying technology that was powering it, and ended up moving into the blockchain industry in 2016, at the end of 2016. And it wasn't so much a particular use case. By sort of the spring of 2017, there was this wild energy in London, and obviously all around the world, around how transformative it could be. Now, a lot of our thinking from then has played out to be quite redundant. A lot of the challenges were nothing to do with the technology, but it felt really interesting at my vantage point at working at Applied Blockchain, dealing with multinationals, but also some very exciting and very interesting startups and seeing all these different use cases of where blockchain and cryptography could be interjected into their operating model, and what sort of commercial opportunities arose off the back of that. And it was kind of like a drug in a weird way, if I'm honest. It was so creative, it was so fast-paced. I find it fascinating now, the rooms and conversations that I find myself in and the people who that I'm talking to. When I look back only a short period ago, and it was people in kind of hoodies and a lot of the events, people would cover their faces to hide their identity. So, it's taken a long time, but I'm very happy that the principles of the technology are being understood in the traditional industry sense, and we have some kind of grown-up applications that we're all working towards, and stablecoins are a big driver of that.

Tom Hughes	Luke, with a deep passion in tech like that, it makes perfect sense that you'd end up on *The Influencers* podcast, because that's exactly what we're here to have and to talk about. And I want to just step back, because stablecoins often sound deceptively simple. Digital tokens pegged to a real-world value, and I've read various articles to give me as much information as I possibly can, but I feel like I'm just scratching the surface and there's a lot more under the hood. From your perspective, what separates a well-designed, resilient stablecoin from one that's fundamentally fragile?
Luke Kovic	That's a good question, and there's a few things to unpack. Firstly, let's just take a step back. A stablecoin is a digital asset that's moving across a blockchain. A blockchain is a decentralized network that keeps a record of all transactions happening within that particular network. Now, if you and I were part of a singular network, we could send value to each other. That's broadly the premise of Bitcoin. Bitcoin allows anybody to send value to another person on the Bitcoin network. Now, when crypto-trading really started to kind of take off in 2016, into 2017, there was a burning need for a trading pair of stablecoin, much like you would in traditional markets. You would trade in and out of your fiat currencies to whatever asset it was that you were purchasing. And that gave birth to Tether. And they kind of made the promise that your one Tether would be redeemable to $1. And it was all very murky. And, largely, parts of it are still quite murky. But, what that allowed people to do was to transact in something which had stable value, because the cryptocurrencies, if you will, were incredibly volatile and continued to be incredibly volatile. So, that was the sort of the genesis, the foundation of why there was a stablecoin. It was to facilitate movement of money across blockchains and to facilitate trading, which didn't require people to come back into dollars and then go through another exchange and purchase Bitcoin with real money. Since that sort of breakthrough from Tether, we found ourselves in a situation where there's been lots of different stablecoins and how they've been designed. And I'd like to caveat this and say, resilient stablecoin is a bit of an assumption at the minute. The two largest stablecoins we have at the minute are Tether, which has $183 billion of supply, and Circle, which has $73.5 billion of supply. Now, for these two platforms to issue tokens, they need to own US treasuries and there's been great clarity provided by the Genius Act in the US. And we'll talk about this in a little bit. And that's provided a lot of confidence, because essentially the coin is underwritten by the US government. However, what we haven't experienced is if there's, for some reason or another, a significant redemption event, and if people were looking to redeem 30, 40, $50 billion worth of stablecoins on the same day, what would that do to the price of the stablecoin? And what would that do to the price of the underlying asset that's supposedly keeping it stable? Would one Tether and would one USDC coin ultimately equate to $1 in your pocket? It might do, but it also might be marginally less. So, the resilience piece is kind of TBC. What crypto has taught me and has taught people who've been in it for a long time, nothing can be sort of 100% trusted. And there will be some form of stress test or black swan event, which will really put this term resilience under the

	spotlight. But, what we can make some educated guesses on, or at least educated assumptions on, is around what makes a well-designed stablecoin. And there's a few layers to that. One is the most obvious, is the reserve quality. And there's different avenues within Europe and the UK and the US, but ultimately what is underpinning the stablecoin? And the popular route seems to be bank deposits and/or short-term government debt. So, if there's transparency around the reserve quality and a stablecoin is issued off the back of that, that's a good start. The other piece is the custody segregation of these assets and of these reserves. What are the rules and titles around these? For example, there can't be any rehype associated to any of these, because that would add some underlying risk to the stablecoin itself. So, custody segregation is incredibly important. But also, most importantly now at the minute, is the smart contract itself. What does the rules of the token say can happen and where they can happen? And this is on how do you audit it, how do you upgrade controls, things like key management? And from an insurer's perspective, the smart contract becomes the counterparty. That's where your counterparty risk sits. Because if there's inaccuracies or weaknesses within the smart contract, then the previous points of the reserve quality and the sort of the custody segregation, they mean nothing. The stablecoin could be compromised and you could have a serious event on your hands. We've seen a few of these already. And in 2021, Terra Luna, which was a platform that had its own algorithmic stablecoin, UST, had a significant drawdown. It was offering people 20% APY on a lending platform called Anchor Protocol. And then there was a mass redemption event on people looking to cash out, because they'd be making a fortune. This collapsed the price by 80% in less than 24 hours. So, your dollar was now worth 20 cents and then it ultimately ended up going to 0. And that wiped out around $60 billion from the crypto-market. So, we've seen different structures appear. And what we have now at the minute with the genius-backed stablecoins in the States is the best iteration of the well-designed stablecoin that we've had. But, we still need to be cognizant that there could be some risks associated to this particular model as the industry grows.
Karishma Paroha	Thank you, Luke. It's reassuring, but obviously, as you said, the risk is ongoing. So, moving on now, if we look across payments, treasury management and institutional finance more broadly, where do you see the biggest real-world opportunity for stablecoins over the next few years? And is there a use case you think the market is still underestimating?
Luke Kovic	So, I think there's a lot of excitement. Retail, just some pure remittances. So, I think from retail being able to move money internationally, this is just a great, simple piece for people to be excited about at an institutional level. And these are some projects that we're working on at the minute with some multinationals. If a major corporate has 2,000 to 3,000 bank accounts all around the world in multi-currencies and lots of different local currencies, the capital efficiency that treasury departments would now receive from being able to send money between operating businesses with near-instant settlement and remove that trapped capital, which is just in transit on a daily

	basis. This provides some really interesting opportunities. Specifically, if the assets were on chain, there could be a single wallet or a multi-wallet interface where there would be dollars, yen, euro, pounds, all managed from one interface rather than from multiple bank accounts all over the world. They would then be accessible to people within that Treasury Department 24/7. Obviously, you can bake in different governance rules and permissions about what can and can't happen, but on the face of it, people will be able to access and move their money whenever they saw fit as opposed to being beholden to the hours that the corresponding bank or one of your international banks were open. And, so, if we think about this treasury capital and bank deposits coming on chain, and then the traps liquidity being unlocked, then there's some really interesting things that are happening. So, kind of, I don't want to say vanilla, but the first step in that direction is there's lots of tokenised money market funds now, and there's lots of iterations of them and whether they're truly digitally native, and we can put that to the side for one minute, but what they allow is people who are holding stablecoin in multi-currency is to access yield issued by the money market fund, and have 24/7 redemption and intra-daily distributions of their yield. And, so, for treasurers of multinationals, but also of SMEs, this is quite an interesting piece for you, specifically just for the smaller business. Our company, let's say our cost-basis, sits predominantly within the 7 to 10-day window at the end of the month. If we were able to access on-chain yield in that period, redeem back into pounds and cover our cost basis, there's a strong economic incentive for this. But, where it gets really quite exciting is if we think about people tokenizing more cash or tokenizing more deposits or holding more stablecoins, really is what is the home for them. And to answer that, we need to look at what's happening within the real-world asset environment, where we're trending from $40 billion of tokenised assets to $150 billion worth of tokenised assets within the next sort of five years. These are big numbers, but in reality, they're completely insignificant. If you think there's roughly around $150 trillion worth of assets under management globally at the minute, even if we were to tokenize 10% of those, this is a significant uplift in requirement for stablecoin, stablecoin issuers and people participating within that particular market. So, there's capital efficiency plays from purely being able to move money from location A to location B, but where it gets really sexy is when you start talking about the funds and products that are going to be tokenised as well, which can offer those stablecoins a home.
Tom Hughes	Luke, this might be time for me to just briefly ask an additional question here, which is about algorithmic stablecoins. Do you think there's a future around algorithmic stablecoins or too much hype?
Karishma Paroha	Look, there's always going to be a home. The crypto and cryptographic world is vast. We have institutional finance now sitting in this ecosystem. They will never touch an algorithmic stablecoin, and rightly so. But, there are sort of Web3 natives, if you will, that are completely comfortable with the mathematical premise of what they are and how they operate. And, so, we spoke earlier of Circle having $73 billion and Tether having $183 billion

	worth of market cap. DAI, D-A-I, is the largest algorithmic stablecoin and it's got $8 billion of market cap. So, there are usages for this and it is used, but it's going to be predominantly further out on the risk curve, further within the kind of Web3 natives, if we call them that. But, in terms of a traditional finance sort of institutional environment, I can't see how they will be able to be ingested and utilized at any meaningful scale.
Tom Hughes	Thank you, Luke. And Karishma will know I'll be particularly happy, because we're just approaching the insurance section now, but you've already taken the opportunity to mention insurance, which is great. Now, when it comes to stablecoins, and I think insurers perspective, there really are two sides of the same coin to consider here. You've already mentioned some of the really significant risks, the possibility of black swan events, but of course, there are opportunities. So, insurers might see the opportunity in actually providing some cover for elements of the stablecoin network. But, of course, there might be the opportunity to actually integrate stablecoins into insurers' own way of working. So, if stablecoins are effectively promising stability in a system that's inherently volatile, if you were sitting in the shoes of an underwriter, what would genuinely be keeping you up at night at the moment?
Luke Kovic	So, I guess there's two ways to think about this. There's the stablecoin itself and that will bring concerns over, and these are things that we've touched on, but the reserve composition matrix. What is it being underpinned by? Where are those assets held? Who's holding them? What are the rules around that? There's risk there. The redemption mechanics, there's slight ambiguity and there's differences on a jurisdictional-to-jurisdictional basis. If there's a black swan event or a redemption run, what does that mean in Europe compared to the Middle East, compared to the UK, compared to the US? How does that impact a business that has exposure into all of those different jurisdictions? There's the smart contract risk, which is arguably the largest and most important, because this kind of underpins everything. If the smart contract is faulty, for want of a better word, then everything else becomes sort of largely redundant, because that money will be sort of hacked and broken and stolen into. And obviously, kind of mentioned it a minute ago, is this concept of regulatory fragmentation and how that might change on an administration-to-administration perspective, on how that might change from a country-to-country perspective. If I'm a multinational and I'm holding tokenised euros and I'm holding tokenised pounds and I'm holding tokenised dollars, they're all very three different regulatory frameworks that we have to sit and operate under. So, there's a bit of confusion and complexity around that as well. The second way that we should think about this is stablecoins are just part of what we're talking about. For stablecoins to do things, there's apps required to execute transactions. There's interfaces and marketplaces and exchanges that they go to transact in and do certain things. If you're talking about a stablecoin moving from my wallet to your wallet on the Ethereum public network, that's kind of fine. There's not a lot of risk associated to this, but if it's going on to an exchange or a marketplace to, you know, participate in a private credit

	round, or I've got a certain wallet requirement that I have and I've built one, so there's lots of KYC, KYB and AML around it, what does the app player look like? You know, who's built all of these things? Who are they geared towards? What is the risk associated to this? Because oftentimes, and most times within my industry, the breaches that you hear of and the terrifying numbers of capital being lost and stolen isn't really the asset on the blockchain. It's the asset interacting with an app that sits on top of it. That's where the weaknesses sit. So, if I was an underwriter, I'd be thinking, yes, about the principles of how the stablecoin itself has been designed, but I'd also be thinking about who is this business? What is the entire ecosystem that they're designing for this kind of stablecoin usage? What are the counterparties and third parties involved in this? And what is the risk associated to them?
Karishma Paroha	On a slightly lighter note, Luke, what's the most surprising or unexpected stablecoin use case you've come across so far?
Luke Kovic	Yeah, it's an interesting question. I mean, really, the use case is payments, right? Whether that be buying an asset, buying a, you know, sharing a fund or sending money from A to B. I did have a think and to make it relevant for some of your audience, there is an interesting platform called Nexus Mutual, which is an on-chain insurer. So, if I'm Long Stablecoins, I can deposit stablecoins into the Nexus Mutual DAO. I'll receive my DAO tokens, and then when people would be looking to access that treasury balance to underwrite risk based on the amount of tokens that I hold, I can vote on whether I would like my capital allocation to be involved in that risk. And then, if it's a yes, then I will receive a certain percentage of the premium that's paid by the insured. And, so, it's more, again, kind of goes on to what I was just saying previously. It's more about what are the apps? What, like, where do the stablecoins sit? Like, what do they do? And what is the outcome of that thing, if you will, rather than the stable coin itself. So, that was something which I find pretty interesting.
Tom Hughes	So, Luke, we're coming to the end of our discussion now and we've covered a huge amount of ground from the engineering realities of stablecoins to the governance, the risks, of course, the possibility of black swan events, which will ultimately determine whether this tech truly goes mainstream. We might not be able to guarantee the US dollar, but perhaps insurers have the key to put the stable in stablecoins. But, what bureaus will need is regulatory certainty to be afforded the confidence to continue dipping their toes into a fast-moving wrist landscape. Thank you so much, Luke, for joining us.
Luke Kovic	Thank you. It's been a pleasure.
Karishma Paroha	Yes, thank you so much, Luke, for sharing your insights and your perspective from the front lines at Applied Blockchain. For Tom and I, it's been a fascinating look behind the stablecoin headlines and a great example of how infrastructure, regulation and risk all have to move together if innovation, here crypto-innovation, is going to scale responsibly. Stability

	isn't just about pegged value. It is about building trust in the future of money. Thank you all for tuning in. Stay curious, coin-savvy, and please do join us again soon. For now, take care and goodbye.