

Missing Blocks in the Chain: Why Lending Markets Hold the Key to Real Liquidity in Tokenized Finance

***A strategic opportunity for banks and asset
managers to lead the next phase of capital
markets innovation***



Executive Summary

Tokenization & Real-Time Settlement

Common Myth: Tokenizing assets automatically yields high liquidity and minimal friction.

Reality: Real-time settlement removes the T+2 buffer, requiring pre-funding and making uncovered short selling impossible without a robust lending infrastructure.

Traditional Market Mechanics

T+2 Window: Market Makers benefit from the 2-day settlement cushion to locate shares and secure cash, allowing them to continuously provide bids and offers. This buffer sustains liquidity by enabling short selling and risk management, ultimately leading to tighter spreads and more stable market conditions.

Securities Lending & Repo: Critical for short selling, day-to-day funding, and overall market fluidity.

Myth vs. Reality

Pre-Funding: Without a settlement delay, traders must lock up assets / cash in advance or set up credit lines, limiting flexibility and scalability.

Covered Short Selling: Still feasible under real-time settlement but demands a strong securities and crypto assets lending market.

Supportive Ecosystem

Securities / Crypto Asset Lending & Borrowing: Under real- or near-time settlement, it ensures market makers can maintain two-sided quotes through covered short sales, safeguarding liquidity and market efficiency. At the same time, it offers fee-based revenue opportunities for asset holders—making them pivotal to vibrant, fluid markets.

Prime Brokerage & Repo: Provide collateral management and short-term funding, maintaining liquidity.

Conclusion

Not Automatic: Real-time settlement alone hinders deep liquidity; ecosystem services remain vital.

The Business Opportunity

Banks, asset managers, and DeFi can collaborate to replicate or enhance traditional market structures on-chain, potentially unlocking new liquidity avenues.

A strategic opportunity for banks and asset managers to lead the next phase of capital markets innovation?

1. Introduction

Blockchain technology has stirred significant excitement in capital markets, with many proclaiming that once assets are tokenized and moved on-chain, liquidity will inevitably surge, counterparty risk will disappear, and transaction costs will plummet. In truth, real-time or near-real-time settlement—one of blockchain’s hallmark features—does promise certain advantages, from faster clearing to potentially lower operational overhead. However, these benefits also introduce new complexities, such as the requirement to pre-fund trades to meet instantaneous settlement deadlines.

This paper, “***Missing Blocks in the Chain: Why Lending Markets Hold the Key to Real Liquidity in Tokenized Finance***”, argues that true liquidity in tokenized markets ultimately hinges on the existence of a well-developed ecosystem. Key elements include robust securities lending facilities, avenues for covered short selling, and supporting market services that collectively uphold continuous trading and price discovery.

Simply placing assets on a blockchain does not guarantee deeper liquidity unless these critical components are in place.

The discussion begins with a concise overview of how today’s markets actually function, emphasizing the role of settlement windows, short selling, and the repo market. **We then contrast blockchain’s real-time settlement model with traditional practices, illustrating how some of the touted benefits can also constrain liquidity if not carefully managed.** Next, we highlight the importance of a supportive ecosystem, from securities lending and prime brokerage to regulatory clarity. Finally, the conclusion ties these insights together and underscores **how asset managers, in particular, can leverage the shift toward tokenized markets to unlock new revenue streams and opportunities—if they help cultivate the necessary infrastructure.**

2. Traditional Market Mechanics: A Brief Overview

In most modern equity markets, trades settle two business days after they are executed. This T+2 window allows participants to line up the necessary funding or locate shares for the delivery. Behind the scenes, clearinghouses, custodians, and brokers coordinate large volumes of transactions to ensure each investor receives the correct cash or securities on settlement day. This delay, while not instantaneous, provides a buffer period for operational checks and risk management.

Short selling contributes to market liquidity and price discovery by letting market makers sell shares they do not currently own. In a **covered short sale**, sellers borrow shares in advance, reducing the risk of failing to deliver. In contrast, an **uncovered (naked) short sale** relies on post-trade borrowing during the two-day settlement window, offering a quick boost to trading volume but carrying higher regulatory scrutiny and potential settlement risks. **Prime brokers and other intermediaries play a key role here: they pool shares lent by institutional investors and asset managers**, making them available to short sellers who need immediate access to borrowed stock.

The repo market adds a further layer of liquidity to the financial system. In a typical repurchase agreement, securities serve as collateral for short-term loans. This arrangement allows institutions to meet their funding needs

quickly—often overnight—by swapping securities for cash. Because it is backed by collateral, the repo market can handle large volumes at relatively low risk, providing a dependable source of daily liquidity for banks, broker-dealers, and other market participants.

To maintain orderly trading and protect against systemic risks, regulators impose measures like mandatory “locate” requirements for short sellers and capital requirements for broker-dealers. These rules ensure that market participants can deliver the shares they sell and have the financial strength to back their trades. Ultimately, a clear regulatory framework upholds confidence in trade settlement and supports continuous market liquidity.

By combining T+2 settlement cycles with robust securities lending, a well-functioning repo market, and prudent regulatory oversight, today’s markets keep liquidity flowing—albeit with certain inefficiencies and delays. This framework of staggered settlement windows and organized lending channels has proven effective but also highlights the complexities of maintaining a seamless trading environment.

3. The Myth vs. Reality

The excitement around blockchain-based markets often centers on real-time (or near-real-time) **settlement**, reduced reliance on intermediaries, and the promise of deeper, more efficient markets. Proponents argue that minimal friction and near-instant finality will transform how assets are exchanged,

ushering in higher liquidity and lower overall costs.

Despite these potential benefits, on-chain markets face several constraints that can counteract—or even reduce—liquidity gains:

- **Pre-Funding Requirement**

By eliminating the buffer period that today's markets rely on, real-time settlement obligates participants to have funds or collateral ready *before* a trade. Without the brief window to arrange borrowing or gather cash, market makers and other traders may need to lock up more capital in advance, limiting their agility to execute rapid trades.

- **Impact on Short Selling**

Short selling depends on the ability to borrow shares at, or soon after, trade execution. In a framework where settlement occurs almost immediately, **uncovered (naked) short sales become practically unworkable**—there's simply no time to secure the shares post-trade. While covered short sales remain possible, the onus shifts to having a robust securities lending network that can fulfill borrowing requests quickly and reliably. Without that support structure, the capacity for dynamic market-making is constrained.

- **New Complexities and Risks**

While real-time settlement is meant to reduce counterparty risk, some crypto exchanges offer credit lines or margin facilities to high-volume clients, effectively reintroducing

exposure that can undermine the benefits of instant settlement. This arrangement not only creates potential counterparty risk—should a large client fail to meet its obligations—but also poses scalability challenges if the platform lacks robust collateral and risk controls.

In short, adopting real-time, on-chain settlement doesn't automatically yield the broad, frictionless liquidity some envision. Without pre-arranged funding mechanisms, scalable securities / crypto assets lending and borrowing, and clear collateral and risk controls, the very features that make blockchain appealing can also limit the flexibility needed to maintain vibrant trading and market-making.

4. Importance of a Supportive Ecosystem

A tokenized market may streamline certain processes, but simply moving assets on-chain will not unlock greater liquidity unless the full spectrum of market services is also adapted to this new environment. Banks, brokers, and asset managers currently underpin liquidity in traditional markets by enabling short selling, providing financing, and maintaining collateral mobility. For real-time settlement to function effectively, these elements must be replicated—or improved upon—in an on-chain setting.

1. **Securities / Crypto Asset Lending & Borrowing**

A robust securities / crypto asset lending & borrowing infrastructure ensures that covered short selling remains viable. If market makers can quickly borrow assets, they can continue to offer tight bid-ask spreads and provide immediate two-sided quotes. This not only sustains liquidity but also presents an attractive business model for institutional asset holders, who can earn additional revenue by lending their tokenized assets.

2. **Prime Brokerage Functions**

Even in a tokenized environment, large-scale traders such as hedge funds and market makers rely on leverage, financing, and execution services. Prime brokers—or analogous decentralized platforms—facilitate these needs. By integrating services such as collateral management and trade execution in a regulated context, prime brokers enable high-volume participants to navigate on-chain markets as seamlessly as they do off-chain.

3. **Repo Markets and Collateralization**

Allowing tokenized assets to serve as collateral for short-term loans can significantly bolster day-to-day liquidity. On-chain repos, for example, let participants quickly pledge and retrieve collateral, but these transactions must have clear legal and technical frameworks to account for potential defaults. Equally important is the ability to reuse collateral, whether through lending, staking, or other

mechanisms—this mobility is what drives efficiency and liquidity in traditional markets, and it's just as vital on-chain.

Real-time settlement can be a powerful enhancement, but only when accompanied by securities lending, prime brokerage services and repo markets. Together, these components recreate the essential conditions under which traditional markets thrive—allowing participants to manage positions, secure financing, and hedge risks just as effectively in a tokenized world.

4. **Conclusion**

The idea that simply tokenizing assets and moving them on-chain will deliver immediate, frictionless liquidity tends to gloss over the complexity of market structure. While near-real-time settlement can streamline certain processes, it does not by itself ensure deeper market depth or narrower spreads. A robust ecosystem—complete with securities / crypto asset lending & borrowing, repo markets, prime brokerage services, and clear collateral and risk controls—remains essential.

The continuing need for pre-arranged borrowing or lending facilities highlights the central role of ecosystem services in a tokenized world. Even under a real-time settlement model, market makers still rely on covered short sales to provide liquidity and tighten spreads, and repo markets continue to drive short-term financing.

Looking ahead, there are **significant opportunities for banks, asset managers, DeFi platforms, and other market players to collaborate in building infrastructure** that mirrors or even surpasses traditional market mechanics. Asset holders, in particular, stand to benefit by generating yield from lending out their tokenized assets, thereby reinforcing market liquidity.

Ultimately, the transition to real-time settlement presents a blend of **opportunities**—fewer intermediaries and faster clearing—and **challenges** such as pre-funding requirements. Ensuring that all the necessary support structures are in place will determine whether tokenized markets can realize

the liquidity advantages often attributed to blockchain technology.

If you are interested in examining further details on blockchain based capital markets infrastructure then feel free to read our [Tokenization Study](#) on the cost savings potential that can be achieved throughout the value chain.

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