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## FED NY: The Financial Stability Implications of Tokenized Investment Funds

- This post by the FED of New York explores **the potential financial stability implications of tokenized investment funds**, a nascent innovation integrating digital asset technology with traditional fund structures. The analysis is organized around three core mechanisms: **liquidity transformation, interconnections between financial systems, and transaction settlement.**
- **Liquidity Transformation:** Tokenized funds, like traditional investment funds, engage in liquidity transformation by holding illiquid assets while allowing near-instant redemptions. Tokenization could alleviate redemption pressure by enabling investors to use fund tokens in transactions or for margin requirements without selling the underlying assets. For example, in stress events like March 2020, tokenized shares could have mitigated liquidity strains by serving as margin collateral. Secondary markets for tokenized shares could also enhance liquidity, although their development may introduce new vulnerabilities. Specifically, market shocks unrelated to a fund's assets could trigger redemptions due to declining token convenience yields.
- **Interconnections:** Tokenized shares expand the interconnectedness between the digital and traditional financial systems. Their use as collateral, liquidity instruments, and reserve assets enhances efficiency but also increases systemic risk. Potential benefits include diversification of funding sources and reduced reliance on banks. However, risks include bank disintermediation, contagion through cross-holdings (e.g., stablecoin issuers holding tokenized fund shares), and amplified stress propagation if redemption pressures in one segment spill over into others.
- **Settlement and Market Infrastructure:** Tokenized assets offer real-time settlement and 24/7 trading, which could improve collateral management and enhance liquidity under stress. However, such features may accelerate runs during crises, especially on opaque, permissionless blockchain networks. Concentration of settlement activity on a few platforms could introduce systemic infrastructure risks, undermining the central bank's ability to preserve financial stability.