SACRA

EXPERT INTERVIEW

UPDATED
05/04/2024

Bhanu Kohli, CEO of Layer2 Financial, on stablecoin-backed payments for platforms

TEAM

Jan-Erik Asplund
Co-Founder
jan@sacra.com

DISCLAIMERS

This report is for information purposes only and is not to be used or considered as an offer or the solicitation of an offer to sell or to buy or subscribe for securities or other financial instruments. Nothing in this report constitutes investment, legal, accounting or tax advice or a representation that any investment or strategy is suitable or appropriate to your individual circumstances or otherwise constitutes a personal trade recommendation to you.

This research report has been prepared solely by Sacra and should not be considered a product of any person or entity that makes such report available, if any.

Information and opinions presented in the sections of the report were obtained or derived from sources Sacra believes are reliable, but Sacra makes no representation as to their accuracy or completeness. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information, opinions and estimates contained in this report reflect a determination at its original date of publication by Sacra and are subject to change without notice.

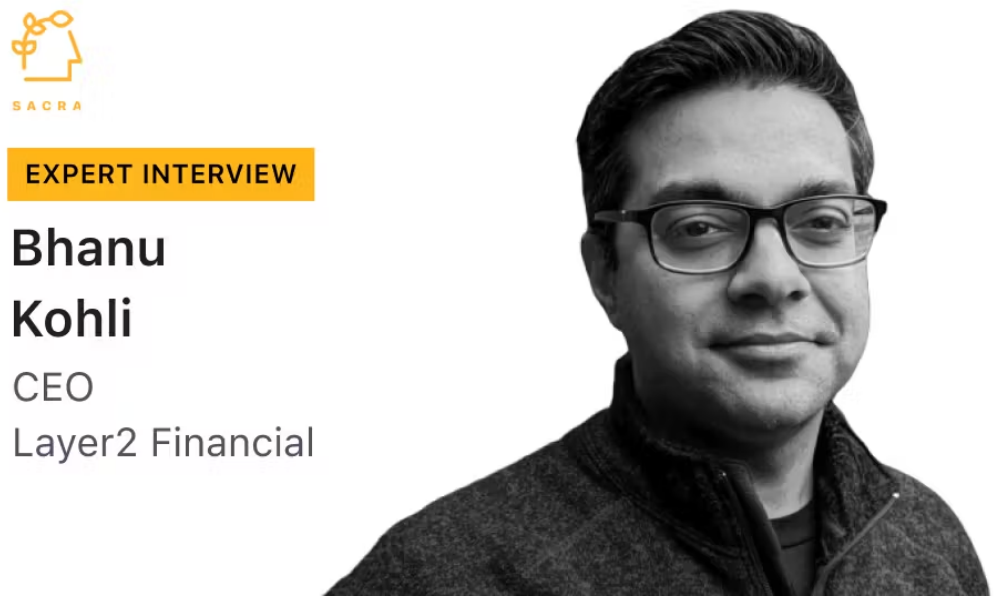
Sacra accepts no liability for loss arising from the use of the material presented in this report, except that this exclusion of liability does not apply to the extent that liability arises under specific statutes or regulations applicable to Sacra. Sacra may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect different assumptions, views and analytical methods of the analysts who prepared them and Sacra is under no obligation to ensure that such other reports are brought to the attention of any recipient of this report.

All rights reserved. All material presented in this report, unless specifically indicated otherwise is under copyright to Sacra. Sacra reserves any and all intellectual property rights in the report. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of Sacra. Any modification, copying, displaying, distributing, transmitting, publishing, licensing, creating derivative works from, or selling any report is strictly prohibited. None of the material, nor its content, nor any copy of it, may be altered in any way, transmitted to, copied or distributed to any other party, without the prior express written permission of Sacra. Any unauthorized duplication, redistribution or disclosure of this report will result in prosecution.

Published on **May 04th, 2024**

Bhanu Kohli, CEO of Layer2 Financial, on stablecoin-backed payments for platforms

By **Jan-Erik Asplund**



Background

Bhanu Kohli is the CEO of Layer2 Financial. We talked to Bhanu to learn more about how stablecoins are both accelerating and benefiting from the rise of cross-border payments, how neobanks and fintechs are positioned to compete with banks on speed, cost, and convenience, and Layer2's vision for replacing SWIFT as the dominant cross-border payment system.

Interview

What is Layer2 Financial and what inspired you to build it?

Layer2 Financial today is a global payments infrastructure that allows businesses to move money faster globally. That is the vision, our North Star, to replace SWIFT as the global B2B, B2C payment rails and eventually global payment rails for any sort of cross border transaction.

Why did we build it? It didn't start off as a payments infrastructure or pure payments infrastructure. It started off as a crypto-as-a-service infrastructure for crypto native financial products, and that's where the name Layer2 Financial comes from. This was before the concept of Layer 2 became big in the Ethereum world.

The reason we started that was because I was a partner at Capco, a global financial services consulting firm with 7,000 people just focused on financial services. I worked with some of the largest banks in the world. After a number of years, it became clear that we're just building new stuff on top of very old shit. And we all know that if the foundation is not good, if it's not meant for this new world, then it's not going to work no matter how much lipstick on a pig you put there.

The other issue I found was that a number of financial institutions provide a suboptimal service because they control the flow of money. They are the gateway into the money system. If you take that control over the flow of money away from them, I guarantee they will provide the best service you can ever find because they know the customer has options. Customers can find another way of paying through open networks like Ethereum, Bitcoin, and others.

We think open digital asset networks, not closed networks, are in fact the better way to move money globally. If we get back into constructing closed digital asset networks, we have failed. If you're going to move to new financial infrastructure, it has to be based on open networks, not on open banking APIs that sit on top of existing closed infrastructure.

If you really, truly want to be open, you have to take the control of money movement away from the banks. Let banks compete on providing better products, better lending. Let them compete on things that consumers find value in—a better mortgage product, a better credit card.

That's why we decided digital asset infrastructure is the right underpinning for a whole new financial world for everybody. It's open, it's global.

More esoterically, if you provide people better financial products, they will do great things. You give them opportunities that they have not had before because maybe they couldn't get

a loan from a bank that discriminated against them for whatever reason. But if you create an open ecosystem, someone else will provide them that product.

So that's why we're doing it—to create a better financial system, provide access to products, and spur more innovation in payments. Our focus is payments, but if you create a better payments infrastructure, you can do many things.

Layer2 initially started out with an explicit crypto-forward positioning. Today, it reads more like a fintech infrastructure provider that happens to be powered by crypto rails and have crypto-related features. I'd love to zoom in on this sort of pivot moment—can you talk about that moment, what it meant to pivot and what it means to be hybrid?

Post FTX, we realized there wasn't enough demand for pure crypto infrastructure for now. We thought, do we fold or do we pivot? We decided to pivot because we were seeing demand on the payment side from customers, and not just for crypto payments, but fiat as well.

Customers were asking, "Can you create a single infrastructure for us that can do fiat and digital asset payments and mix the two together where we need to? Can you move money faster for us?"

It was a tough decision for us to go deeper into fiat, but at the end of the day, we had to look at the market demand. We were maybe a little too optimistic on how long it's going to take for everybody to go to pure digital asset infrastructure.

While I'd like that to be the case in the next five years, I think we are going to operate in a hybrid world for the next 10 years. Adoption will go slow and then it'll go super fast. It's the adoption curve that any new innovation follows.

For us, what it meant to pivot was to provide better fiat support. The reason for that is not everybody's transaction flows are pure stablecoin or pure crypto, as much as we'd like. For folks to even interface and buy stablecoins, it's such a journey for them. It's such a difficult moment for them.

Whether it was for us to support customers that want to transact in fiat and actually don't care to operate in crypto at all, they don't care if the stablecoin is part of the flow, they actually don't give a shit. But when you have clients like AngelList that want to provide a stablecoin service but don't want to build the infrastructure that's required, whether it be from a compliance perspective, tech perspective, ops perspective, it's very hard to build digital asset infrastructure and build a digital asset product today.

So whether it is for us to provide a seamless flow from crypto into fiat or fiat into crypto, or whether it is to support B2B and B2C clients that are getting absolute garbage service and no APIs for the pure fiat flows, that's what it meant for us to pivot. It's to provide better fiat support but not to provide better fiat support to eventually kill crypto. It's actually quite the opposite - to provide better fiat support so we can build a client base that we can transition over to crypto. And it's working out really well.

For a lot of our clients, the bigger part of their portfolio in terms of growth is actually not the fiat side, it's actually the stablecoin and the crypto side. The beauty about our platform is that when customers come to us, they're not just getting your standard on and off-ramp flow, they're actually getting a full payments platform that can handle fiat assets just as well as digital assets.

Who is your customer at Layer2 and what are the core use cases?

We sell to fintechs, neobanks, payment processors, and now banks are also emerging as potential clients. We don't sell direct to the end customer: corporate or retail.

AngelList is an example, a client of ours, but the end customers actually sending the money in are LPs of AngelList. They're the LPs that fund the funds or in some cases the funds themselves will become clients of our customer, end customers of ours. You've got clients and you've got end customers. The end customers of the client are actually our customers as well because for all the KYC and AML purposes, we have to onboard these customers and they conduct transactions on our platform and so on.

AngelList was actually our first client. They started with us when we launched in 2022. They've been through lots of ups and downs with us in terms of market changes, crypto collapse, switch from partner A to partner B, been through a couple of banking issues, and they've been an amazing design partner for us.

Regarding AngelList, where's the strongest usage, the strongest use case?

From the data we've seen, it's actually LPs that are not based in the US. That's the majority of the usage - coming from LPs outside the US that want to settle faster.

They could go to a bank to do a SWIFT, answer many questions because the bank doesn't know the transaction, and then they may have to wait for days for the funds to arrive. Or they can go and buy USDC from a local exchange, send it in and it settles in minutes. The largest ever settlement I think we saw from them was about $2.5M in a single transaction which got traded, settled and deposited into AngelList bank accounts in a few hours. That's a magical moment when you literally can move money and see your funds show up internationally within T+0.

That's the experience we are working to create for every single transaction globally.

We're just opening up Europe right now in Beta mode with a couple of clients. We're opening up a USD to Euro corridor where you can move funds in USD and get EUR on the other side delivered to the destination bank account in T+0.

That experience could be as fast as 60 minutes. We moved half a million, I think it was on Tuesday, half a million on Friday. Funds arrived into our US account around 8:30am Eastern, and by 9:30am Eastern, EUR was in the destination bank. You can't get that anywhere else.

That is what we're building - that experience of T+0 to move money across borders without using SWIFT, without using our balance sheet, like Wise.

Can you walk us through a payment end-to-end that's powered by Layer2?

End-to-end, there are a few different flows that people facilitate through the platform. Let's pick the simplest one. A customer comes in, call it a fintech from Singapore or a company in Singapore. They have to pay bills, pay their suppliers, make payroll, but for them they need to make those payments in USD.

They'll be like, "Okay, here is some USDC, can you please convert this to USD?" Amazing, thank you. Operation one done. Now you're holding on to $1 million of my USD. Now I need to make 120 payments. I need to make some payments in USD locally. I need to make some payments in INR. You provide me that service. I need to make payments in EUR. I need to make payments in CAD. I need to make some SWIFT payments. They come in, off-ramp and then they will basically make all these payments all from a single spot. That's amazing. That's the experience they're getting from that.

Then you have other flows where people say, "Okay, I want to collect USD in the US from my customers, and now I want to on-ramp that to USDC and USDT and take it back to my home country." Okay, great. And that could take the form of many different flows. It could be a contractor receiving USD inside the US and converting it to USDT and taking it. It's an Argentinian contractor that wants to hold funds in USDT because they want to protect their currency from inflation.

And then we have customers that just want to do fiat to fiat. They don't care how money moves from point A to point B, they're like, "I have USD and need to pay someone in Hong Kong in USD and would like to use SWIFT. Or if I want local currency, I'll just tell Layer2 to convert to the local currencies that Layer2 supports. Layer2 can use crypto rails, or payment partners, I don't care."

Layer2 custodies customer funds. Could you talk about why you made this design decision and what the tradeoffs are vs a non-custodial solution?

We are a regulated entity, but it's a hybrid model of how we custody funds. In some cases, we hold the funds in the customer's name at qualified custodians/ banks. In some cases we hold it under our name at qualified custodians/ banks.

I think your basic intent with the question is asking why are we using centralized exchanges/ custodians vs. self custodying/ DEXs?

DEXs are good for retail, but when we're trying to move a million dollars or $5 million or $10 million, there isn't enough liquidity in these platforms. We'd have to go to multiple platforms, but that's not our job. That's not our core competency.

That's number one. The number two issue is that we still have to operate in a highly regulated fiat world. We're regulated as well, and there are a lot of compliance and regulatory items we have to comply with such as Travel Rule. We cannot get that type of clarity from DEXs because their entire value prop is to keep things decentralized and anonymized.

So because of regulatory and liquidity reasons, we cannot use DEXs, which means we have to use centralized market makers and LPs that are going to provide us the best rates and liquidity.

So yes, are there risks on the centralized exchange side? Yes, but from a regulator perspective, the KYC and AML risks of the DEXs are much larger than a potential centralized exchange going under.

When it comes to custody of crypto funds, we tend to work with custodians like Bitgo Trust. We are not a custodian and we don't want to be. There are security issues that come with it and a bunch of other risks that quite frankly are a different game altogether. I don't want to be a custodian. From a regulatory perspective, it's going to have a different flavor to what we do, which is money movement, not money storage.

It may seem counter to my earlier position that we should take away control of movement of money from banks, but in this case, I see storage of money versus movement of money differently. Movement of money should still be on open networks. For storage, customers can choose to either keep the funds with our custodians or withdraw to their self custody wallets.

As between the digital assets that Layer2 supports, what does the volume mix look like between stablecoins vs BTC

/ ETH / other?
It is limited. It goes back to the purpose of our platform, which is to support payments. We're not looking to be an exchange. We want to support payment flows.

So we support USDC/ USDT on Ethereum, USDC on Matic, BTC, ETH, MATIC and SOL. We'll be supporting Tron very soon. And that's really it. We have DAI but it's very low volume.

When we think about payments, they tend to operate on stablecoins. No one wants to take on currency risk and crypto volatility risk at the same time.

It's all about liquidity too. Can I take these assets and give them to anyone and have them give me fiat in return? If we start supporting exotic coins and chains, no one's going to accept that. It might be a cool product, but is it ready and stable enough? Does it maintain its peg and does everyone trust that it will maintain its peg? That's why we focus on stables over any non-stables.

Last year, two crypto-friendly banks failed, Signature Bank and Silvergate Bank. The upshot is that many banks pulled back from working with crypto companies. How did this pullback affect Layer2 and Layer2's customers? How should we think about the current regulatory climate with respect to the adoption of stablecoins and Layer2 for payments?

The constraints that have been placed on us have just optimized our product. They've made us realize there's a much bigger need for our product. If anything, it has just deepened our resolve.

Has it caused issues for us in finding bank partners? Absolutely. I think most bank partners are digital asset shy. However, we are working with some amazing bank partners that share a common vision of the future of financial services..

We have spun up an entire team just to focus on partnerships, specifically bank partnerships. It's caused us to delay our global expansion because we have to stabilize home turf before we expand. If we have a weak foundation in the US, we can't expand globally.

Growth has been slower than I would expect it to be, but still pretty stellar. I think we could have moved a lot faster with a more stable US banking system, in my opinion. But that's the job.

Do customers tend to rip and replace their entire payments infra with Layer2, or do they use Layer2 as a parallel crypto infrastructure to their tradFi infrastructure?

Sometimes for some of the smaller and mid-size fintechs, yeah it is a rip and replace. They're using another partner, they're using three partners, and they consolidate it all into one with us and off we go.

For others it is in addition to their existing infrastructure. AngelList, for example, is not going to replace their entire infrastructure with Layer2. The risk is too high. The core flows are baked and operating well. We have to earn the right to take on more and more of their flows.

10 years ago, a wave of payments companies like Stripe, PayPal, Shopify and others announced support for Bitcoin payments. Low volumes followed and many of those platforms stopped accepting BTC. What's different this time around with stablecoins?

I think what has changed is that stablecoins are now the "Bitcoin". Lightning is a great product, except it is not scalable enough for us. It's still focused on retail. There's too much volatility on the Bitcoin side to run at scale for large corporate transactions. Our average transaction is about $50,000-100,000. It's a pretty large ticket item for us to take on. Even a 1% volatility wipes out our entire margin. If we push that volatility to the customer, they will just wait and do a SWIFT transaction. It's all about risk—the volatility risk versus time.

Why is this the right time for stablecoins to be used for cross-border transactions?

Stablecoins have increased in volume and value. Stablecoins are not considered securities and are generally being accepted by various corporate partners now. Adoption has just grown, which has really made stablecoins a viable alternative for cross-border payments, either as a bridge currency or as a

direct pair like USDC to USD, USDC to EUR, or as a bridge between USD and EUR.
Cross-border money movement in general has gone up post-Covid with migration flows and supply chain diversification, which has just led to an explosion of cross-border money movement.

It's now easy to be in Argentina and make the same amount of money, maybe slightly less, than you were making in the US. You have a better quality of life. People moved and that led to an explosion in cross-border money movement.

Supply chain diversification has also happened quite significantly. You look at very mega examples of Apple opening up factories in India to diversify from China. When there's that diversification of the supply chain, cross-border business money movement just explodes. And what are the alternatives? Today it's only SWIFT.

So now if you take a look at the stablecoin market growing, the increase in supply chains, increase in cross-border money flow and movement, it just seems to be an obvious match.its these various market forces culminating together to make stablecoins increase in adoption.

Now, by the way, I don't care about using stablecoins for payments, to be honest with you. Whether it's stablecoins today or some other digital asset that maintains its value in the future—it could be a tokenized money market fund, it could be a central bank digital currency, anything that maintains its value, can be used, and has a market on both ends. That's what I care about. We're just using it as a way to facilitate money transfer.

The long-term future is to create an entire pure end-to-end stablecoin infrastructure. I'm hoping that in 10-15 years, we're not doing any fiat conversion or it's such a small amount that everything is stablecoin to stablecoin or some digital asset to digital asset. And everyone has a wallet that they can buy goods in digital assets. That future is what we are building.

Stripe appears to have a renewed commitment to crypto and stablecoins in particular (USDC). How do you think about Layer2's positioning with respect to Stripe and where does Layer2 win?

I see Stripe as going after the merchants. Their rates are very, very expensive. We cannot charge 100 bps. They're going after the merchants that want to accept payments from customers in crypto. We are building infrastructure for different payments use cases that fintechs like Stripe can offer to their customers. Accepting payments from customers in Crypto is just one.

I'm sure it's going to be a great proposition for the merchants that already use Stripe. They can now combine crypto as a payment form in addition to providing cards and other payment forms. If you're working with Stripe already and you are a merchant accepting retail payments, amazing proposition, all integrated.

Within the stablecoin market, are you seeing USDC winning out? We talked about supporting USDC and USDT. Does Layer2 have any kind of focus on USDC or is it sort of all the same to you?

I don't really care whether its USDC or USDT today or some other digital asset in the future. The reason we prefer USDC today is stability, demand and liquidity. We don't care if some other new coin pops up

We're actually talking to a few interesting projects that are claiming they will have X amount of liquidity in certain corridors. They have the corridors baked. I'm like, amazing, let's talk. I don't actually care if it's USDC or USDT.

Whats more important than volatility is market. Is there market on both sides for us to do transactions? Can we buy a million, 2 million, 3 million, 10 million, a hundred million at the scale we want to operate at in the future?

5 years from now, I want to be able to move a billion dollars a day. Is there enough market for us to do that? It's very important for us to look at—is there market to buy and sell on the other side? That's important for these projects.

When you think about USDC or USDT, there's market, there's enough volume, there's billions floating around. The exchanges and market makers have liquidity.

Bitcoin has that as well. It's a global currency accepted in every single exchange over the world. So if we need to use Bitcoin for some high volatility currency pairs, the volatility of Bitcoin may actually be worth it because we may not hold onto it for very long and it may actually be stable enough for us to conduct a transaction. If we need to create a basket, we'll create a basket.

Companies like Deel for payroll have gone in reverse from startups historically—starting globally and then using that as a wedge to conquer the domestic U.S. market. Is global-first a rising trend and where do you see it playing out in other markets besides payroll?

The only reason people do that is the US is the hardest market to crack in the world from a compliance perspective, from a banking perspective. It's a tough market. But you know what? We did that by design. We're like, lets go after the hardest market you can operate in. It's going to be easy for us to go operate in other markets if we can make it in the US.

We took the reverse approach. There were many opportunities for us to say, forget the US, go somewhere else and open up Europe first. But the US is still the largest market in the world. Everybody wants to hold USD.

It's a very complex regulatory environment and a very complex banking environment, anti digital assets right now. But to me, to me, these are the perfect conditions to build an amazing company, isn't it?

A lot of the constraints actually help you build a better company because you come up with amazing solutions. The constraints in the US market have helped us build a better company, quite frankly, to take advantage of the biggest market in the world. We have not only survived but have thrived.

Now we can use that as a template and take that everywhere else to operate. Taking that level of maturity that we have built and taking that across globally is actually just an asset for us. I think it's a better approach.

If everything goes right for Layer2 over the next 5 years, what does it become and how is the world changed?

How has the world changed? More of these USD to EUR transactions in T+0, man. That's how the world's changed. We're going to allow companies to move money globally faster without having to hold float, without having float, and more predictably show them where their money is at any given point.

A lot of this was actually born out of our own frustration with SWIFT, our own frustration with currency cloud and other payment partners. We built this product for ourselves and we eat our own dog food every single day.

For us, what is cool, what will be success, is if we built a global network that spans multiple massive trade hubs around the world—US, Canada, UK, Europe, Dubai, Singapore, Hong Kong, India, Australia, China, Egypt, South Africa. Then you go into Latin America—Mexico, Argentina, Brazil, Colombia, Uruguay.

To me, if we've done that, if we have T+0 between all these corridors, I'll be a super happy guy.

Looking forward 10 to 15 years, I think if we have transitioned the world to a pure digital asset infrastructure, at least within the realm we operate in which is payments and remittances, I will be happy with that kind of progress.

Disclaimers

This transcript is for information purposes only and does not constitute advice of any type or trade recommendation and should not form the basis of any investment decision. Sacra accepts no liability for the transcript or for any errors, omissions or inaccuracies in respect of it. The views of the experts expressed in the transcript are those of the experts and they are not endorsed by, nor do they represent the opinion of Sacra. Sacra reserves all copyright, intellectual property rights in the transcript. Any modification, copying, displaying, distributing, transmitting, publishing, licensing, creating derivative works from, or selling any transcript is strictly prohibited.