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6. An Introduction to Non-Fungible Tokens

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Abstract:

'Those who do not change with time are changed by time'. These wise words perfectly highlight the significance of adapting to the changing times. On should always try to keep up with the dynamism of the world. This makes even more sense in the concurrent business world where a little delay in identifying the growing trends can put billions at stake. One common factor among most of the changes that are taking in and around our lives is the continuous technological advancement which has spread to all the fields ranging from finance, telecom, healthcare to marketing and human resources. One such innovation that is currently proving to be apple of the eye of investors in the finance world are 'Non-Fungible Tokens' (NFTs). The objective of this chapter is to make the readers aware about the existence of NFTs, and explain to them the technology behind them. It is also going to look at the future of NFTs by instilling a sense of advantages and disadvantages, so that the reader can have a 360 degree of this investible alternative and analyze the suitability of NFTs for different kinds of users depending on the priorities and risk-return preferences.

6.1 Introduction:

Anything that claims to turn many into quick millionaires is definite to make the headlines of newspapers and financial blogs. Non-Fungible Tokens (NFTs) have lately been talk of town. If you have not been living under a rock, then chances are high that you must have heard about NFTs. Something that has caught the fancy of celebrities ranging from Amitabh Bachchan, Salman Khan to Yuvraj Singh and Dinesh Kartik deserves at least some wrangling. But the Achilles Heel is understanding the concept of NFTs before one can try to discuss and debate about them. It's imperative to learn the prospects of this technology and simultaneously look at the risk they pose. And something, which is as novel as this technology needs to be analyzed in greater depths. But before digging deeper, it is important to understand its meaning and then only we can move ahead to understand its implications in various fields. The benefits that it can provide to budding artists in terms of commercial gains based on their art as well as claims for ownership is one area that needs to be explored. This piece will try to detangle the mystery of Non-Fungible Tokens and present it in a way which is understandable by a layman.

6.2 Fungibility:

Before moving to NFTs, let's talk about the concept of fungibility. It is defined as the quality of an asset to be replaced or interchanged by another asset of the same category. Let's suppose I take a loan of Rs 10,000 from you today and promise to pay you back after one week (after I receive my salary), assuming that you have given me 5 notes of Rs. 2,000. I take this money and spend it. After one week, I receive my salary in my back, withdraw 5 notes of Rs. 2000 from ATM and pay it back to you. Now, do you expect me to give the exact same notes back to you while paying back the loan? Definitely not. You will be fine with receiving any 5 notes of Rs. 2000 (or even 20 notes of Rs. 500).

So, this is what is called being fungible. One note can be easily replaced with another note of same denomination (or even notes with different denominations provided the value of money same). Money even cryptocurrency like Bitcoin are fungible assets.

Now, let's change the example. Let's say you have an exclusive vintage watch with which you share an emotional connection. One of your friend borrows it. Now, she wears it to party and then it gets lost. Would you be fine receiving money in return for it? Similarly, there are many assets which are unique by nature.

They derive their value from their exclusivity and the demand that exists for it. Such assets are called non-fungible assets as they cannot be replaced with others of the same kind. Non-fungible tokens, as the name suggests are not interchangeable. They are unique assets and one of their kind.

6.3 Blockchain:

If you buy a new car, what is the proof that you are owner of that car? Or how would you prove that you own the house that you live in. The evidence of ownership is generally a document that mentions the name and details of owner of a property. This document (or documents) provide exclusive rights to the owner related to use and sale of their owned properties. That's why you must have seen your parents safely storing such important documents in lockers!

But what if we need to prove ownership of assets which do not exist physically? In this case, Intellectual Property Rights (IPRs) come into the scenario. We have patents and copyrights to protect the owners of innovative ideas. In case of assets of extremely exclusive nature, the data regarding ownership is stored on digital ledger called Blockchain. It is the disruptive technology that has been revolutionizing the methods in which we store data.

Blockchain is referred to as Digital Ledger Technology (DLT). In simple words, it can be explained as a ledger (or simply a notebook) which exists in a digital format where data can be safely stored. In physical state, the documents or the records are vulnerable to manipulation or tampering. We all have heard stories (at least watched in movies!) of people forging documents to acquire the control of assets in a fraud manner.

But the data that is stored on blockchain is next to impossible to manipulate, it can be considered as one of the safest recordkeeping methods. The word 'decentralized' in DLT refers to the fact that these blockchain ledgers are not owned by anyone individual or organization. So, it is like a public document that can be accessed to all.

Blockchain can be understood as a collection of blocks which contain data about various transaction (can relate to sale/purchase of assets, transfer of money and many more). The reason behind the safety feature is that the data is encrypted and contains details about all the previous transactions that have taken place on blockchain. It is the underlying technology of cryptocurrency which is being considered as one of the most disruptive technologies of 21st century. Blockchain is a significant component in the generation of NFT technology.

6.4 Non-Fungible Tokens (NFTs):

Non-Fungible Tokens are nothing but a method to buy unique and exclusive assets where the data regarding this purchase transaction is stored on Blockchain which makes it super secure. Ethereum is one Blockchain technology that is underlying technology for many NFTs. But what makes NFTs special is the kind of assets which are being purchased and sold. Not only conventional assets but anything that is considered as art can be traded using the NFT technology.

Be it a song, an image, a meme, a movie scene, an animation, a tweet, an event – anything that has a buyer and seller can be exchanged. NFTs let us tokenize all these things and brand them as a token in which interested buyers can invest.

The data regarding their investment will sit safely on the blockchain, which can be easily verified by anyone.

In short, NFTs provide investors with a method to buy an ownership stake in anything they like or they want to invest. Few features of NFTs can be summarized below:

- Unique
- Indivisible
- Safety of data
- Transparent
- Trackable
- Negligible Chances of Fraud

6.4.1 What kind of investor buy NFTs?

- Patrons of a certain art forms – For Example - If you a paining enthusiast, you would want to buy NFTs based on paintings as you will like to be associated with your passion. Or imagine a song which can invoke a havoc of emotions in you. Would you like to own some proportion of that particular song?
- People who believe in appreciation of these assets – Many people might want to invest in NFTs, not because they believe in associated art but because they feel they that the demand of this asset will rise and the value of their investment will increase. In future, they can easily sell these NFTs and generate revenues – just as shares are bought with the objective of selling at higher prices in future.

6.4.2 How can NFTs be used?

- Authenticating the ownership of an asset – If you buy something, the record of your purchase is totally safe due to the DLT technology, which is fundamental in NFTs. So, you don't have to worry about the documents which state your ownership. The chances of anyone tampering these records are negligible.
- Platform for budding artists – A bone of contention for budding actors, singers, dancers, actors or other artists is that it takes them a lot of time to reach to the biggies of the industry and build their careers and then, they are able to make their both ends meet. And if they are lucky enough they might make some decent money. NFTs eliminate the need of building networks in the industry and hiring costly agents. So, they cut the costs of intermediation. But with the use of NFTs, it is easier to commercialize their art forms and monetize it gradually. NFTs provide a platform to these emerging entertainers to connect with their target audience and offer a stake of ownership to their patrons.

  Apart from that, these artists can also generate a revenue stream of royalties whenever the underlying asset of an NFT is sold, some royalty would be provided to the original creator. Hence, NFTs reward originality and provides a way to monetize their art.
- Higher Scale of Securitization – It helps to convert everything that has a buyer and seller into a tradable asset.

  That means not only financial instruments and real assets (commodities like oil and cotton), but even art forms like paintings, songs, memes, tweets can be commoditized and traded. It provides investing opportunities for their original creators as well as people who buy them with the objective of selling them at higher prices.
- Investment Opportunities – From the point of view of investors, NFTs provide investors with an additional alternative to invest which can help them to diversify their portfolio. Also, they can provide investors with good returns.

6.5 Risks Associated:

- Loss of Value & High- Risk Market - The asset that the investor is buying using NFT technology might not be able to retain value in long-term. Hence, it is a possibility that one can end up buying an asset at a very high price for which there is no market to sell or there is very low demand which will crush the value of the asset.

Let's say you find a video on internet that looks really cool to you but others do not think the same.

You might want to buy a stake in it but it might be possible that no else thinks so. In this case, you might want to put your money into buying a stake into it but in future if you want to sell it for money, there is no guarantee that you will find buyers for it.

- The usage of blockchain consumes a lot of power which might not sync with the concurrent eco-friendly wave. Although, many researches are being carried on to discover newer technologies to make these decentralized technologies less power consuming in nature.
- Art Theft – NFTs might open possibility of some people stealing the works of undiscovered artists and making a commercial gain on the backs of people who have invested time and energy in authentic creation of the art forms.
- Some people call NFTs – 'securities made out of anything'. So, it might lead to creation of securities taking any invaluable asset as fundamental.

  This value is not determined in terms of intrinsic method but on the basis of market perception. So, if there are buyers for even an invaluable asset, it becomes worthy. The same principle renders a valuable asset worthless if there are no buyers for it.
- Grey Area – The NFT field is a novel field that's why there is a dearth of rules and regulations related to trading in NFTs. It will take a common person a lot of time to understand NFTs.

The name in itself seems complicated enough – So, it might not be easy to spark the interest of Indian investor into this unsafe and new instrument, considering low risk appetite of Indian Investor.

6.6 Conclusion:

In this chapter, we have only discussed a few basics of Non-Fungible Tokens. The prospects they hold is an ocean of opportunities – which is waiting to be explored. The implications that NFTs hold in the various field especially giving boost to budding artists need to be examined in greater detail and supported with constructive research. Apart from that, NFTs can also be a helpful tool in fighting piracy by making art forms accessible to all but changing those who want to have an ownership stake in it, providing due credits to the original creators in the process. In the wake of pandemic, where trends like Robin hood Investing (retail investors entering into stock markets to invest directly) is growing and availability of platforms to trade (Applications in your phone that can be used to buy and sell shares) are making trading of securities as easy as touching certain tabs on your phone, NFTs are sure to spark the interest of investors. But the point to be analyzed is figure out stability of these instruments, which would emerge when utility of NFTs will start growing for common public. The question to look forward is 'NFTs – Here to Stay or Just a Fad?'

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