

Recent Market and Regulatory Developments in the Digital Asset Space

Recent years have seen global interest in digital assets¹ grow significantly. The digital asset market has also been characterised by high risks associated with significant volatility. After sustained increases since June 2020, the market capitalisation of digital assets peaked at USD3.1 trillion in November 2021. This trend has reversed since then amid geopolitical uncertainties, rising interest rates and inflationary pressures. By December 2022, market capitalisation of digital assets stood at USD830 billion, down 73% from its peak.² The reversal of crypto's rise – termed as the 'crypto winter' – has been further exacerbated by high profile failures, including that of the TerraUSD stablecoin and the collapse of FTX, one of the largest digital asset exchanges, which led to a broader decline in confidence and reignited concerns over risks associated with digital assets.

Spillovers from crypto's recent reversal have had little impact on Malaysia's financial system. The digital asset market in Malaysia remains small relative to the domestic financial market, with limited linkages between the two. The cumulative net deposit outflow from banks to the four regulated domestic digital asset exchanges represents only 0.6% of the total banking system deposits for individuals as at end-December 2022. Interest by banks to engage in digital asset activities also remains mostly at an exploratory stage. Growing linkages could however increase financial stability risks.

An increasing involvement of banks in digital asset activities would strengthen such linkages. Banks' involvement in the digital asset space can take a variety of forms, including investing in digital assets, offering a range of digital asset-related services such as custody, trading and asset tokenisation, or lending against digital assets as collateral. These activities create channels through which risks can be transmitted from digital asset markets to the broader financial system.

Potential financial stability concerns stem from several sources. Digital assets are considered an emerging asset class, with their performance during stress periods yet to be fully tested. Many digital assets are characterised by a high degree of volatility and are difficult to liquidate, exposing banks to considerable market and liquidity risks. Digital assets also rely heavily on relatively new technology and involve unregulated players in the ecosystem. These may result in heightened and more pronounced operational and legal risks than that typically associated with traditional banking products and business models.

With these considerations in mind, the Basel Committee on Banking Supervision (BCBS) has clarified the prudential treatment of cryptoasset exposures³ of banks under the Basel standards on capital and liquidity (Diagram 1), aimed at preserving financial stability outcomes from banks' involvement in digital asset activities. The standards apply the 'same risk, same activity, same treatment' principle, where the same capital and liquidity requirements are applied on exposures and activities that serve the same economic functions and carry the same risks, regardless of the underlying technology. In addition, the standards also account for specific risks associated with the unique characteristics of digital assets which are not seen in traditional assets.

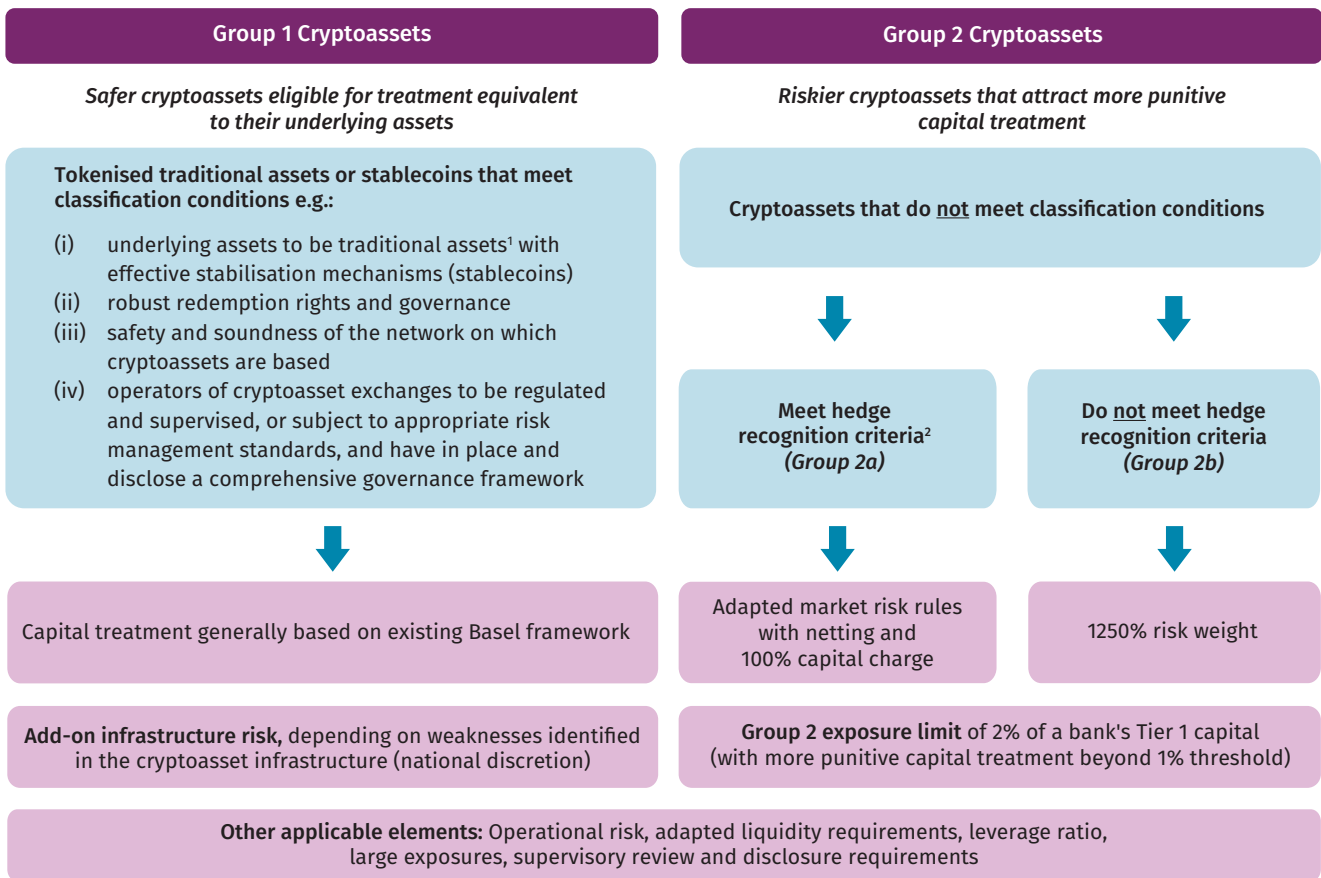
The publication of this global standard will inform the Bank's work towards strengthening the regulatory framework to account for emerging risks in this area. Given the cross-border nature and implications of digital asset activities, consistency with global standards will be an important consideration. The Bank will also continue to coordinate closely with the Securities Commission Malaysia in monitoring developments surrounding digital asset-related activities in Malaysia, and balancing the risks and opportunities associated with such activities in progressing a more vibrant digital financial services landscape as envisaged in the Financial Sector Blueprint.

¹ For the purposes of this article, the terms 'digital assets' and 'cryptoassets' are used interchangeably. They refer broadly to digital representations of value that depend primarily on cryptography and distributed ledger or similar technology. Examples include stablecoins and unbacked digital assets.

² Source: CoinGecko.

³ <https://www.bis.org/bcbs/publ/d545.pdf>

Diagram 1: Summary of BCBS Standard on the Prudential Treatment of Cryptoasset Exposures



Given the rapid pace of market developments, the Basel Committee will also issue additional refinements and clarification over time. This includes addressing issues such as the risk posed by cryptoassets that use permissionless blockchains and the calibration of Group 2 exposure limit.

■ Qualifying criteria ■ Prudential treatment

¹ E.g., equities, bonds and commodities.

² These include various thresholds relating to the market capitalisation, trading volume and price observations for cryptoassets to meet.

Source: Basel Committee on Banking Supervision (BCBS), summarised by Bank Negara Malaysia