Cryptos as an asset class: the road ahead

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Key takeaways:

- *Risks around cryptocurrency usage as a payment instrument include operational, liquidity and legal risks*
- *A greater use of cryptos may also present macro financial risks, especially with respect to asset and currency substitution*
- *The fate of CBDCs and cryptos are somewhat intertwined but it's too early to predict if they can possibly coexist or one would emerge as the clear ruler*

In recent times, global financial markets, including India's, have been abuzz with news around cryptocurrencies and central bank digital currencies (CBDC). The Cryptocurrency and Regulation of Official Digital Currency Bill was scheduled to be tabled during the winter session of the Indian parliament in December 2021. However, it was postponed amidst evolving regulations in this area across the globe. The finance minister in her fourth budget speech announced that the Reserve Bank of India (RBI) will issue India's digital rupee in the financial year 2022-23. CBDC will be based on blockchain technology and will be regulated by the RBI.

As reported in the press, several international corporates seem to be holding cryptocurrency /bitcoin as part of their portfolio.[1] Further, bitcoin and cryptocurrency-based ETFs in the USA continue to witness growing interest.[2]

According to a crypto research house, as of October 2021, 105 million Indians, or 7.90 per cent of the population, have invested in some form of digital token. According to a press release in November 2021, one of the leading crypto exchanges based in India is claimed to have facilitated trading volume worth over USD38 billion in the past 12 months, with a month-on-month growth rate of 44 per cent. Another crypto exchange platform based in India, is claimed to have witnessed a 300 per cent rise in its trading volume over 2021, coupled with an increase in its user base by 130 per cent to over 5 million in a year's time. Another exchange which started active operations recently, has claimed to have seen daily trading volumes jump from USD10,000 to USD40 million in a period of six months.[3]

Using cryptocurrencies as a payment instrument includes operational, liquidity and legal risks. There are two sources from which these risks stem—one is the settlement risk and the second from the fact that some cryptos might not be sufficiently liquid to pass muster with the liquidity standards applicable to assets playing the role of a settlement asset in a sophisticated Large Value Payment System (LVPS).

Regulators have also been wary of cryptos as a 'store of value', given there is no physical asset or sovereign backing it. Coupled with this are challenges around their extremely volatile nature, its use in funding for terrorist financing and money laundering as well as its impact on the broader monetary stability of an economy. Some other risks include:

- Using a Distributed Ledger Technology allows it to be decentralised and eliminates the need for any central authority. However, the responsibilities for identifying, mitigating and managing the risks borne in the crypto-asset network cannot be allocated.
- Addressing any fraud or operational risk events, cyber security events become difficult and may lead to monetary loss for end customers.
- Environmental impact stemming from energy intensive crypto mining process is also a concern.

Greater use of cryptos may also present macro financial risks, especially with respect to asset and currency substitution—a term popularly referred to as '*cryptoisation*'. At the current levels of adoption, widespread spill overs to financial markets seem unlikely.

Some central banks are already piloting CBDCs while others are still in the exploratory phase. These would be built on a block chain network similar to cryptos but unlike them they would be centralised in nature. The central bank would maintain reserves to back this liability. In theory, this could disintermediate banks entirely as individual citizens could hold their CBDC savings on account with the central bank directly, thereby eliminating the role of banks as deposit accepting institutions. However, that is less likely to be an outcome, and CBDC would continue to flow within the economy in the same way as traditional currency.

Given that there are still multiple unresolved questions around the integration of CBDCs into the mainstream banking and payment ecosystems, it is quite early to forecast the trajectory of digital currencies. The use cases, especially around retail and wholesale CBDCs, cross-border settlement transactions, and the evolution of the regulatory landscape around cryptos would be some of the critical factors to consider. The fate of CBDCs and cryptos are somewhat intertwined, but it is too early to predict if they can possibly coexist, or one would emerge as the clear winner.

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[1] Companies with the most bitcoin on their balance sheets, Yahoo Finance, 27 August 2021

[2] 17 Bitcoin ETFs and Cryptocurrency Funds You Should Know, Kiplinger, 9 March 2022

[3] CREBACO, accessed on 31 March 2022