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DIGITAL FINANCIAL ASSETS IN THE CONTEXT OF THE CURRENT CONFIGURATION OF THE BANKING INDUSTRY

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Abstract. In the current context, the need to study the role of digital financial assets, in particular banking assets, is gaining more and more attention, as we are living in a time when these assets seem to be moving towards a „consensus" or rather a general adoption. Users of digital financial assets range from retail customers to traditional banks and financial service providers. There are different views on the essence and content of digital banking assets, the attitude of authorities towards these assets, the technologies that underpin them, the regulation of these assets, and the prospects for their evolution both in terms of forms of development and number of transactions. The aim of this research is to study digital financial assets, specifically in banks. An important role will be devoted to the role of central banks and their contribution to the management and issuance of digital financial assets. We will analyses the impact of the development of digital financial assets on the global financial system and how these digital assets change the payments system. We will analyses the strengths and weaknesses of banks' digital financial assets compared to cryptocurrencies. Research methods will be description, comparison and synthesis. Accordingly, we will elucidate the phenomenon of digital financial assets in the domestic market and in international practice.

Keywords: digital assets, banking, convergence, information technology, globalization, regulation

JEL Classification: F65, F69, G21, G28, O31

Introduction

Currently, we all feel the benefits and inconveniences of the virtual world. Everyday life is becoming increasingly digitalized and this means that most traditional assets are being transformed into digital assets.

Digital assets are any „electronic record" that we own under license or manage. To qualify as a „digital asset", you need the following conditions: it is an online account or digital file that you can access online, via your phone or PC, and that requires authentication. These include an email, online bank account, social media accounts, cloud and digital photos, etc.

If we talk about „digital banking assets", digital assets are only the online bank account, not the money in the account. From the category of accounts, which are currently digitized, we can list: term deposit accounts, credit accounts, including mortgages, accounts associated with cards, electronic trading and brokerage accounts, credit monitoring and budgeting services, cryptocurrency platforms and crypto assets, insurance accounts (such as for car insurance, home insurance, life insurance, health insurance).

Digital bank files can include documents, photos, account statements, while software can include financial, legal and tax software, mobile and WEB applications.

I. Risks associated with digital banking assets

The emergence of new digital products and the rapid adoption of IT in the financial sector has not only a positive effect, but also comes with certain challenges (risks). So one of the most difficult to regulate financial market instruments are digital assets. The biggest controversies are related to cryptocurrencies. In some countries, cryptocurrencies can be used as payment instruments. For example, the European Union has not yet enacted requirements to regulate cryptocurrency transactions, but some companies are allowed to make payments with digital currencies.

The risks associated with the development of the digital private money market are largely related to the lack of control over such operations by the state. Given the non-mandatory identification of users of crypto platforms and owners of crypto wallets, there is a *risk of fraud and tax evasion.* In this case, the mandatory authorization and identification of participants in the crypto market would help increase its transparency. However, this measure could not fully compensate for these risks.

The fact is that when the cryptocurrency market is small, the lack of monetary regulation does not have such a noticeable impact. The situation may change as the share of digital money in circulation increases.

Even in the case of the implementation of monetary policy, the result will be reduced, since the central bank is not able to fully control and regulate the issuance of private cryptocurrencies. Payment transactions in cryptocurrencies can uncontrollably increase the money supply because they remain „invisible" to the central bank until the person wants to withdraw them in the central bank's currency. In this way, forecasting and regulating the circulation of money becomes a difficult task. This, in turn, increases *inflation risks.*

As for investing in cryptocurrencies to generate additional income, the high volatility of the market causes high risks of investment loss.

The opportunity to quickly make money from exchange rate dynamics constantly attracts new users to the crypto market. This allows, on the one hand, to introduce modern investment instruments, and on the other, involves people in the investment process, including those from countries with underdeveloped financial systems.

However, the quick desire to make money can lead to losses due to an unplanned decline in the value of digital assets.

In addition to the difficulty of predicting the price dynamics of digital assets, fluctuating cryptocurrency exchanges also pose a risk to investors.

For example, some crypto platforms Thodex from Turkey, Africrypt, Finiko from Russia went bankrupt and investors lost their money [Luzgina, 2022].

The digital asset industry is expanding and this manifests itself on the evolution of the financial market. The use of digital assets in traditional financial services (TradFi) carries risks and imposes new areas of application on supervisors.

Banks are increasingly exploring digital assets. Financial institutions use digital cash and central bank digital currency, issuance of digital bonds, digital asset trust, blockchain-based payment instruments.

„Financial institutions continue to explore the potential of payment services based on blockchain or digital assets. In Deloitte's December 2021 Merchant Adoption of Digital Currency Payments Survey in collaboration with PayPal, nearly three-quarters of respondents reported that they plan to accept payments in cryptocurrencies or stablecoins in the next 24 months. Moreover, 87% of merchants agreed that organizations that accept digital currencies have acompetitive advantage in the market" [Deloitte, 2023].

TradFi should re-evaluate its approach to risk management and compliance.

Traditional risk assessment and annual assessment are inadequate for managing risks related to digital assets. There is also a lack of a standard on the necessary controls.

The money laundering risk linked to cryptocurrencies is becoming a barrier to adoption by TradFi. It is more difficult to detect the origin of financial assets. Financial crime compliance programs will require advanced staff expertise to keep up with the risks.

Banks face challenges integrating crypto and FinTech issuer clients as they find it harder to assess their *counterparty risk* for digital asset business models.

Table 1 shows the global digital asset adoption index on 12 September 2023. Are presented the top-20 most representative countries. Most countries are in the Central & Southern Asia and Oceania region and Latin America.

Table 1. The 2023 Global Crypto Adoption Index Top 20 on September 12 2023

Country	Region	Overall index ranking	Centralized service value received ranking	Retail centralized service value received ranking	P2P exchange trade volume ranking	DeFi value received ranking	Retail DeFi value received ranking
India	Central & Southern Asia and Oceania	1	1	1	5	1	1
Nigeria	Sub-Saharan Africa	2	3	2	1	4	4
Vietnam	Central & Southern Asia and Oceania	3	4	4	2	3	3
United States	North America	4	2	8	12	2	2
Ukraine	Eastern Europe	5	5	3	11	10	10
Philippines	Central & Southern Asia and Oceania	6	6	6	19	7	7
Indonesia	Central & Southern Asia and Oceania	7	13	13	14	5	5
Pakistan	Central & Southern Asia and Oceania	8	7	7	9	20	20

Brazil	Latin America	9	9	11	15	11	11
Thailand	Central & Southern Asia and Oceania	10	8	15	44	6	6
China	Eastern Asia	11	10	5	13	23	23
Turkey	Middle East & North Africa	12	11	9	35	12	12
Russia	Eastern Europe	13	12	10	36	9	9
United Kingdom	Central, Northern, & Western Europe	14	15	20	38	8	8
Argentina	Latin America	15	14	12	29	19	19
Mexico	Latin America	16	17	18	30	16	16
Bangladesh	Central & Southern Asia and Oceania	17	18	19	33	22	22
Japan	Eastern Asia	18	22	21	49	18	18
Canada	North America	19	25	23	62	14	14
Morocco	Middle East & North Africa	20	27	25	21	26	26

Source: based on Chainalysis (2023)

Regulation of banks dealing in digital assets

Thus, the International Monetary Fund sees the need to adopt uniform cross-state principles and standards in the area of digital asset regulation. There is a need to develop special regulation of digital asset transactions at the national level, which should include licensing and control of digital asset service providers. Adapt current legislation to regulate the functioning of the digital asset market in those market sectors where it is objectively necessary. Improving risk management, introducing capital adequacy requirements, liquidity and other standards for financial companies trading in digital assets is key to the stable functioning of the digital asset market, according to the IMF.

For its part, the Basel Committee on Banking Supervision published in June 2021 a consultation document on the prudential regulation of risks associated with crypto-assets. The main proposals include dividing all crypto assets into two risk groups. The risk weights in the first group may vary and, traditional tokenized assets will generally be subject to the same rules for determining credit and market risk weighted assets as the corresponding traditional assets.

In the second group of crypto assets, the risk weight is always 1250%.

Banks with direct or indirect holdings of crypto-assets will be subject to the supervisory review process (Pillar 2) established by the Basel capital adequacy framework.

The Basel Committee document also defines additional responsibilities for banks, including the development and implementation of a system to assess the risks associated with crypto assets, including the coverage of operational and cyber risks. Banks must be guided by the FATF2 rules on anti-money laundering and counter-terrorist financing. As for supervisors, they determine requirements at national level for banks working with crypto assets, including taking into account additional risks in stress tests, making changes to capital requirements, creating additional buffers for underestimated risks and introducing additional limits.

As banks continue to explore digital assets, regulators have created processes to protect the banking system. In the US, a joint statement was issued by supervisors outlining the main risks to banks

associated with digital assets and participants using digital assets. Banks were instructed that they must seek written permission from supervisors before engaging in certain activities with digital assets and must demonstrate that they have adequate risk management tools in place before undertaking activities such as providing trust services to customers who hold cryptocurrencies.

The possibility of introducing blockchain technology for processes and procedures relating to customers, transactions and sanctions is also being explored.

Regulators are seeking to create greater supervisory discipline among market participants to protect customer interests.

Banking regulators are treating new digital asset product offerings much like new licensing efforts, meaning that business plans, financial, governance, risk and compliance documents will need to be developed and reviewed before a license is obtained.

In order to launch any digital asset product offering, banks will need to train staff in digital asset risk management.

Conclusions

TradFI is taking advantage of increasing regulatory clarity and trying to gain a more market share. New ecosystems are developing blockchain-based infrastructures and solutions to create innovative business models and disrupt traditional ones.

Working with innovative tools such as cryptocurrencies certainly involves a number of risks.

Private cryptocurrencies are traditionally seen as speculative financial assets. In order to reduce and diversify risks and to increase the efficiency of people operating with digital assets, digital literacy of the population is necessary. However, an equally important condition for the efficient functioning of the market is the formation of transparent and understandable rules for all participants.

Banning crypto-trading in some countries, while allowing it in others, may lead to the formation of regional crypto-centers, create further imbalances in the development of individual countries' financial markets and increase the underground economy and the flow of capital to more favorable jurisdictions, and leave the national financial systems of countries less open to innovation lagging behind in digital development.

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