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Digital Asset Risk Assessment: A New Paradigm in Risk Management

Introduction

Over the past year, the digital asset marketplace witnessed the insolvency of crypto-native firms and digital asset-friendly banks. Regulators have continued to heighten their scrutiny across the landscape, with varied approaches to different jurisdictions. Numerous jurisdictions have standardized frameworks, including licensing and registration obligations and standard definitions of industry terms. The United States, however, appears to have a divergent regulatory approach to the industry, including through enforcement actions. Financial institutions that were once confident about engaging with digital assets in the US are instead waiting for regulatory clarity before embarking on new products and services. On January 3, 2023, the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) issued a joint statement not only highlighting the increased risks associated with crypto assets, but also reiterating their cautious approach to "current and proposed crypto-asset-related activities and exposures at financial institutions[1]."

While the accelerated growth of the industry has slowed down and deterred some, opportunities still exist. According to a 2023 Deloitte report, blockchain and digital assets are witnessing greater levels of investment than in the two years preceding the crypto bull market of 2021 through Q2 2022[2]. Such adoption uncovers unique risks for emerging disruptors, tokenized businesses, digital asset exchanges, crypto natives, traditional financial services, and other organizations using the technology or investing in blockchain-based assets. However, the path forward involves not only understanding how you will engage with digital assets, but understanding the evolving and incremental new risks associated with these activities in an ever-changing global regulatory environment and the increasing need for a standard, global approach. Aligning yourselves with specialists who understand the ecosystem will be important so you may continue to engage in the activities in a safe and sound manner.

Anticipating digital assets regulatory polices

Digital assets represent a new paradigm in risk management. As the concept of digital asset risk assessment develops, it should remain anchored to the foundation of traditional risk assessments, while acknowledging the idiosyncratic characteristics of digital asset products and services. Key regulatory bodies have expressed concerns that the risks posed by digital assets could lead to systemic and financial impacts on consumers and the overall economy. The New York Department of Financial Services (NYDFS) set the foundational criteria for virtual currency business activity by requiring comprehensive licensing requirements, including capital requirements, consumer disclosures, anti-money laundering programs, and coin listing/delisting policies in 2015[3]. In September, the NYDFS released two proposed updates to its guidance for virtual currency businesses that would require these businesses to adhere to enhanced oversight and standards for listing coins on their platforms[4]. This follows guidance the NYDFS released earlier this year in January around safer custody requirements for virtual currency businesses[5]. Meanwhile, the Securities and Exchange Commission (SEC) has sued major crypto exchanges for alleged regulatory violations. These coinciding conflicts in the banking and crypto sectors underscore the need for prudential regulations. The SEC has taken a firm position on governing activities in the blockchain and digital asset space. Gary Gensler, chairperson and the head of the SEC, has made it clear that regulations to govern crypto already exist under "securities regulations."

Despite a "crypto winter," banking turmoil, and the aforementioned regulatory disagreements, opportunities in the digital assets marketplace continue to exist. Since the White House released an executive order on March 9, 2022, ensuring responsible development of digital assets and detailing policy across key priorities, regulators have planned to address these concerns within the context of their respective oversight mandates with specific requirements around safety and soundness, consumer protection, and market integrity[6]. Additionally, the European Union passed "Markets in Crypto-assets" (MiCA), which aims to regulate digital assets that are not currently covered elsewhere; the goal of which is to harmonize European law on the matter and provide a framework that elevates the status of these new instruments[7]. There is an expectation of implementation by the end of 2024, granting new powers to European authorities on the topic.

Elsewhere, regulators are beginning to take action to bring clarity to the global digital asset market. In Hong Kong, the Securities and Futures Commission (SFC) has proposed new rules for crypto exchanges, with a focus on retail investor participation and protective measures for these platforms. Hong Kong's government has also established a licensing regime for Virtual Assets Service Providers (VASPs), making it mandatory for crypto exchanges to be licensed starting in June 2023[8]. In Singapore, the government has brought in the Monetary Authority of Singapore (MAS) to explore blockchain and distributed ledger technologies while also passing the Payment Services Act in 2019 to regulate cryptocurrencies by requiring providers to obtain a license[9]. These developments highlight how regulations surrounding digital assets is progressing with strength through active participation from governments around the globe.

In addition to the adherence of new policy, regulators expect that firms will establish or enhance their risk and control frameworks and conduct risk assessments specific to the characteristics of the underlying products and technologies. This is highlighted in the OCC Interpretive Letter 1176, which outlines the requirement of firms to have adequate controls in place before taking part in digital asset activities[10]. Regulatory bodies like the OCC are looking to discern the ongoing and prospective digital assets-related activities carried out by financial institutions.

Overall, engaging with digital assets requires active management oversight across a wide spectrum of risks and the leverage of core safety and soundness playbooks to meet the expectations of regulators. One of Deloitte's industry-leading tools is a digital asset risk assessment designed to help organizations identify digital asset-specific risks that need to be mitigated to engage in the marketplace in a manner consistent with regulatory expectations and overall risk assessment objectives.

Deloitte's digital asset risk assessment tool

Leveraging our blockchain-related experience, we have developed a proprietary risk assessment tool comprised of more than 300 unique blockchain and digital asset targeted risks. The tool provides a baseline view of risk applicability across many of the emerging service offerings in the digital asset marketplace, taking into consideration the nuanced and evolving development of digital asset products, such as cryptocurrencies versus Central Bank Digital Currencies (CBDCs). It is important to note that this tool, along with any risk assessment tool, is to be viewed as an accelerator rather than a blanket or universal solution. With over a decade of blockchain and digital asset experience[11], our team works closely with executive stakeholders to fully understand the specific service offering and product scope of their operating model before conducting the risk assessment.

For clients exploring digital asset-related use cases or are early in the development lifecycle, Deloitte can leverage its framework to provide a clear understanding of the unique risks they may be exposed to and help map out capabilities to further develop in order to engage in the space. For other clients who are further along in the development lifecycle, Deloitte can leverage its framework to efficiently conduct a risk assessment on new digital asset-related products. In doing so,

Select key risk areas

Security breaches	Fraud	Quality of market surveillance	Anti-money laundering procedures	Compliance with applicable laws
Complexities with forked and airdropped digital assets	Market manipulation	Insolvency	Conflicts of interest	Account reconciliation

our clients may not only gain a better understanding of the potential risks their new digital asset product may pose, but also determine whether they have in place or need to implement the mitigating controls necessary to deploy a product that aligns with regulatory expectations.

Our systematic waterfall approach pivots on the applicable digital asset risk areas to drive a risk-based assessment that integrates with existing controls and assists in developing a prioritized remediation plan targeted to establish a robust risk and control framework for digital asset activity. Deloitte's digital asset risk assessment methodology provides visibility into nuanced digital asset risks while helping you determine whether mitigating controls are in place and appropriately aligned to risk appetite. In the fast-paced digital asset marketplace, the risk assessment tool may accelerate the risk assessment lifecycle, while providing confidence in navigating the rapidly evolving landscape.

Considerations for digital asset risk management

Classification of digital assets
Securities, commodities, or a separate asset class

Know your customer
Procedures to verify and update customer account information

Performance
Functioning of the underlying technology and if it continues to work as intended

Trading venues
In-scope venues/exchanges, integration with firm surveillance systems, etc.

Transaction monitoring
High-frequency transactions or transactions specific to digital asset exchanges/entities

Network congestion
Ability of the underlying technology to handle a potential increase in the network activity

Trade execution & settlement
Execution and post-trade processing

Governance
Appropriate governance structures, risk appetites, and controls for readiness

Protocol updates/forks
Updates to the protocols, malicious code updates

Regulatory requirements
In-scope jurisdictional regulatory requirements

Threat monitoring
Identification and management of blockchain-specific threats (e.g., rogue miners)

Key management
Protocols for key generation, use, storage, backup, and protection

About Deloitte's Blockchain and Digital Assets practice

At Deloitte, we work with clients to understand how blockchain and digital assets are changing the face of business and government today. New ecosystems are developing blockchain-based infrastructure and solutions to create innovative business models and disrupt traditional ones. This is occurring in every industry and in most jurisdictions globally. Our deep business acumen and global industry-leading risk and financial advisory services help organizations across industries achieve their blockchain and digital asset aspirations. Reach out to our leaders to discuss harnessing the momentum of blockchain and digital assets, prioritizing initiatives, and managing the opportunities and challenges associated with blockchain adoption efforts.

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Endnotes

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