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Navigating Digital Asset Risk in Traditional Finance

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As the broader digital asset industry continues to digest and reflect on recent market events, learnings from a recent industry event "Taking Control of Digital Assets", hosted by 1LoD's[1] Digital Assets Leaders' Network and sponsored by Deloitte in New York, can provide some foundational considerations for financial institutions as they navigate digital asset innovation while complying with evolving expectations. Event attendees included C-suite level and senior representation from leading banking and financial institutions. Insights from this event have been leveraged to understand the evolution of digital asset use cases and impacts on digital asset risk and control frameworks for traditional financial (TradFi) services.

TradFi focus on digital assets is evolving

Despite industry headwinds, many regulated financial institutions are continuing to explore capabilities in the digital assets ecosystem. According to attendees at the 1LoD Digital Assets Leader's Network event, the institutions they represented are building capabilities in the below focus areas:

- Stablecoin, Digital Cash and Central Bank Digital Currency (CBDC)
- Tokenization of Digital bonds, private funds, and real-world assets
- Digital Asset Custody
- Blockchain-based payment solutions

Financial institutions are increasingly exploring the potential of tokenization of "real-world assets", including, tangible assets, such as real estate; and precious metals and intangible assets, such as private equity (e.g., fund tokens) or debt securities (e.g., digital bonds). For instance, traditional firms are launching tokenization platforms and issuing digital bonds. This interest is driven by the fact that tokenization of real-world assets represents an opportunity for financial institutions as a large chunk of the world's wealth today is locked in illiquid assets. The asset tokenization market is expected to grow rapidly, projected to reach $16.1 trillion[2] by 2030 and potentially $24 trillion[3] by 2027 per more aggressive estimates.

Additionally, financial institutions continue to explore the potential of blockchain or digital assets-enabled payment services. In the Merchant Adoption of Digital Currency Payments Survey[4] prepared by Deloitte in Dec 2021, in collaboration with PayPal, nearly three-quarters of those surveyed reported plans to accept either cryptocurrency or stablecoin payments within the next 24 months. Further, 87% of merchants agreed that organizations accepting digital currencies have a competitive advantage in the market.

Regulatory Tone has shifted

As banking organizations continue to explore tokenized deposits, payment networks, digital asset custody and other consumer facing offerings involving crypto-assets and stablecoins, regulatory agencies have created notification and non-objection processes to protect the US banking system. In January 2023, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (FDIC) issued a joint statement highlighting key risks to banks associated with crypto-assets and crypto-asset sector participants[5]. This was in line with a November 2021 letter from the OCC, which instructed banks that they must seek and obtain written permission from their supervisors before engaging in certain activities involving cryptocurrency and must be able to show that they have the appropriate risk management tools before taking on activities such as the provision of custody services for customers' crypto holdings[6]. Earlier in 2022, the New York Department of Financial Services (NYDFS) issued guidance on the use of blockchain analytics[7], emphasizing its importance in effective policies, processes, and procedures, including those relating to customer due diligence, transaction monitoring and sanctions screening.

Regulators are seeking to create increased control discipline among market participants to protect customer interests

Taken together, it is becoming increasingly clearer that banking regulators are using Joint Statements and notification processes to moderate and coordinate digital asset activities at supervised firms. Each agency has issued guidance, broadly applicable to their respective supervised firms, requiring that at a minimum local agency staff be informed of crypto-related activities. It appears that banking regulators are treating new crypto or digital asset product offerings very much akin to new licensing and application efforts meaning business plans, financials, governance, risk, and compliance materials will need to be developed and reviewed prior to non-objection/permission. It has become clear that to launch any product offerings in digital assets, banks and traditional financial institutions will need to meet a high bar in demonstrating their risk and control frameworks to regulators.

TradFi should re-evaluate its risk management and compliance approach

As institutions build capabilities, they are increasingly asking themselves if existing governance, risk, controls, policies and transaction monitoring tools that are available today are sufficient to manage the risks in digital assets. Attendees at the 1LoD Digital Assets Leader's Network event agreed that traditional risk assessments should be the foundation while considering unique risks posed by digital assets, such as operational, market, and compliance risks highlighted in recent NYDFS guidance for institutions involved in virtual currency-related activity[8].

It was noted by attendees at the 1LoD Digital Assets Leader's Network event that legacy risk assessment and annual review methodologies are inadequate for managing digital asset risk considerations. There is also lack of an industry standard of what controls are required. Close to three quarters (73%) of event attendees felt that current risk and control frameworks were inadequate for managing other aspects of digital asset risk. A recent view by banking regulators of risks posed by digital asset products is outlined in our publication "Digital Asset Risk Assessment: A New Paradigm in Risk Management.[9]"

Enterprise Framework for Digital Assets Activity

Corporate Governance	Business Plan	BSA/AML	IT Risk Mgmt. & Cyber	3rd Party Risk
• Oversight framework for proposed activity • Senior management's understanding of new risks • Ongoing product risk reviews/ monitoring • Integration of new risks, limits and thresholds into risk appetite and an escalation process for when risk limits are breached	• Planned operating model and key technology architecture • Project Plan – Staffing plan, roles and responsibilities, deliverables, milestones, testing plans and schedules • Business rationale and how blockchain technology and digital assets are leveraged to facilitate activity	• Policy and procedures, risk assessment(s) and methodology relevant to the proposed activity • Uplifted Transaction monitoring, Sanctions and KYC processes, including use of blockchain analytics • Independent review of BSA/AML and OFAC Compliance program	• Cybersecurity and information security program • Assess critical dependencies on third-party technologies and technology providers relevant to the proposed activity	• Third-party risk management program • Third-party service provider management and onboarding policy • Monitor operational and financial resiliency of service providers associated with the proposed activity

Consumer Protection	Risk Management	Legal & Regulatory	Financial & Treasury	Digital Asset Risk
• Customer protection policies, client agreements, disclosures, and/or acknowledgments • Customer service and product management systems used, including an explanation of the customer redress framework • Suitability analysis of proposed services offered to customers	• Manage non-financial risks associated with the proposed activity such as: ➢ Operational risks ➢ Credit risk ➢ Market risk ➢ Fraud risk ➢ Reputational risk ➢ Strategic risk • Develop continuity and disaster recovery program	• Analysis of legal permissibility of proposed activity • Description of controls in place to ensure compliance with applicable regulation • Documentation of approvals and licenses for proposed activity	• Financial projections and business plan assumptions • Stress testing • Analysis of impact of the proposed activity on the entity's risk based capital and liquidity ratios • Explanation of expected costs, sources of funding and fees to be imposed on customers	• Evaluation of blockchain and digital asset solutions • Monitor, manage, and mitigate blockchain risk • Policies and procedures associated with the generation, management, storage, or use of private and public keys (i.e., custody services)

Leading regulatory bodies have also expressed concerns that the risks posed by digital assets could lead to systemic and financial impacts on consumers and the overall economy[10].

Digital Assets Ecosystem Risks

Fraud & Financial Crime Risk
Risk of fraud and scams among crypto-asset market participants

Contagion risk
Contagion risk and concentration risks for firms with exposures to the asset sector due to interconnections among engaging participants

Consumer Protection Risk
Inaccurate or misleading disclosures by crypto-asset firms that may be unfair, deceptive, or abusive

Market Risk
Significant volatility in crypto-asset markets that may lead to potential impacts on deposit flows associated with crypto-asset firms

Technology & Cyber Risk
Heightened risks associated with open, public, and decentralized networks, such as lack of governance, vulnerabilities from cyber-attacks, outages, lost or trapped assets and illicit finance

Stablecoin Run Risk
Susceptibility of stablecoins to run risk, creating potential deposit outflows for firms that hold stablecoin reserves

Legal Risk
Legal uncertainties related to custody practices, redemptions, and ownership rights

Governance Risk
Risk management and governance practices in crypto-asset sector exhibiting a lack of maturity and robustness

Barriers to TradFi Adoption

The risk of money laundering linked to crypto is becoming a barrier to TradFi adoption. Mixing or tumbling is used to obfuscate financial flows in the crypto world, making it harder to detect their origins. Firms will also need to look back at transactions using blockchain analytics data. Close to three quarters (72%) of attendees at the 1LoD Digital Assets Leader's Network event felt that the quality of testing of financial crime controls related to digital assets is "medium" while over a quarter of attendees felt that the efficacy of controls is "low". Over 80% of attendees also expressed concern with finding people with the right background and experience to help navigate this emerging ecosystem.

Financial Crime Compliance programs in this space will require advanced people expertise to keep up with evolving risks

Event attendees at the 1LoD Digital Assets Leader's network event agreed that 1st line sales teams are facing long wait times for New Product launch with some initiatives taking ~1.5 years for go-live due to evolving capabilities in the 2nd line and relevant support functions.

Further, banking and financial institutions are also grappling with client onboarding challenges. With convergence in offerings, TradFi players are also seeking to partner with or offer their services to crypto natives and FinTechs with emerging business models. Given that current diligence frameworks are likely inadequate to effectively assess counterparty risk for evolving digital asset business models, many TradFi firms are struggling to onboard crypto native firms. A rapidly evolving regulatory environment is also complicating the picture for firms.

A Path Forward

Despite these challenges, the desire among traditional financial services to adopt digital assets and blockchain technology remains unabated [11]. Traditional firms are taking advantage of increasing regulatory clarity (e.g., NYDFS industry letter for prior approval for covered Institutions' virtual currency related activity [12]) and seeking to capture market share from natives that have been adversely impacted by recent market events. There are further regulatory developments expected in the coming months. Institutions that begin to develop their capabilities will likely be better positioned to capture market share among increasing regulatory clarity.

We expect institutions to engage with regulators earlier in the new product lifecycle to gain a competitive advantage in pursuing opportunities afforded by industry convergence

We anticipate that regulated entities will play an increasingly active role in addressing client demand in a compliant manner.

About Deloitte's Blockchain and Digital Assets Practice

At Deloitte, our people 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 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 assistance with managing the opportunities and challenges associated with blockchain adoption effort.

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Footnote

[1] https://www.1lod.com/
[2] Asset Tokenization Market Could Reach $16.1 Trillion By 2030 – Study
[3] The era of tokenization — market outlook on a $24trn business opportunity
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