



# Digital Asset – Risk Review

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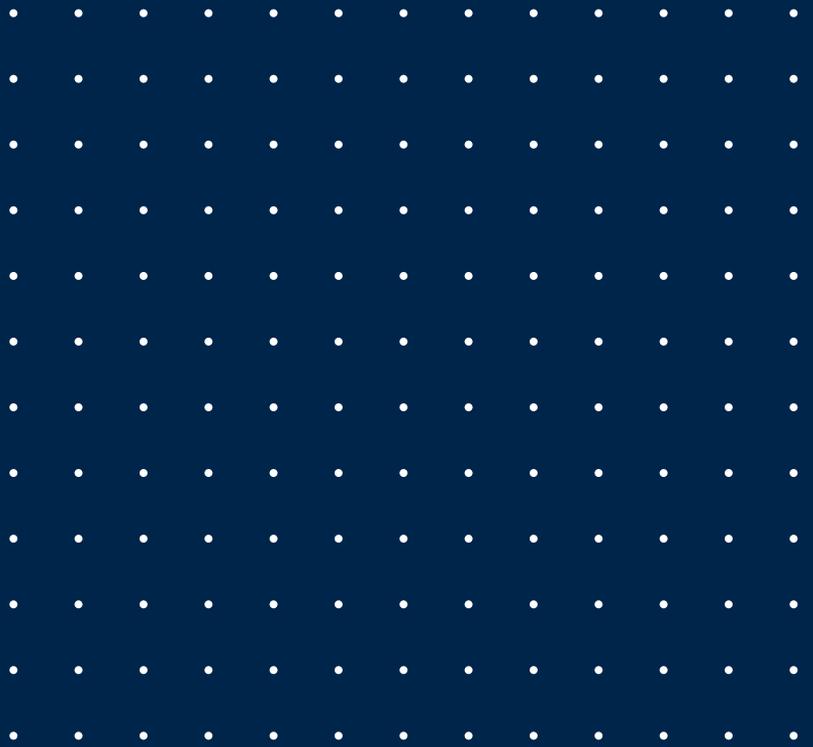
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## Introduction

The distribution and acceptance of digital assets continues to grow. Banks, trust companies, financial technology companies (fintechs), and other financial institutions have started to accept digital assets, including cryptocurrencies, as legal tender and to custody those assets for their customers. As digital assets become more prevalent, customers are looking for financial institution partners that can accept the digital currencies that they receive or would like to receive from their customers. This will put continuing pressure on financial institutions to compete in the digital currency space.

Central banks also have started to accept cryptocurrencies as part of their national monetary policies. However, the discussion of the risks and the risk management processes to be applied by a financial institution beyond pure compliance considerations (e.g., Bank Secrecy Act/anti-money laundering) have lagged behind the acceptance.

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Regulators have begun to pay more attention to the risks associated with digital currencies, but the supervisory process is in its nascent stages. The Securities and Exchange Commission (SEC) has implemented a digital asset framework.<sup>1</sup> Earlier this year, the FDIC issued a request for information (RFI) seeking input on the current and potential use cases of digital assets and digital asset technologies. The comment period for this RFI closed in July. While we wait for the output or reaction to the comments that the FDIC received, banks should assess the risk associated with digital assets and ensure that they have the appropriate infrastructure to manage those risks

<sup>1</sup> SEC, "Framework for 'Investment Contract' Analysis of Digital Assets" (modified April 3, 2019). <https://www.sec.gov/corpfm/framework-investment-contract-analysis-digital-assets>

## Definitions

Before we dive too far into the ether of digital assets, we first must define what we mean by digital assets. For purposes of this article, we divide digital assets into three categories: stablecoins, central bank digital currencies, and cryptocurrencies.

STABLECOINS	CENTRAL BANK DIGITAL CURRENCY	CRYPTOCURRENCIES <i>(such as Bitcoin)</i>
Backed by assets that have a value independent of the cryptocurrency itself, such as dollar-backed assets.	A form of money that central banks developed to allow private parties to transact business electronically using the central bank as an intermediary	A form of money cleared between two parties with no central third-party involvement. The transaction is recorded in the blockchain and confirms that the funds are transferred appropriately and can be followed

### ***Blockchain Explained<sup>2</sup>***

- Blockchain is a specific type of database.
- It differs from a typical database in the way it stores information; blockchains store data in blocks that are then chained together.
- As new data comes in, it is entered into a fresh block. Once the block is filled with data, it is chained onto the previous block, which makes the data chained together in chronological order.
- Different types of information can be stored on a blockchain, but the most common use so far has been as a ledger for transactions.

## Risks

As discussed earlier, the risks to financial institutions as they look to start accepting or to custody digital assets are as varied as those for any other asset. To describe the risks associated with digital assets, we leverage the standard nomenclature used by most banks:

- Credit Risk
- Operational Risk
- Compliance Risk
- Interest Rate and Price Risks
- Liquidity Risk
- Reputational Risk
- Strategic Risk

<sup>2</sup> Luke Conway and Julius Mansa, "Blockchain Explained," Investopedia (May 31, 2021). <https://www.investopedia.com/terms/b/blockchain.asp>

## **Credit Risk**

Widespread lending of digital assets is coming. The decentralized nature of digital assets and the non-transparent nature of the name of the borrower or the lender will make it difficult to assess the ability of the borrower to repay a loan in digital assets. The process of following the digital blockchain and creating relationships with the custodians of the digital assets will be paramount in determining how to manage the inherent credit risk in the lending relationship. It is likely that lending of digital assets will be more prevalent for stablecoins than cryptocurrencies, since they have an intrinsic value that can be supported by other collateral. Risk managers will want to ensure that there is a process to understand where the digital assets are custodied, how they are lent, and the types of collateral that will be taken in the event of nonpayment.

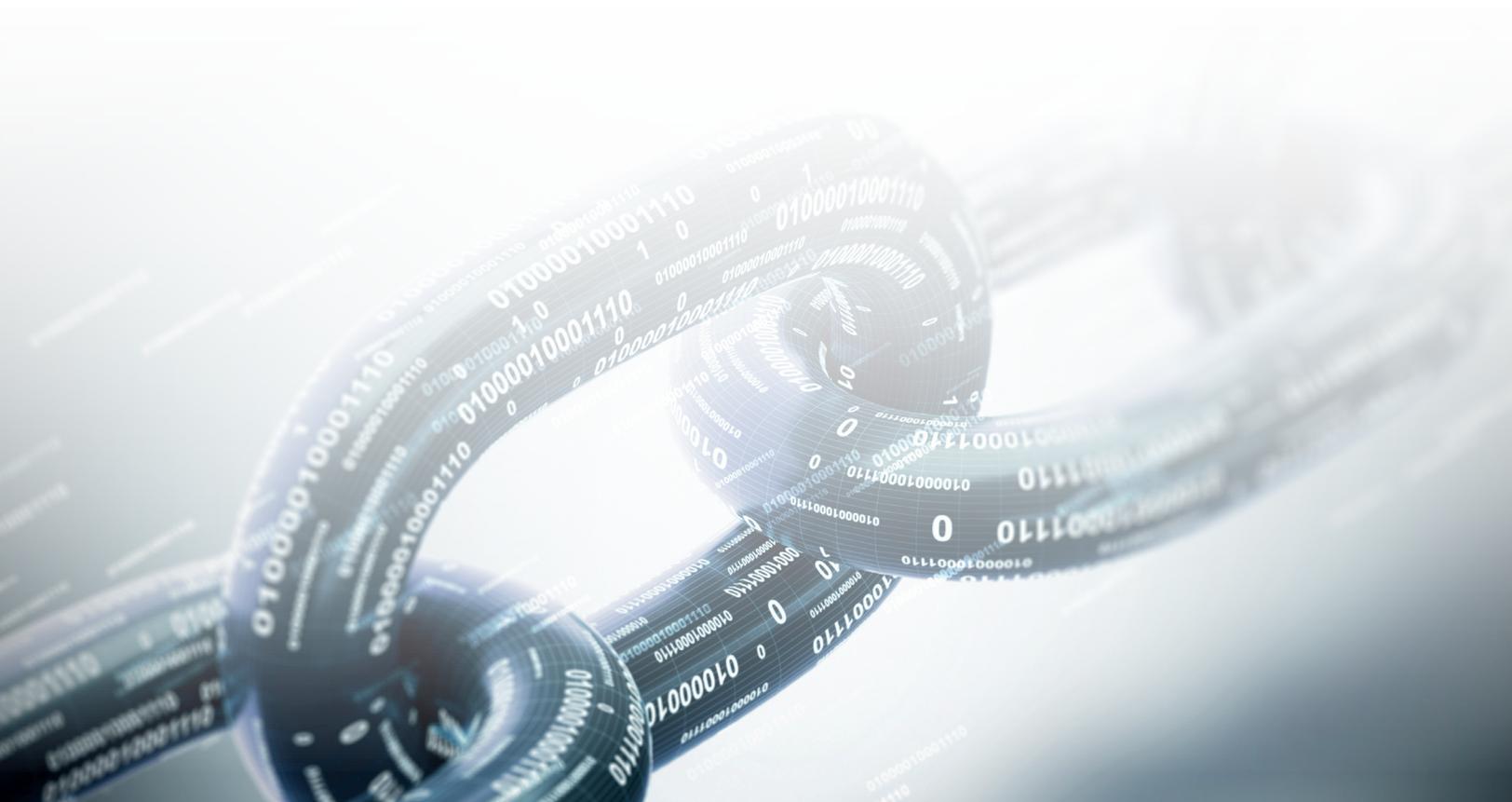
## **Operational Risk**

Operational risk is one of the largest risks related to digital assets given their new and decentralized nature. Within operational risk, we can define several sub-risk categories: cyber risk and third-party risk are most prevalent in transactions related to digital assets.

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Many risk officers cite cyber risk as the top threat facing financial institutions currently. For traditional assets, cyber-risk events may result in a loss for the institution or for some individuals, but preventive measures like credit monitoring programs help protect from risk and mitigate losses. However, cyber risk related to digital asset transactions ups the ante considerably. If the private keys are lost through a cyber-attack, the value may be lost forever and not recoverable.

Similarly, third parties often are nonregulated entities that are still developing their risk and compliance programs. Therefore, the ability for a financial institution to monitor the third party's activities and viability is not as well designed as if the third party had existed for a longer period.



## Compliance Risk

While much in the digital asset regulatory regime remains to be fleshed out, there is a clear expectation that a financial institution will continue to comply with traditional financial crime-related compliance obligations. In addition, given the view of the “crypto” world, financial institutions would be well placed to go above and beyond when applying their compliance protocols to their digital asset clients and portfolios.

## Interest Rate and Price Risks

Cryptocurrency values are driven by market demand and perceptions similar to securities. This can lead to substantial volatility in value over time. Banks inherently will have a difficult time confirming and managing the swing of prices driven by market-demand factors rather than sound financial fundamentals that would be used to price and monitor security transactions (although those too can be driven purely on noise in the markets).





## **Liquidity Risk**

The liquidity of digital assets has yet to be tested in times of stress. Given the wild swings in valuation (and exchange rate impacts), a digital asset liquidity event can come swiftly and is likely to be sizable.

## **Reputational Risk**

The legal and regulatory issues surrounding digital assets and the impact on a financial institution's reputation are uncharted territory. Certain jurisdictions have limited the ability for cryptocurrencies to be traded within their borders. Many regulatory agencies have not yet opined on their views. This leaves financial institutions open to criticism, lawsuits, and uncertainty in the public eye that may cause longer-term harm to the brand.

## **Strategic Risk**

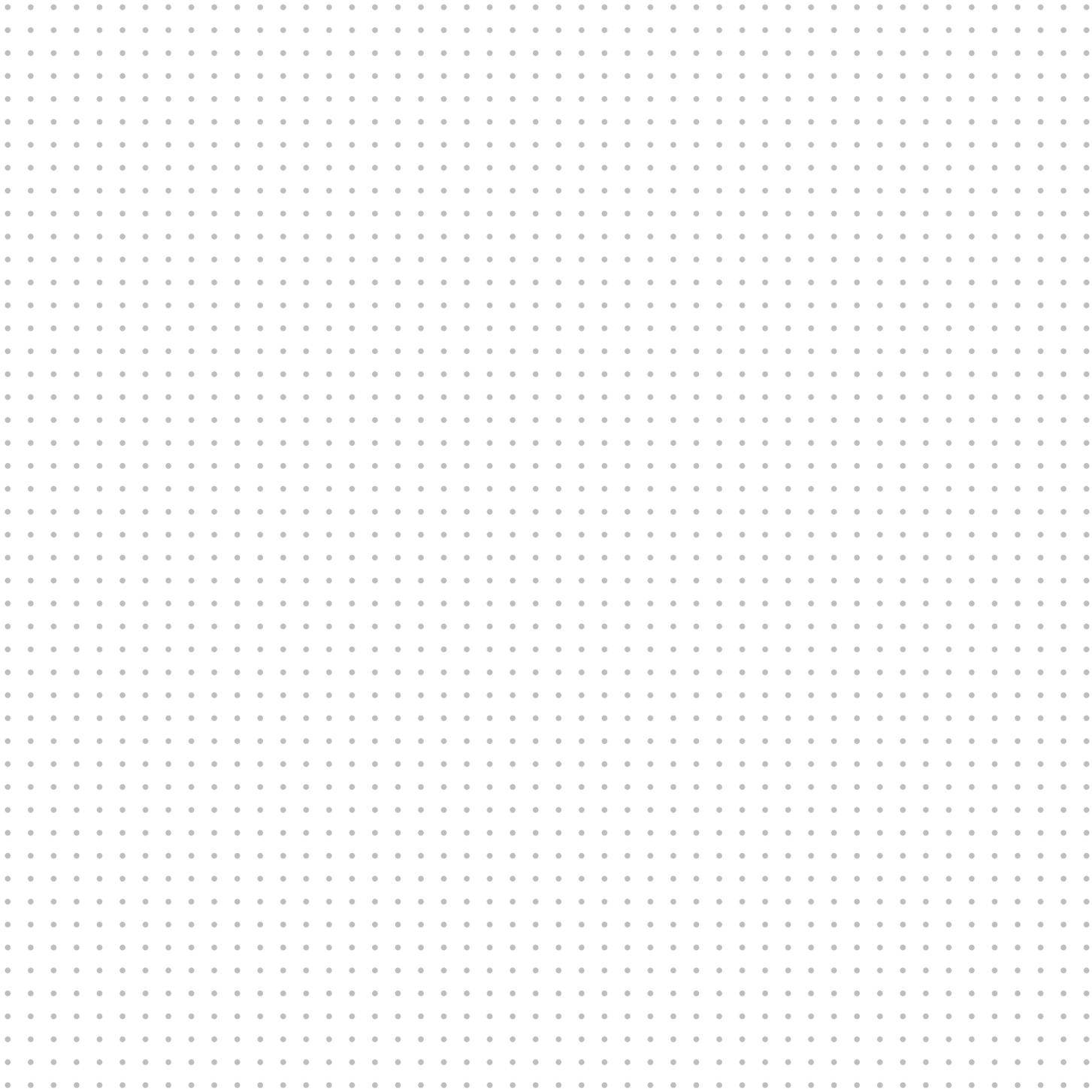
Given the uncertainty of the digital asset space and the inability of many to forecast where the pitfalls lie, financial institutions must ask strategic questions when it comes to undertaking digital asset service offerings. How does this fit into the grand scheme of the institution's direction? How does this impact our risk appetite?

## How BRG Can Help

BRG professionals have deep experience in the digital asset space. Our experts understand the risks institutions will face as they start to offer these products to their customer bases. BRG can help financial institutions:

- Conduct risk assessments based on the specific products and services the financial institution is exploring
- Develop the appropriate risk framework, including policies and procedures, to effectively manage the risk and scale with the portfolio's growth
- Train management and the board on the risks inherent in this nascent path





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