Editorial

Risk Management of Digital Assets

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The crypto markets are currently in their second crypto winter. With crypto markets having failed so far to deliver on their promise of new financial infrastructure and products, the daily hype of the crypto news cycle has died down considerably; many observers have concluded that crypto innovation has ended. However, a closer look reveals that the crypto markets are continuing to rapidly develop, albeit in different directions from the past. PayPal just announced a stablecoin as institutions continue to show great interest in tokenising real world assets, with a number of banks having already developed pilot projects. Meanwhile, regulatory proposals from legislatures and banking supervisors continue to be offered in the US and abroad.

The financial crisis in the crypto markets that led to the current crypto winter was caused largely by poor risk management practices coupled with inadequate regulation. If this next phase of institutional crypto is to succeed, financial institutions will need to develop risk management models, methodologies and standards for digital risks as they did historically for market, credit, operational and other risks. To contribute to this discussion, in this Special Issue we have brought together a wide range of practitioner-oriented views on how risk management of digital assets could be formulated. For example, Nathan, Kaponis and Lustgarten in 'Understanding and Managing Blockchain Protocol Risks' focus on the most basic risk of a blockchain, the protocol, and propose a method for analysing and reporting on the risks. Similarly, Lüssem, Aziz, Frías and Koyluoglu emphasise the importance of measuring the degree of decentralisation in a blockchain in 'Risks Inherent within Various Models of Decentralised Crypto Networks'. In 'How Can Run Risk in Digital Markets be Reduced?' Hopper suggests that proof of reserve methodologies developed for pure crypto assets could be adapted to reduce the run risk of conventional financial institutions that offer tokenised financial products such as stablecoins. On the regulatory front, Cianci, Strohbehn and King in 'Blockchain Technology as a Potential Risk Source and a Risk Mitigator: US Reflections and Outlook' complement Hopper's paper by arguing more generally that blockchain technology could reduce risks in the financial system. In contrast, Milkau in 'Risk of Digital Assets: Developments in Regulation and Implementation' takes a more skeptical view, arguing that the crypto markets are more similar to gambling than financial markets and should be treated as such for risk management and regulatory purposes.

To round out this issue, we have also included two additional papers that cover some other important risk management issues. Rajaratnam in 'Sovereign Credit Default Swaps: Managing Risks When the Fiscal House Rumbles' offers practical guidance on how to assess the risks of using sovereign credit default swaps as a hedging tool. In 'Frontloading ESG Risks and Benefits into the Capital Charge to Incentivise Green Financing', Ozdemir proposes that climate regulation should move from the more limited goal of ensuring climate resiliency of the financial sector to the broader goal of encouraging the financial industry to actively assist in the transition to a carbon-free economy.