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AML & Crypto

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The Crypto Sector Today

Virtual Assets (VAs) & Virtual Asset Service Providers (VASPs) – An Advancing Sector

- Rapidly developing sector becoming increasingly significant with general raised activities—70m crypto owners in 2023 compared to 40m in 2021—as well as increasing alignment with mainstream financial frameworks, e.g. recent Bitcoin ETF approval.

- Country approaches are constantly evolving regarding prohibition or licensing and estimates vary, but globally 3,000 VASPs are registered. Canada contains 1,254 licensed VASPs whilst Europe has 1,577 licensees across 20 countries, suggesting currently unlicensed VASP activities in other jurisdictions.

- Meanwhile, heightened awareness of VA-related risks regarding terrorist financing, proliferation financing and other illicit activities – e.g. growing concerns regarding the Democratic People Republic of Korea's activities using VAs to finance proliferation of weapons of mass destruction.

- Where VA/VASPs are a constantly developing and moving target in a relatively new sector, supervision of the sector is to be captured by extending and appropriating existing regulatory frameworks, presenting alignment challenges along the way where VA characteristics do not overlap naturally with traditional finance.

Supervision of VASPs – Developments

Regulation – Catching Up

- Regulators are signaling growing appetite for active supervision – in 2023 Crypto and FinTech were fined $5.8 billion for inadequate compliance controls compared to $835 million in fines for traditional financial institutions.

- Legislative compliance framework is emerging but lack of globally defined and implemented VASP regulations create great variations in levels of requirements and coverage.

- Noteworthy is **Europe's 'Markets in Crypto-Assets' (MiCA) regulation** which was adopted in April 2023, is estimated to enter into force by end 2024/early 2025 and is the first of its kind in legislating sector-wide standards that VASPs should adhere to.

- Definition and implementation of regulations takes time – e.g. only 39 jurisdictions currently have a specifically defined VASP licensing regime.

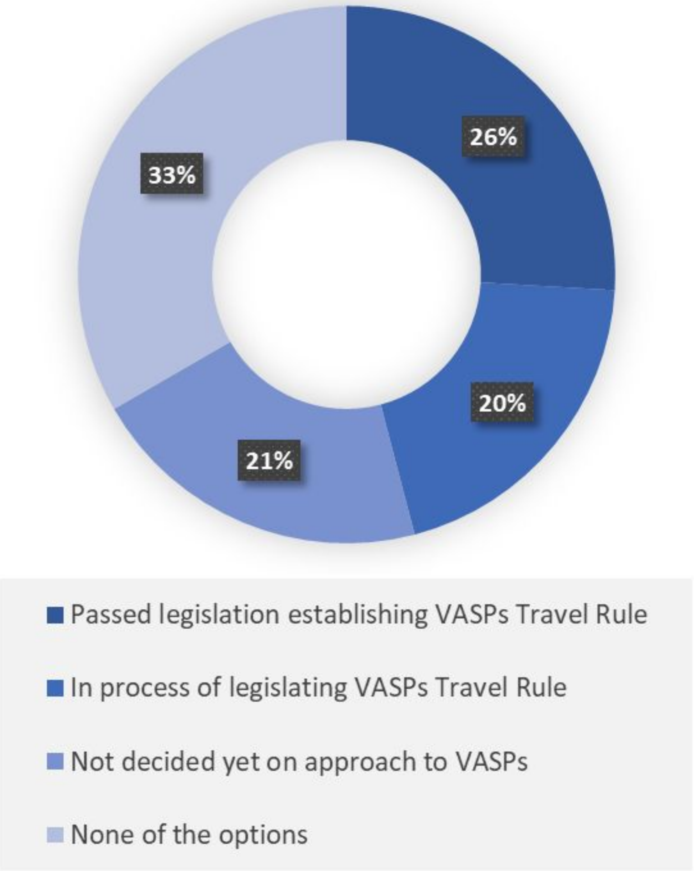
Supervision of VASPs – Current Global Guidelines

Guidance from the Financial Action Task Force (FATF) (2019 / 2021)

- **Recommendation 15** calls for adequate **VASP licensing and monitoring** to ensure compliance with FATF standards based on initial scrutiny and identification of VASP by supervisor during licensing process and subsequent supervision for compliance with AML/CFT requirements on a **Risk Based Approach (RBA).**

- In April 2023, 75% of jurisdictions reviewed by FATF since release of the VASP Guidance in 2019 were only Partially or Not Compliant with Recommendation 15, whilst 73% of jurisdictions do not conduct adequate Risk Assessments.

- The FATF's **Travel Rule** requires sharing of originator and beneficiary information alongside virtual asset transactions – requirement is widely acknowledged but not yet fully implemented (see illustration).



VASP Supervision In Practice – Implementation of RegTech

Getting Started – Practical Considerations

- Despite the lack of consistent global approach to VASP regulation, the direction of travel for supervision is to **build from current practices** to include VASPs into existing supervisory structures.

- As per FATF standards, key areas to incorporate in the Risk Assessments are Customer Due Diligence, treatment of Politically Exposed Persons, Correspondent Banking activities, Wire Transfers and the Travel Rule, Internal Controls, STR reporting.

- Supervisory methodologies should account for the fast developments relating to VASPs – whereas traditional methodologies (often spreadsheet-based) tend to be rigid as well as resource- and time intensive, available **RegTech is agile** and enables the execution of **Risk Assessments in weeks**.

- Adopting such a consistent approach to VASP Sector Risk Assessments to align with methodologies for other DNFBP sectors establishes the FATF specified national-level understanding.

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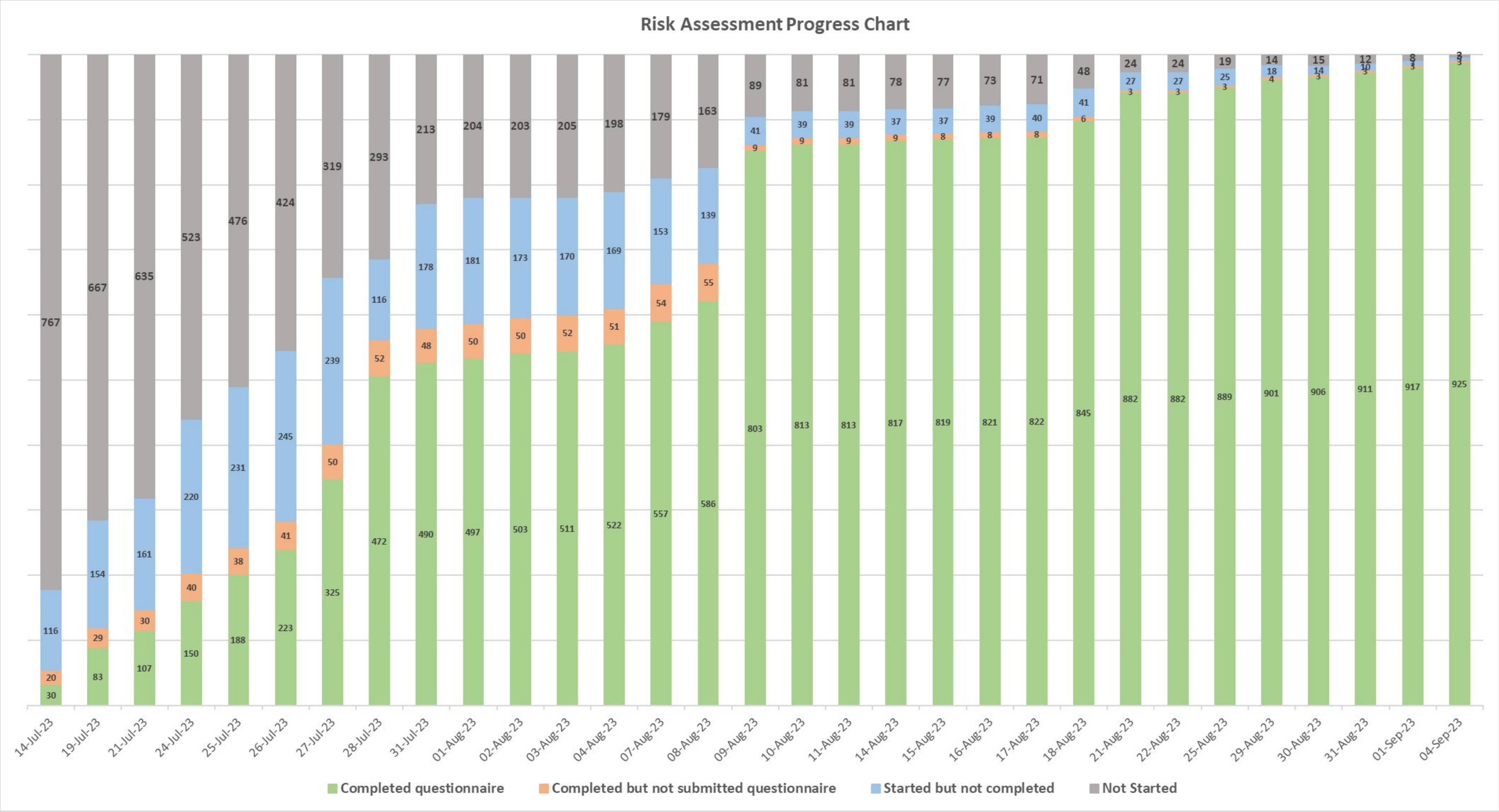
VASP Supervision In Practice – Risk Assessment



VASP Supervision In Practice – Risk Assessment

Inherent Risk across 935 DNFBP entities

Category Name	Risk Score	Entities Per Level
Entity Characteristics	1.01	8 923 2 2
Products and Services	2.66	8 623 301 3
Client Relationships	2.07	8 371 42 473 27 11 3
Geography	2.03	8 338 7 544 30 7 1
Delivery Channels	2.73	8 535 379 13

Control Risk across 935 DNFBP entities

Category Name	Risk Score	Entities Per Level
Risk Assessment	4.02	8 142 140 113 115 151 108 158
Policies and Procedures	4.25	8 119 64 277 31 18 326 92
Customer Due Diligence	3.02	8 76 207 294 212 124 14
Enhanced Measures	3.50	8 127 74 319 89 176 94 7 41
Targeted Financial Sanctions	5.54	8 91 117 28 232 11 72 376
Suspicious Transaction Reporting	2.99	8 419 263 14 231
Internal Controls	3.45	8 99 202 201 126 59 240
Wire Transfers / EFTs	2.65	8 709 218

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VASP Supervision In Practice – Targeted Testing

Enhanced Monitoring, Assessment & Remediation

- Following identification of high-risk areas in the RA, further RegTech tools are available to focus on the greatest threats and vulnerabilities in the sector:

    - Validate **Sanction Screening Solutions** used by VASPs on a per entity basis or as a Thematic Review

    - Assess **Transaction Monitoring** capabilities through analyses of blockchain tools

- Remediation efforts can be defined and where needed mandated by supervisors for both individual entities as well as the entire sectors, e.g. circulating guidance or providing training for specific vulnerabilities as identified through the RA

- By optimizing use of appropriate RegTech solutions the RBA supervisory framework will be efficient and effective, allowing for an **annual cycle of sustainable supervision** to be established that incorporates assessment, investigation and remediation.

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