Risk-Based Approach to VASPs: Internal Controls and Supervision

CFATF Research Desk
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Introduction

- In this monthly article, the CFATF Secretariat presents the second part of our articles relating to the risk-based approach applicable to Virtual Assets Service Providers (VASPS).

- This article will discuss internal controls and supervision.

Internal Controls

- It is essential for VASPs to conduct a thorough and well-documented ML/TF risk assessment throughout their entire enterprise, as stated in FATF's Recommendation 15.

- The IMF also recommends assessing potential violations and non-compliance with targeted financial sanctions regarding proliferation financing when considering the risks of virtual assets (VAs).

- VASPs should perform this assessment before determining how they plan to fulfil their obligations for anti-money laundering, counterterrorism, and proliferation financing. (1)

- It is of utmost importance for entities participating in VA activities, products, or services to develop and implement effective AML/CFT programs and systems to mitigate potential risks. (2)

- The FATF highlights the value of a robust RBA for VASPs, which calls for competent senior management to establish and enforce strict AML/CFT compliance policies and procedures. (3)
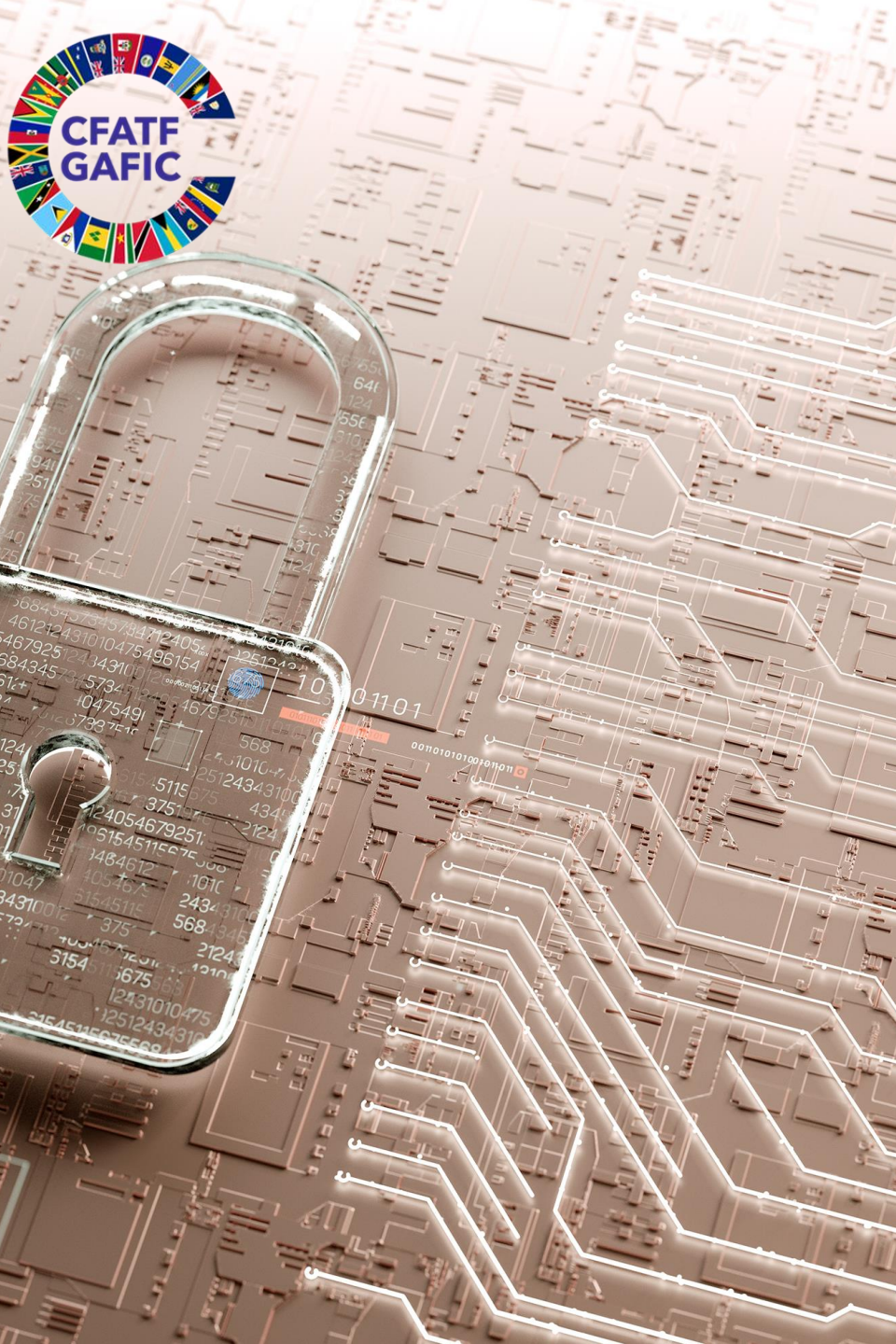
Internal Controls

- As VASPs plan their AML/CFT programmes, they should consider various factors that influence the AML/CFT controls they will implement.

- These factors include the nature, scale, and complexity of their business, the diversity of their operations across different regions, their customer base, product offerings, and activity profile, as well as the risk associated with each area of their operations.

- By considering these factors, they can develop effective and comprehensive controls to ensure the safety and security of their business and customers.

Internal Controls

- Regulators set out internal control requirements for VASPs, such as the following:

    - VASPs must establish and maintain robust internal controls to manage risks effectively in all operations, spanning across departments, branches, and subsidiaries nationally and internationally.

    - The assignment of AML/CFT programs to a compliance officer at the management level is an absolute responsibility that must be fulfilled without exception.

    - Internal control measures must cover several aspects such as customer due diligence (CDD), Know Your Customer (KYC), source of funds, record-keeping, and targeted financial sanctions.

    - Having measures in place to ensure staff members maintain their integrity and receive continuous training is crucial.
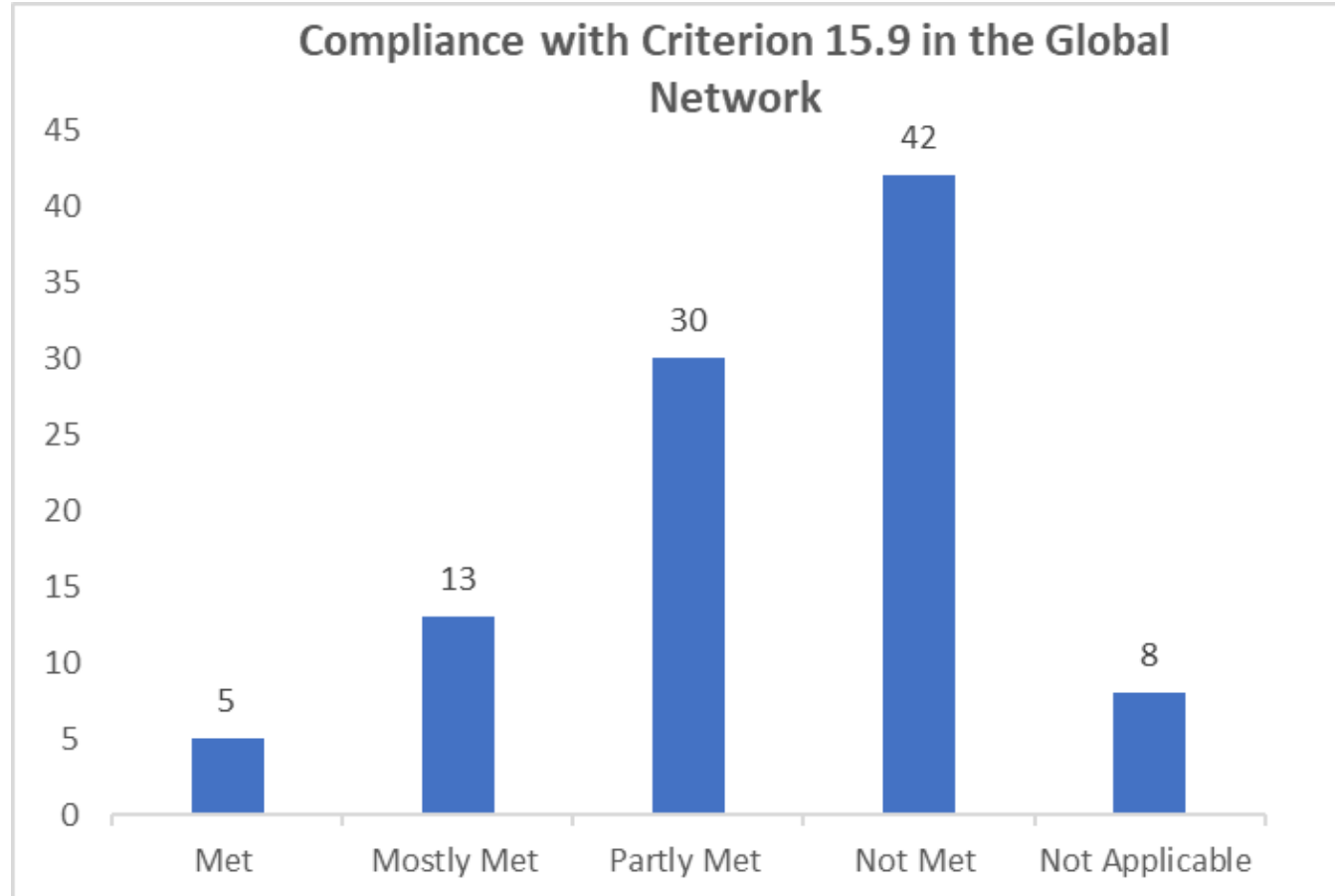
Internal Controls

- Ensure that all suspicious activities are reported promptly internally and report any suspicious transactions to the VASP supervisor.

- It is imperative to establish an independent audit function to guarantee full compliance of the VASP with AML/CFT regulations.

- It is imperative that the transfer of money to third parties is strictly prohibited, and it should be mandatory that both the source and destination accounts match to exchange money for virtual assets or vice versa.

Internal Controls in the Global Network

Compliance with Criterion 15.9 in the Global Network

Category	Value
Met	5
Mostly Met	13
Partly Met	30
Not Met	42
Not Applicable	8

As of April 2023, criterion 15.9 has been assessed in 98 countries. According to the graph above, around 73% of those assessed did not fully comply with this requirement.

Risked-Based Supervision of VASPs

VASP supervisors should: (4) Understand the ML/TF risks VASPs face, including higher and lower risk lines of businesses, services and activities.

Ensure staff is trained and equipped to assess whether a VASP's policies, procedures, and controls are appropriate and proportional to its risks and risk management procedures.

Assess whether a VASP's AML/CFT compliance and risk management program meets regulatory requirements and effectively mitigates relevant risks.

Risked-Based Supervision of VASPs

VASP supervisors should: Consider the risk exposure of VASPs when they operate across different jurisdictions based on multiple licenses or registrations and the extent to which those risks are adequately mitigated.

Communicate findings and views about an individual VASP's AML/CFT controls.

Communicate guidance on expectations of the obligations/measures needed for VASPs to comply with the applicable legal and regulatory frameworks.

Risked-Based Supervision of VASPs

VASP supervisors should: Collaborate with other supervisors in cases where different competent authorities oversee the VA sector to ensure that expectations are clearly communicated to VASPs and reporting entities that offer VA activities or services.

Follow up and assess the robustness of remediation actions to rectify identified AML/CFT deficiencies.

Possess a wide range of regulatory/supervisory measures that can be applied to address the risks exposed by non-compliance.

Risk-Based Supervision Strategies (5)

- **Identification of the VASP population**: To accurately estimate the number of VASPs/obliged entities engaged in VA activities, it is essential for supervisory authorities to engage in early outreach and engagement activities regarding regulation and registration.

- This proactive approach would support the analysis and research conducted by supervisory authorities on the VASP sector. Early engagement also enables authorities to anticipate the resources required for supervision and develop a supervisory strategy. Additionally, VASPs benefit from a better understanding of the requirements by engaging with the regulator early on.

- **Identification of ML/TF risks in the VASP sector**: To identify and understand the risks associated with ML/TF in the VASP sector, it is important for competent authorities to conduct risk assessments on VAs and VASPs.

- The assessments should be based on various data, including the level of exposure of public and private sector entities to VAs and VASPs, STR-related statistics, investigations, prosecutions, convictions, and international cooperation requests.

- It's also essential to consider the type of products and services VASPs provide, the number of legal persons/arrangements registered to offer VASP services, the type of customers served, and the countries where VASPs are registered.

- The number of customers using mixers and/or tumblers should also be evaluated. The collected data can be used to hold workshops with relevant entities and provide expert judgment to determine the policy responses to the identified risks.

Risk-Based Supervision Strategies

- **Use of technology in VASP supervision**: The use of blockchain analytical tools can be useful in the supervision of VASPs by providing insights into various aspects of blockchain and other distributed ledger technologies.

- These tools can help supervisors in identifying high-risk firms based on their activity and categorizing them for assessments, as well as assessing global risks to develop risk-based regulations.

- Additionally, these tools can assist in developing national ML/TF risks assessments. However, it is important to consider factors such as cost, training for tool usage, and data protection requirements.

- **Recruitment and training of VASP supervisors**: When it comes to recruiting and training VASP supervisors, it's important to consider their technical knowledge and supervisory experience. Many VASP supervisors may lack the necessary combination of skills needed to effectively oversee VAs and VASPs.

Risk-Based Supervision Strategies

- **Recruitment and training of VASP supervisors (cont'd):** To address this, some organizations opt to form multi-disciplinary teams that include experienced supervisors with financial crime and AML expertise, as well as external and internal recruits who have knowledge of VASPs. Additionally, it's important to provide external training to all team members on blockchain technology and VAs to ensure that everyone has a baseline understanding of the industry and proper supervision techniques.

- **Multi-jurisdictional operations and supervisory cooperation on VASPs**: VASPs have the ability to operate in multiple jurisdictions and establish relationships with customers without a physical presence. This can pose a challenge for supervisors who require information on VASP registrations or license applications in other jurisdictions to identify international counterparts and better understand the associated risks.

- Some supervisors request information on VASP registrations or license applications in other jurisdictions to identify international counterparts they can reach out to better understand the risks involved.

Supervision in the Global Network

Compliance with Criterion 15.6 in the Global Network
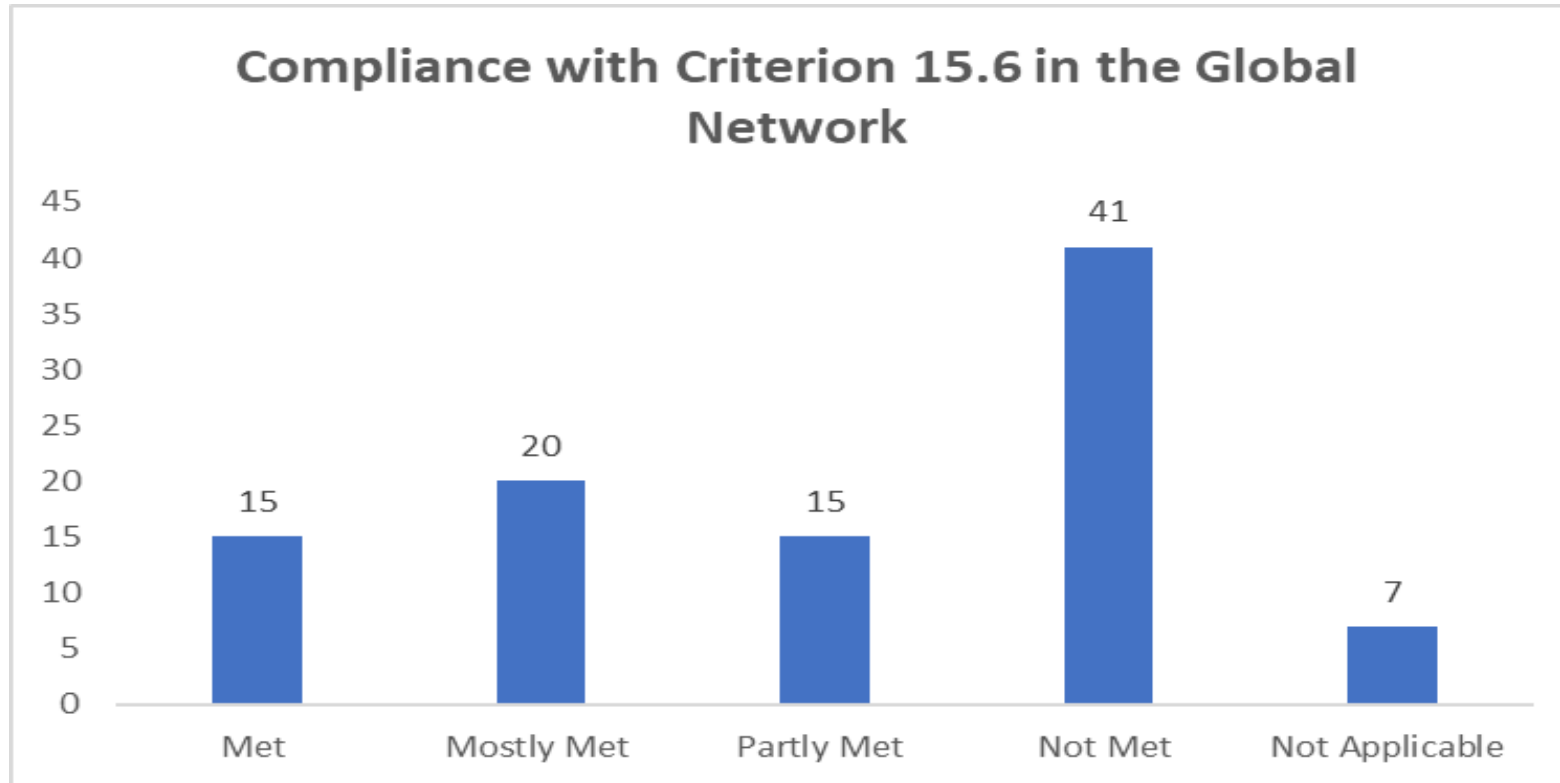
As of April 2023, an assessment of 98 countries found that 57% of them had notable shortcomings in meeting the criteria for supervising and regulating VASPs to ensure compliance with AML/CFT regulations.

This suggests that there may be an overall lack of capacity in implementing adequate supervision or monitoring systems for VASPs.

References

1. Schwarz, Nadine; Chen, Ke; Poh, Kristel; Jackson, Grace; Kao, Kathleen; Fernando, Francisca and Markevych, Maksym. 2021. "Virtual Assets and Anti-Money Laundering and Combating the Financing of Terrorism (2) Effective Anti-Money Laundering and Combating the Financing of Terrorism Regulatory and Supervisory Framework— Some Legal and Practical Considerations." International Monetary Fund (IMF), p.5

2. Obliged entities are entities or individuals that are legally required to implement measures to prevent money laundering and terrorist financing. https://transparency.eu/european-parliament-vote-strengthens-proposals-to-fight-money-laundering/

3. FATF. 2021. "Updated Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers." FATF, Paris. p. 87

4. FATF. 2021. "Updated Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers." FATF, Paris, ps. 74-75.

5. The FATF identified several strategies used in the global network for implementing risk-based supervision of VASPs. See FATF. 2021. "Guidance on Risk-Based Supervision", FATF, Paris. ps.92-96.

We hope that you found this publication interesting and encourages you to continue looking for information about the different aspects of the risk-based approach to VASPs.

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