FTI JOURNAL

ARTICLE

Innovation and Trust: Imperatives in the Emerging Relationship Between Banks & VASPs

October 2021

With the proper due diligence, banks and other financial institutions can confidently partner with VASPs and grab a piece of the booming virtual asset market.

There's no escaping the fact that cryptocurrency is having its moment, and then some. In the past year, the worldwide adoption rate of cryptocurrency leaped by 880 percent, with users in countries like Singapore, Philippines, Vietnam, India and Pakistan all joining a trend already embraced by brands such as Microsoft, Coca-Cola, Starbucks, Rakuten and Nexon.

After surpassing USD$1 trillion in market value for the first time ever on January 7, 2021, the crypto market cap doubled on May 3. As speculative as the market may be, crypto is here to stay.

The booming interest from a broad consumer audience and institutional investors is spurring banks and financial institutions (FIs) to look for ways they can jump on the rocket. Even with unsettled regulatory questions (more about that shortly), many FIs are considering partnering with virtual asset service providers (VASPs) to give consumers the real-time services and ease of transferability they demand.

Now is the moment for collaboration: Banks and FIs that partner with VASPs can boost their competitiveness and identify novel business opportunities. VASPs, for their part, get the benefit of the trust and level of service that long-time players like banks bring to the table. These partnerships may even influence future regulations.

The Regulatory Eye

Like other digital asset markets (think non-fungible tokens [NFTs]), regulators are playing catch-up even as the need for more structure and guidance grows seemingly by the day. Regulatory agencies and policy makers acknowledge as much, recognizing the runaway popularity of cryptocurrencies and how the market's use of blockchain technology can drive innovation and efficiency in the FI space.

But it's a work in progress. With so many questions on how to apply standards to fast-moving global marketplaces, regulatory enforcement is often inconsistent across regions.

There are signs of progress in the regulatory space, nonetheless. The Financial Action Task Force (FATF), for example, recently amended its recommendations toward VASPs, specifying that they be licensed or registered. FATF also now requires virtual providers to adhere to statutes regarding anti-money laundering (AML) and combating-the-financing-of-terrorism (CFT).

The Monetary Authority of Singapore (MAS) is one of several governmental agencies in Asia Pacific that stepped up regulatory requirements of crypto in 2020. MAS specifies that all cryptocurrency trading platforms that do business or operate in Singapore must apply for a license.

Opportunities for Banks

As trusted entities with a history of protecting customer assets and providing security and assurance in volatile markets, banks have an important role to play in the crypto industry. Not only does adoption open the door to the potential of new financial products and services, but the use of blockchain — the underlying technology that supports virtual asset exchange — increases efficiencies and innovation across other processes and offerings.

Revenue opportunities for banks include:

— Providing currency trading services, such as conversion of cryptocurrencies into fiat currencies, and vice versa

— Processing payments and facilitating international cash transactions and transfers

— Providing escrow services

— Helping customers invest directly in cryptocurrencies

Traditional FIs, such as wealth management firms, also stand to gain by providing crypto custody services for their customers. In fact, many firms have already expanded into digital assets, and it's likely that treasury funds management for large corporations will soon involve cryptocurrencies.

Do Your Due Diligence

Although the regulatory environment is in flux, the advantages of partnering with a VASP are too great to pass up. A successful collaboration in the crypto market begins like any other: by researching potential partners, asking questions and assessing risk.

Prior to onboarding a VASP, an FI should perform its due diligence. First, confirming that a VASP has performed a risk assessment of its own AML program is paramount. The VASP's risk assessment should include the types of customers served, the products and services provided and how those are delivered. Consideration of the VASP's geographic footprint and the location of its customers is also important.

By validating or verifying the VASP's risk assessment, FIs can identify, appraise and evaluate their own inherent risk profiles to include risks and typologies that arise with the addition of a digital asset product and the transferability between fiat currency and cryptocurrency. Through this step, the FI can adapt its approach to managing risks and in turn meet the demands of evolving corporate standards.[1]

FIs must also be attuned to risks related to the cross-border nature of crypto assets and the pseudonymity of transactions. A well-designed and effective FCC program can act as a safeguard here; that means performing a detailed validation of the design and operational efficacy of the VASP's FCC program prior to onboarding.

1: Existing frameworks such as the Wolfsberg Correspondent Banking Due Diligence Questionnaire, for instance, offer a good starting place for financial institutions looking to evaluate their own risk profile and a partner's.

Questions for the VASP

Some key questions an FI should have when reviewing a potential partner include:

- Has the VASP thoroughly assessed their sanctions risk and established the necessary mitigations? What preventive measures have been implemented to ensure users cannot be onboarded while located in sanctioned countries — including monitoring the use of virtual private network (VPN) services?
- Has the VASP deployed solutions that monitor both on- and off-blockchain transactions and provide coverage across all applicable risk typologies, such as the use of money mules and anomalous peer-to-peer (P2P) behavior? What capabilities have been implemented to correctly identify the underlying senders or recipients?
- With fraud, financial crime and cyber threats rapidly converging, how does the VASP monitor movement related to criminal activity, such as the use of an unregulated exchange? How does the VASP handle threats related to market abuse, ransomware, hacking, fraud, Ponzi schemes or gambling sites?

Does the VASP have a strong and well-defined governance program in place? Does the VASP take proactive measures on information-sharing about trends, typologies and suspicious activity with regulators across borders?

As traditional FIs consider entering the trillion-dollar digital asset space, collaboration with an established VASP or cryptocurrencies exchange provides enormous potential for economic growth. A well-designed digital asset product or offering can put an FI in a good position to differentiate itself in the industry and attract new clients.

But it is essential that partner VASPs have the legitimate characteristics of a financial institution: superior customer engagement, regulatory compliance, scalable and stable operations and robust governance. The perfect VASP may not be easy to find, but they're out there. After all, VASPs recognize opportunity and want more business, too.

AUTHORS

ANDREW McCARTHY
Senior Managing Director

ANNA BLEAZARD
Managing Director

RAHUL PUNJABI
Senior Director

FTI CONSULTING™