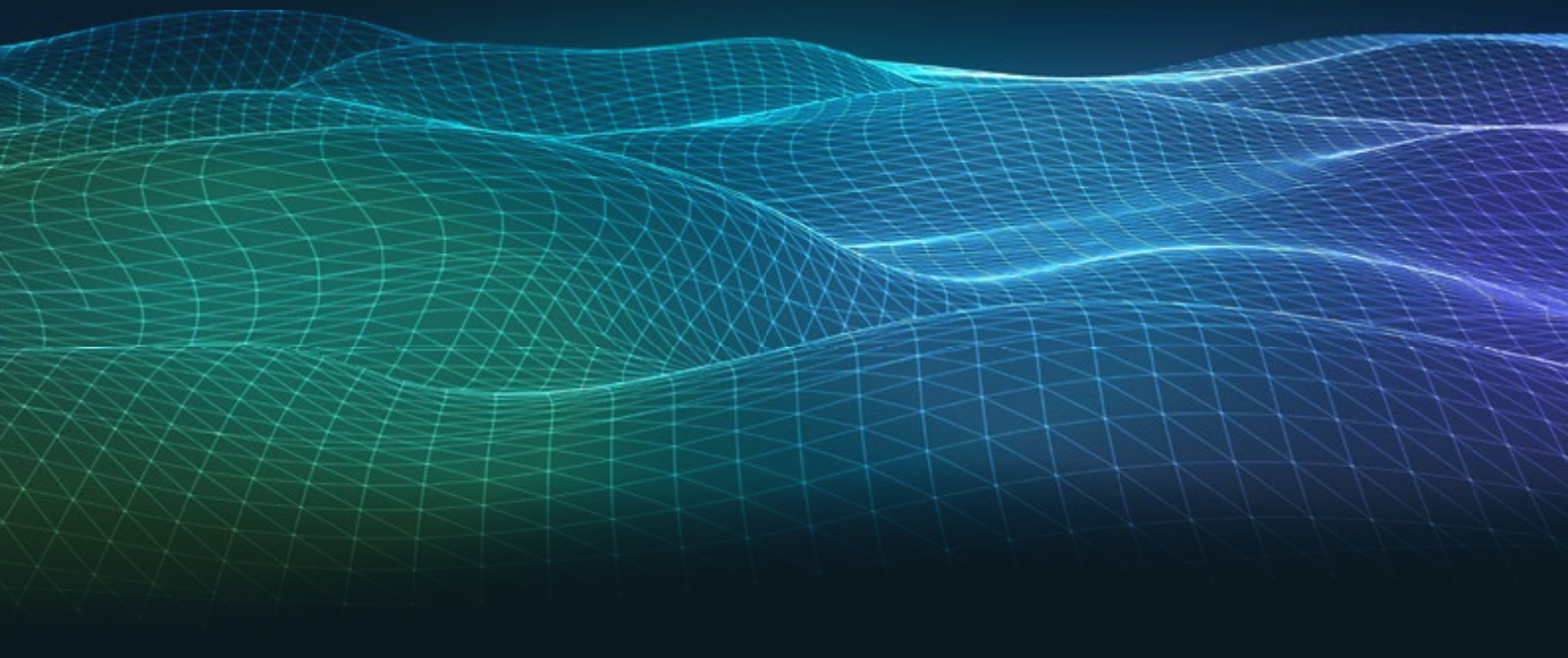


# PLENITUDE

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Crypto: understanding the  
opportunities and effective  
risk management

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Despite the risks that digital assets can present, there is a clear upwards trend of adoption by both retail and institutional investors, so pure abstention by financial institutions (FIs) is not the answer. Beyond recognising the significant potential of this industry, FIs would benefit from increasing their understanding of the sector to inform a crypto strategy and risk appetite, as well as adopting emerging best practices to build an appropriate risk management framework.

# The march towards institutional adoption of crypto

Crypto is a rare example of an asset class that was first adopted by retail investors, before institutional players took notice of it. This bottom-up adoption may explain the reticence of some institutions to engage with it. However, this is changing.

Some commentators trace the beginning of institutional adoption of crypto -mainly bitcoin- to Paul Tudor Jones' [Great Monetary Inflation Thesis](#) in May 2020 (even if Cathy Wood's ARK Invest had become the first public fund manager to invest in bitcoin, back in 2015), because it articulated the macroeconomic / reserve of value argument that would serve other institutions afterwards. Thus, the second part of 2020 and early 2021 saw a wave of announcements from public companies that took the step of allocating part of their treasuries to bitcoin, notably Microstrategy, Square, Tesla and, in the traditional finance sector, Mass Mutual.

By the second half of 2021, this wave of institutional adoption was clearly visible in the results of the [Fidelity Institutional Investor Digital Assets survey](#), which, based on answers from more than 1100 investors from around the world, found that 52% of them had an investment in digital assets. This number masked significant variations amongst respondents, with higher rates of adoption by high-net worth individuals or financial advisors in Europe and Asia, and much lower ones for traditional hedge funds or pension funds, but there was an increase in all of them, nonetheless.

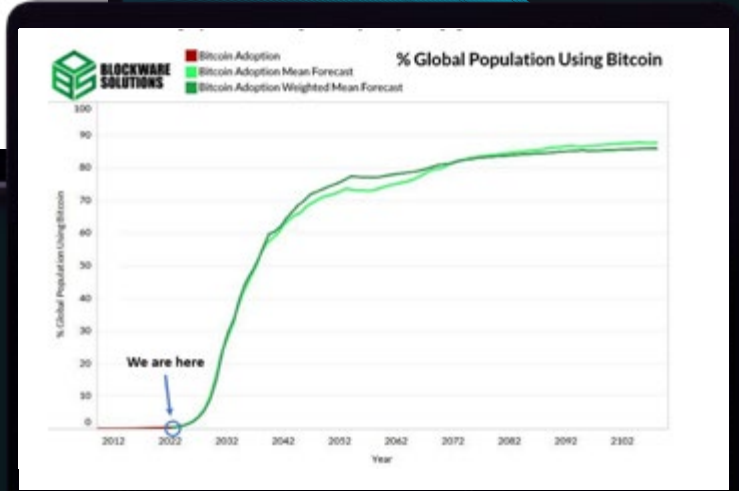
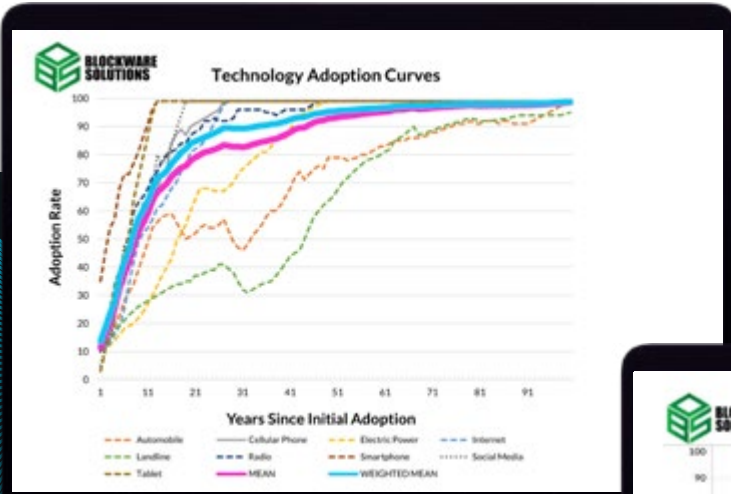
This trend has continued despite the turbulence in markets, with recent moves by BlackRock, abrdn and Charles Schwab, who have launched crypto-related vehicles, announced investments or, in the case of BlackRock, integrated crypto trading with their Aladdin platform via Coinbase.

Besides these direct investments (or investments for the account of clients), the rise of Non-Fungible Tokens (NFTs) in 2021, and increased talk of the metaverse prompted by Facebook's renaming to Meta, has seen numerous companies in different sectors adopting a "metaverse strategy", by buying NFTs or NFT studios (Visa, Nike), virtual land (AXA, JPM), hosting events, launching NFT collections, etc., to the point that by 2026, Gartner predicts that 30% of organisations will offer metaverse products and services.

For FI's, direct exposure is just the tip of the iceberg: to the examples of corporates above that constitute indirect exposure, one can add more than a hundred million retail investors globally (estimates vary, but recent reports put the figures at 12% of adults in the US -[report](#) by the Federal Reserve- and 10% in the UK -[survey](#) by HMRC and Kantar Public-), as well as the numerous players in the cryptocurrency industry, ranging from miners and node operators, to developers, wallet providers, specialised funds, custodians, and exchanges.

These figures are part of a longer-term trend of adoption: In a recent report, [Blockware](#) looked at the historical adoption trends for several previous disruptive technologies, including the automobile, radio, internet, smartphone and more. Based on historic trends, Blockware predicts that global Bitcoin adoption will break past 10% of the world's population in the year 2030. After that, growth could follow the S-shape pattern that new technologies tend to follow and become parabolic, eventually reaching 80% of the population in the 2050s.

<sup>1</sup> Quoted in Elliptic's "[The Future of Financial Crime in the Metaverse](#)".

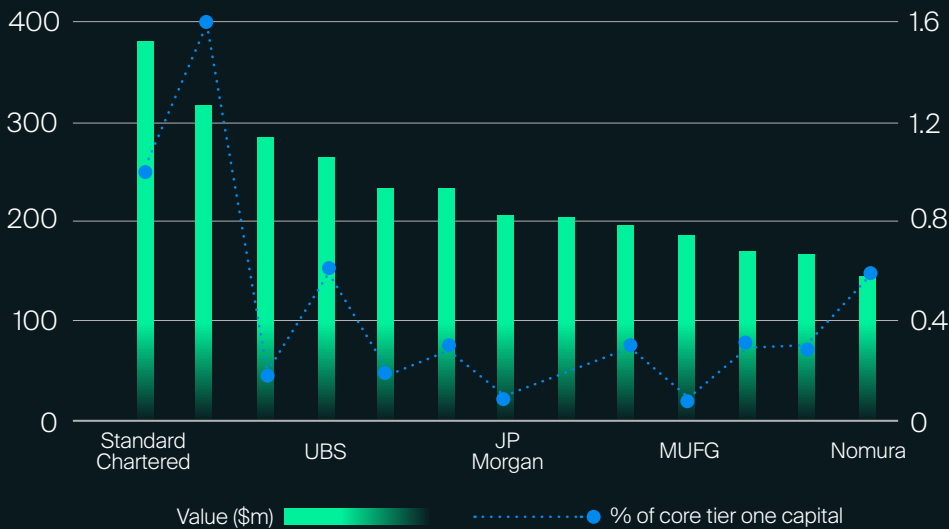


(Source: Blockware Solutions, 2022)

FIs have started responding to this demand, with several of them setting up digital assets divisions, and providing services to crypto firms, including crypto-collateralised loans (a high-profile recent example being Goldman Sachs' loan to Coinbase). This crypto exposure can be in excess of a quarter of loans for emerging small players in the US like Signature Bank

or Silvergate that are actively targeting the sector, but is still very small for large players: less than 1% of core Tier One Capital as measured by investments in crypto and blockchain-related companies, according to BIS figures quoted recently by the [Financial Times](#).

### Exposure to crypto and blockchain-related companies - Selected banks



(Source: BIS, as quoted by the Financial Times, July 1, 2022. Based on investments in crypto and blockchain-related companies. Size of funding round used as proxy for investment. In most cases, it cannot be determined how much money these banks have invested, as they participated in funding rounds with multiple or many other investors)



Some banks, however, remain wary of the sector, and some have adopted policies of not banking crypto customers or not processing transfers to/from exchanges, as evidenced by repeated calls by industry associations in the UK and France for governments to intervene and ensure equal access to financial services. This reticence stems from a perception of crypto as systematically posing high AML/CTF risks and perceived difficulty in verifying crypto as a source of funds / wealth, for example.

However, the increase in investor demand for these assets, coupled with the public nature of the blockchains in which they circulate, have prompted the emergence of numerous solutions that are increasingly being used by FI's to take a more informed view of the risks posed by crypto in order to mitigate them.

Therefore we argue that although cryptoassets can present risks, which can justify a cautious approach, these risks are not mitigated by abstention alone, given the likelihood of crypto exposure, either direct or indirect, through FI's client base. Despite recent market turbulence, the crypto industry has experienced significant growth over recent years and the underlying technology presents compelling use cases which are increasingly being exploited by FIs. We argue that a more sensible approach is to recognise the potential of the asset class and take proactive steps in terms of defining a crypto strategy, risk appetite and implementing an appropriate risk management framework in order to mitigate risk exposure, direct or indirect.

# Understanding the risks of crypto and developing an appropriate risk management framework

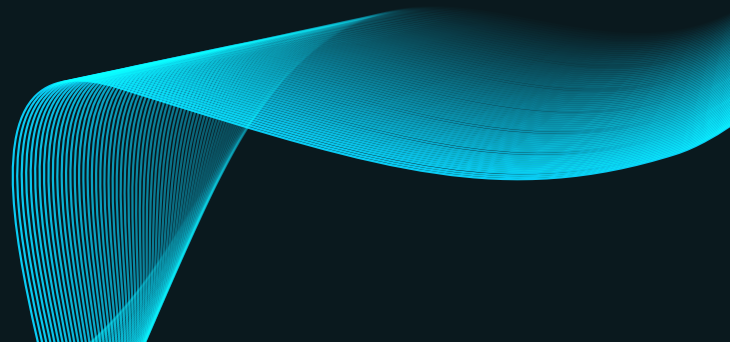
In order to effectively assess the risks, firms should have a clear view on their strategy and potential exposure to crypto. Will it be limited to just risk-assessing existing clients with potential crypto exposure, or will it also involve actively pursuing new ones, investing in crypto assets or developing a specific proposition and offering? The risk exposure is different in each of these scenarios and therefore so is the risk management strategy and required systems and controls.

To formulate a strategy, knowledge is key. Firms will need to devote time and resources to acquainting themselves with the different use cases, sectors, and players in the crypto industry, and to understanding how business models vary from one segment of the industry to another. Only then will they be able to develop a strategy that is coherent with their risk appetite, given how the risks will be different depending on whether their exposure is simply indirect through retail and corporate clients that are active in crypto, or whether it comes from lending to Virtual Asset Service Providers (VASP) or from direct investment in these instruments.

Despite the novelty of the industry, and the emergence of new business models, FIs will find that some of the risks they assess are not necessarily different from the ones they encounter today, such as market risk / volatility, counterparty / credit risk and operational risk exist as well, even if they manifest themselves differently. For example, while scams happen offline and have always existed, “rug pulls” are a specific to crypto, for which the mitigation factors (e.g., smart contract code audits) will be new to FIs. Likewise, assessing counterparty risk on a miner or a node operator, for example, will also be different in practice, as it will require an understanding of the business model and market dynamics of this type of activity, however, these risks are mitigated by the open-source nature of the blockchain and crypto industry, and the wealth of on-chain data that is at the disposal of analysts and institutions.

The mitigation of risks that occur across the client lifecycle, like due diligence on VASPs, require learning on how to use new tools and techniques. These include notably blockchain analytics tools, which leverage the public nature of blockchains to allow tracing the origin of funds and generate risk scores based on the history of transactions of crypto wallets, or that provide detailed information on Virtual Asset Service Providers, thus enabling a documented due diligence process. This is a segment of the sector that already counts several players offering increasingly sophisticated products and a coverage of blockchains in constant expansion, rapidly becoming an essential element in the toolkit of FIs engaging with crypto actors. Recognising the key role of these tools, and learning how to use them, will enable FIs to capture business opportunities that they may be missing today through blanket prohibitions.

The risk considerations will also be different for firms that go beyond this limited exposure to develop crypto-related activities, like custody or exchanging crypto assets between them or for fiat currency, as the trend towards the development of national registration and licensing regimes continues. For example, these activities already require registration with the FCA in the UK, and with National Competent Authorities under the frameworks in place in France and Germany (which from 2024 will be replaced by an EU-wide framework under the Markets in Crypto-Assets regulation). Even in the US, where a detailed national framework is yet to emerge, this does not absolve institutions engaging in these activities from complying with AML/CTF rules, OFAC sanctions or the need to register as Money Service Businesses with FinCen and get Money Transmitter Licences in the states where they operate.



A common factor running through all current regulatory regimes for crypto are AML/CTF and Sanctions obligations, fitness and propriety tests for individuals overseeing these activities and governance arrangements and internal controls, along with activity-specific provisions, like the segregation of assets for entities providing custody services. The above are strict minimums and defy the commonly held view that crypto firms are unregulated.

FIs that decide to pursue these activities may well have an advantage over native crypto players given the experience they have in implementing effective risk management frameworks in these areas, so they could stand to benefit, as they know their way through these obligations. On the other hand, they will need to get up to speed with how the specifics of crypto result in variations to some controls: for example, as mentioned above, blockchain analytics tools play a key role, and are gaining a place in the arsenal of best practices available to FIs to document counterparty and client due diligence, and to monitor transactions.

All the above has an impact in the systems and controls to be put in place, but in the end, the thought process is not overly different than the risk assessments that a firm must carry out when confronted to changes in their **business** activities, new products, etc. However, it must also be noted that crypto being a nascent and fast-changing market whose regulatory environment is taking shape in front of our eyes, means that policies, procedures, systems, and controls must be reviewed **on an ongoing basis**.

So, what is the key to staying on top of these changes and implementing an effective risk management framework? Developing a thorough understanding of the industry and spreading this knowledge widely through decision-makers and operational teams, thus filling a knowledge gap that currently holds back institutions. Only that way can a coherent strategy be elaborated, and FIs will be able to move from an instinctive reflex that paints all the industry with the same brush, to a more refined risk management approach that leverages best practices developed and applies them to this emerging sector, preparing FIs for the disruption that crypto is bringing, not only to financial services, but to society at large.

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## Several question marks hang over the crypto industry:

On the products side, where many of the larger projects and players today did not even exist five years ago, we are still witnessing the birth of a new industry, and what finally emerges from this initial phase may not resemble its current state, but it is clear that the ramifications of this new technology span several industries, and the capital -both economic and intellectual- that has flowed to the sector in this past cycle will ensure that innovation keeps ticking along despite the current market turbulence.

Concerns surrounding the regulatory perimeter, security and stability of cryptocurrency may hold banks back from entering this space—but instead of fearing the risks of this technology, banks should be looking ahead to its potential benefits. Banks can play a significant role in the crypto industry, adding some much-needed assurance and security to the largely unregulated environment. Adopting cryptocurrencies and blockchain technology overall can streamline processes and take banking into the next generation of efficiency and innovation.

Regulation is the other big question mark, and here we can see a general direction of travel in different countries, with the MiCA framework in Europe having an explicit aim of becoming a template for other countries. We can expect many common threads running through crypto and TradFi regulation, notably in matters like AML/CTF and Sanctions, but regulation will not -and should not be- a mere copy/paste of existing frameworks, so this is an area to watch with attention.

One must not neglect either the industry's capacity to evolve even without waiting for regulations: stablecoins issuers producing more frequent reserve attestations, providers exploiting on-chain data to identify risks and activity in real-time, emerging best practices in terms of smart contract audits and disclosures to investors, financial incentives for users to look for and prove fraud (e.g. fraud proofs in optimistic roll-ups), or projects taking the lead in KYCing their users (e.g. AAVE Arc, Otherside metaverse), are just a few examples of this.

What's next?



It is a complex and fast-changing world, and in the end, what will matter most to make informed decisions will be to engage with experienced SMEs who understand crypto and the associated risks, and have a good understanding of the technology, in order to fully exploit its potential benefits.

This understanding is key to the other point that matters: a realisation of the transformative potential of this asset class which embraces its possibilities and stands ready to make the most of the changes that crypto is expected to bring.

Plenitude's Digital Assets offering aims to accompany Financial Institutions that wish to understand the crypto industry and its associated risks better, with a view to gaining a better grasp of this fast-evolving sector and adapt their strategies to best take opportunity of emerging opportunities in this area. This ranges from developing crypto trading and awareness activities to assessing financial crime risks associated with crypto business models, developing, and implementing policies and procedures, and providing guidance on risk management solutions and assisting with selection and implementation.

# About the author



**Manuel Fajardo** is our Digital Assets Lead with over 17 years of experience in the global asset management industry across control functions like Compliance, Internal Control and Internal Audit, in positions with a global remit based in Paris, London and Los Angeles.

Prior to working with Plenitude, Manuel built the global compliance framework for a major investment management group. This involved designing, deploying and constantly refining processes, tools, policies and procedures. His main areas of focus are Anti-Money Laundering, International Sanctions and Financial Promotions / Distribution, in which he has proved adept at balancing local and global considerations and regulatory constraints, the interest of all stakeholders and firms' risk appetite to build solid frameworks that have proved successful throughout the years.

Manuel has a deep knowledge of the cryptoassets industry, acquired through more than six years of studying, investment and advisory work. In the current phase of his career, he has used this knowledge to train companies in the traditional finance sector about the significance of this nascent industry, its actors and developing regulatory framework, as well as advising crypto firms on their regulatory obligations as they seek registrations and; playing an active role in shaping discussions on regulation through industry trade bodies.



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