

## 13. RISK ASSESSMENT OF VIRTUAL ASSETS AND VIRTUAL ASSETS SERVICE PROVIDERS

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### 13.1 Introduction

Over the last decade, VAs and VASPs have been identified as emerging asset class and technology across the globe. In June 2019, the FATF amended its Recommendation 15 on New Technologies to include the new requirements relating to VAs and VASPs. Complying with Recommendation 15, Sri Lanka conducted its first NRA of the VAs and VASPs sector by utilizing the WB Tool. WG on VAs and VASPs has been appointed to complete the task of assessing the VAs and VASPs sector related ML/TF risk in Sri Lanka.

### 13.2 Virtual Assets Ecosystem in Sri Lanka

In Sri Lanka, the VA ecosystem is currently in the developmental phase. The country is yet to announce its policy stance whether to regulate VAs and VASPs or prohibit. However, as at the time of the assessment, there were several emerging initiatives pertaining to VAs and VASPs. While there have been some attempts to establish VASPs within Sri Lanka, the presence of foreign firms engaging in VA-related activities is limited. Since 2017, there has been notable interest among Sri Lankans in VAs and VASPs, as evident from STRs, discussions on social media, and information gathered from FIs. Traditional obliged entities (FIs and DNFBPs) are not directly involved in VA-related products or services. However, these entities are aware of the ML/TF risk and operational risk that can arise from VAs. Indirect involvement of FIs can be identified in Peer-to-Peer (P2P<sup>1</sup>) transactions through VASP.

The WG has identified that only few types of Cryptocurrencies and Stablecoins hold considerable prominence as VAs within Sri Lanka, in contrast to the broader spectrum of globally utilized VAs, including Cryptocurrencies, Stablecoins, NFTs, Central Bank Digital Currencies (CBDCs), Tokenized Assets, Utility Tokens, and Security Tokens such as bankera.

The majority of individuals involved in VA-related products and services can be categorized as young adults, typically between the ages of 18 and 28. This demographic is largely attributed to the widespread knowledge and usage of social media, online VASPs, and crypto forums among the younger generation. Moreover, there is a noticeable inclination among this youth community to view these opportunities as attractive avenues for earning income. The following figures illustrate the Google Trends for major keywords related to VAs and VASPs sector.

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1 In accordance with the classification outlined by the WB tool regarding P2P services offered by Virtual Asset Trading Platforms

Figure 1: Google Trend for Keywords related to Famous Virtual Assets

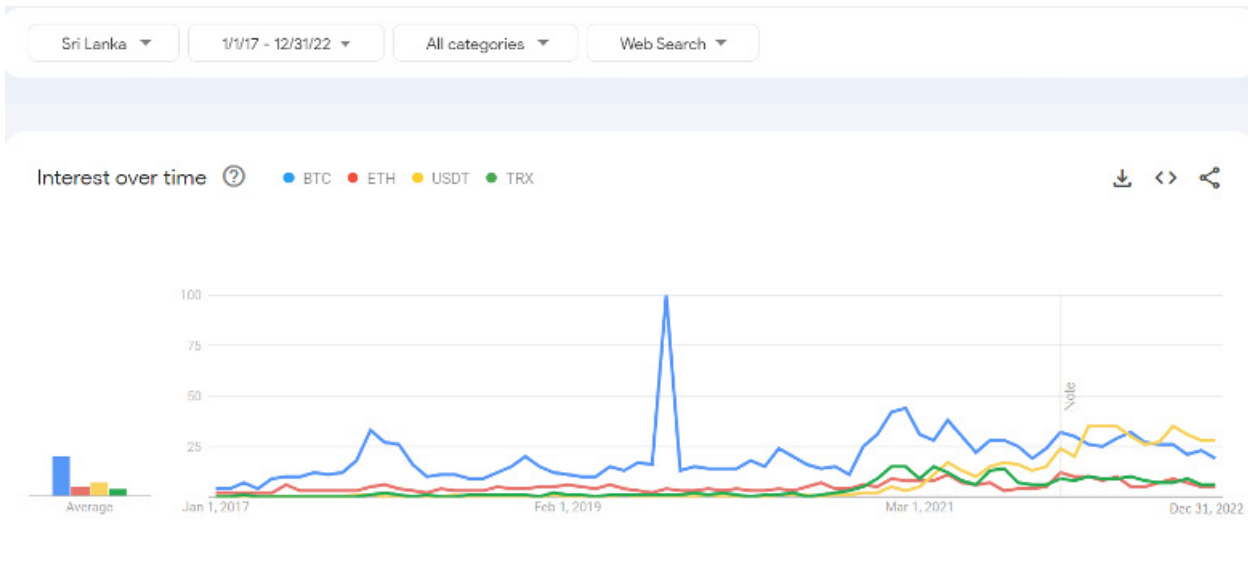
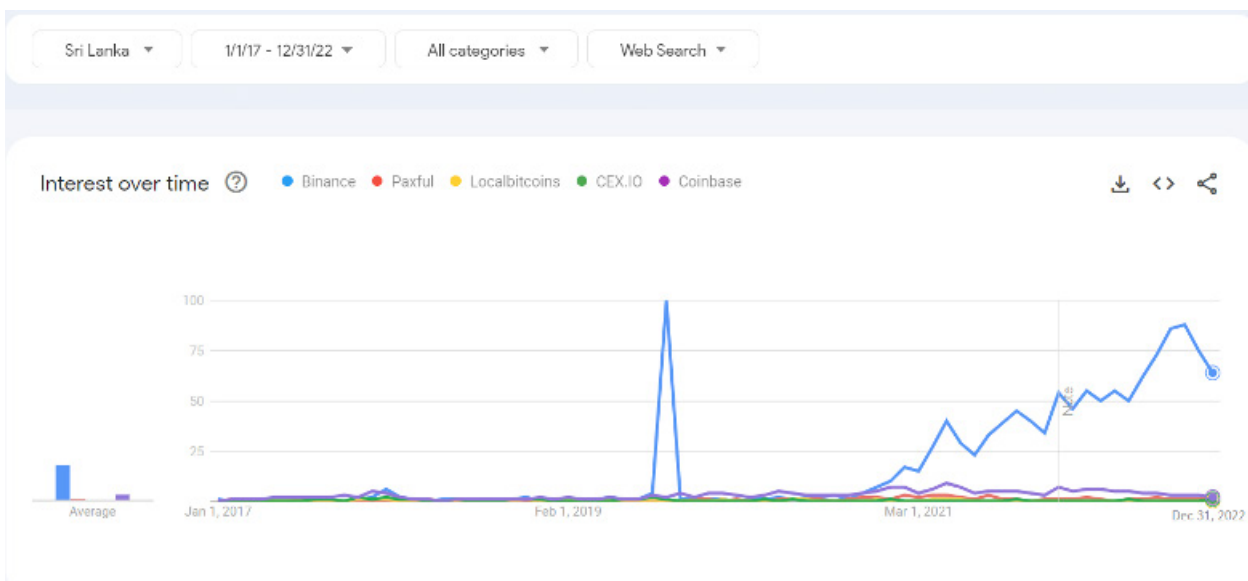


Figure 2: Google Trend for Keywords Related to Famous Virtual Assets Service Providers



VA users can be categorized in three main groups; individuals such as retail investors or natural persons transacting using VAs, corporate users such as firms holding or investing in VAs or transacting using VAs (not on behalf of customers), and merchants, who may be firms or individuals that accept VAs as payment for products and services. Due to the high volatility of VA values, the majority of the people use VAs for speculative purposes to generate profits when asset values fluctuate. The WG noted very few instances of merchants using VAs as a payment instrument in Sri Lanka. At present, three merchants accept VAs as a payment method.

**Table 1: Commonly Used Virtual Assets in Sri Lanka**

Virtual Asset Code	Type of Virtual Asset	Estimated Percentage
BTC	Bitcoin	42%
USDT	Tether	32%
ETH	Ethereum	10%
TRX	Tron	6%
Other VAs		10%

The table above illustrates the VAs that are commonly used by Sri Lankans. These specific VAs were chosen from a pool of over 12,000 globally used VAs, utilizing data gathered from sources such as social media, STR analysis, and other available information channels.

**Table 2: Commonly Used Virtual Assets Service Providers in Sri Lanka**

Name of the VASP	Type of the VASP	Incorporated Country	CDD Requirement	Applicability of CDD Requirements
Binance	Wallet Provider and Exchange	Cayman Island (China until 2017)	Available	3 levels of CDD based on deposit and withdrawal limits
Paxful	Wallet Provider and Exchange	USA	Available	4 levels of CDD based on trade limits
Localbitcoins.com	Wallet Provider and Exchange	Finland	Available	3 levels of CDD based on deposit and withdrawal limits
CEX.IO	Wallet Provider and Exchange	UK	Available	3 levels of CDD based on deposit and withdrawal limits
Coinbase	Wallet Provider and Exchange	USA	Available	CDD measures vary by region and payment method. Coinbase employs an algorithm considering factors like account age, location, and transaction history

Foreign VASPs mentioned in the Table 2 facilitate P2P<sup>2</sup> VA transactions for Sri Lankans, and they have multiple levels of CDD requirements. If a customer completes the advanced CDD requirements, the platform will increase their transaction limits, while customers who do not complete or partially complete the CDD requirements will have limited transaction thresholds. The CDD procedures usually involve selfie image verification, ID verification, and address verification.

2 In accordance with the classification outlined by the WB tool regarding P2P services offered by Virtual Asset Trading Platforms

### 13.3 Existing Legal Framework

At present, mechanism of formation, registration, licensing, monitoring and supervision of VASPs have not been identified under the existing legislations in Sri Lanka.

However, few directions and press releases have been issued by the CBSL with regards to the VAs and VASPs sector in Sri Lanka.

- Direction No. 03 of 2021 under FEA issued by FED, resident cardholders are not allowed to make foreign exchange payments related to VC transactions via EFT cards.
- Press release dated April 16, 2018, issued by PSD, warning the public of the risks of using VCs.
- Press release dated April 09, 2021, issued by PSD, warning of the public regarding significant financial, operational, legal, customer protection and security related risks posed by investments in VCs to the users as well as to the economy.
- Press release dated July 12, 2022, issued by PSD, informing that CBSL has not given any license or authorization to any entity or company to operate schemes involving VCs, including cryptocurrencies, and has not authorized any Initial Coin Offerings (ICOs), mining operations or VC Exchanges.

Further, VCs are not identified as a permitted investment category for Sri Lankan citizens in terms of Regulations, No. 01 of 2021 (Classes of Capital Transactions Undertaken Outside Sri Lanka by a Person Resident in Sri Lanka) issued under the FEA.

### 13.4 Data Collection Methodology

The assessment was made based on the expertise of the team members and the information that was accessible. Given the absence of regulations in Sri Lanka's VAs and VASPs sector, the WG had limited access to information through official channels. As a result, the WG utilized both formal and informal sources of information to collect data pertaining to the VAs and VASPs to obtain insights regarding VAs and VASPs. To ensure accuracy and reliability, formal data collection methods included the use of questionnaires, virtual discussions, one-to-one meetings, telephone interviews and statistical data derived from STRs concerning VAs. The WG conducted an analysis of the STRs using various criteria to extract valuable insights. In addition, open-source information was obtained from various platforms such as social media, online forums, media journals, and even the dark web. This extensive data collection process spanned from 2017 to 2022, providing a thorough understanding of the VAs and VASPs landscape for the purpose of risk assessment.

### 13.5 Risk Assessment

The ML/TF risk associated with VAs and VASPs was assessed by considering the product and threat dimension, vulnerability entity dimension, and mitigating measures. This evaluation took into account 6 distinct categories of VASPs as outlined in the WB tool, which encompasses VASP activities specified by the FATF definitions. These categories include Custodial Wallet Providers, Non-Custodial Wallet Providers, P2P transfer services, Fiat-to-Virtual Conversion Services, Virtual-to-Fiat Conversion Services and Virtual-to-Virtual (V2V) Conversion Services. The identification of these categories was accomplished through the data collection process.

However, several wallet providers commonly used by Sri Lankans were identified as being registered in foreign countries. The inherent characteristics of VAs, such as anonymity, pseudonymity, non face-to-face nature, and portability, pose a significant ML/TF risk to the economy and financial system. Furthermore, the ease of transferring VAs across different countries and the lack of consistent global controls and preventive measures contribute to this risk.

The WG observed that difficulties arise in identifying the source and destination of VA-related transactions due to non face-to-face customer relationships or the inability to access information obtained through digital face-to-face CDD processes by foreign VASPs. As a result, the WG rates the risk related to custodial wallets as **Low** level and non-custodial wallets as **Medium** level. This differentiation is mainly due to the fact that the VASP has full control over the assets in a custodial wallet, resulting in a lower risk compared to non-custodial wallets.

Due to restrictions on cross-border card payments for purchasing VAs since March 2021, many individuals have moved to using P2P<sup>3</sup> transfer services to acquire VAs. Further, people have increasingly turned to VASPs as a method for international payments or as intermediaries for exchanging foreign currency outside the country. The first method identified by the WG involves transferring fiat currency to a third party residing in a foreign country in order to transfer VAs to wallets owned by Sri Lankans via VASPs (similar to Hawala and Hundi systems). The second method, discussed on social media platforms, involves traveling as a tourist to foreign countries while carrying dollars, and purchasing cryptocurrencies using VASPs/ATM machines in those countries where VAs are legalized. Subsequently, individuals transfer VAs to wallets owned by their Sri Lankan counterparts. In this case as well, the WG lacks strong evidence to assess the scale and behaviour of this market. Most of the foreign VASPs which facilitate P2P transfer services for Sri Lankans have a satisfactory level of AML/CFT controls. Even though they have AML/CFT implementations, none of them are licensed or registered in Sri Lanka. Therefore, there is no requirement for foreign VASPs to report any suspicious transactions to Sri Lankan FIU/ LEAs, if foreign VASPs identify a suspicion. The final risk score for the P2P transfer services is **Medium** level.

Due to the absence of physical presence of VASPs within the country, the exchange of fiat currencies to VAs over the counter or via cryptocurrency ATMs/Cash Deposit Machines is not available. However, based on limited survey information, the WG has identified two commonly used methods by which Sri Lankans exchange fiat currencies for VAs. The first method involves using foreign VASP services. However, in accordance with Direction, No. 03 of 2021 under the FEA, most LCBs have blocked payments to many foreign VASPs through EFT cards. The second method used by people is to employ intermediate payment platforms, such as Neteller, Skrill, and PayPal, to convert fiat to VAs. As per the discussions had with FIs, the WG concluded that payments to above mentioned intermediaries have been restricted by FIs. The risk score for Fiat to Virtual Conversion is calculated as **Low** level.

There is limited evidence of the Virtual to Fiat conversion markets. Foreign VASPs operating in Sri Lanka do not support exchanging VAs to fiat currencies to accounts in LKR. Most of these conversions are done through P2P transfer services. The risk related to Virtual to Fiat Conversion services is rated at a **Low** level.

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3 In accordance with the classification outlined by the WB tool regarding P2P services offered by Virtual Asset Trading Platforms

V2V Conversion Services also have very few interested parties, as most people in Sri Lanka are involved in a limited range of VAs. Although the WG has identified several well-known VAs in Sri Lanka, they belong to different VA categories (categories of digital assets). Consumers predominantly own Bitcoin as a crypto asset, while USDT, which is a stablecoin, is mostly held as a payment instrument. Since these two digital assets belong to different categories, the WG believes that consumer investments in these two categories work independently of one another. Due to the lack of sufficient data, the WG is unable to assess and assign a risk rating for this sector.

Apart from the 6 categories considered for the assessment, following categories were included in the WB tool covering Limb (iv)<sup>4</sup> and (v)<sup>5</sup> of the FATF definition of VASP.

- Virtual Asset Broking / Payment Processing

This category includes ATM, Merchants and Cards. The WG could not identify any ATM services or card services in Sri Lanka. However, the WG has located 3 merchants that accept VAs as payment services. Despite this, these merchants have conducted a very limited number of transactions. As a result, the WG has chosen not to consider this category for the assessment.

- Virtual Asset Management Providers

This category comprises Fund Management, Fund Distribution, and Compliance, Audit and Risk Management. The WG did not find any evidence regarding this category. Consequently, the WG did not include this category in the assessment.

- Initial Coin Offering Providers

This category includes Fiat-to-Virtual Fund Raising, V2V Fund Raising, Investment on Development of Product and Services, Security Token Offerings (STOs) and Initial Exchange Offerings (IEOs). No supporting evidence was discovered by the WG in relation to this category. Therefore, the WG did not include this category in the assessment.

- Virtual Asset Investment Providers

This category includes Platform Operators, Custody of Assets, Investment into VA-related commercial activities by Trading Platforms, Non-Security Tokens and Hybrid Trading Activities, Stablecoins, Crypto Escrow service and Crypto-custodian Services. Due to non-availability of supporting evidence in connection with this category, the WG chose not to incorporate this category into the assessment.

## 13.6 Cryptocurrency related Scams

The WG identified developing risk on VA related fraudulent activities, particularly in pyramid, Ponzi, and ICO scams. The preferred payment method among scammers is USDT, which makes it challenging to track down their identities. Victims of these scammers can be found across various professions and geographic locations, making it evident that the impact of these fraudulent activities extends far and wide. The victimized individuals

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4 Safekeeping and/or administration of virtual assets or instruments enabling control over virtual assets.

5 Participation in and provision of financial services related to an issuer's offer and/or sale of a virtual asset.

in these cryptocurrency-related scams can be classified into distinct categories, transcending professional boundaries and geographical locations. Regardless of their occupation or where they reside, these scams have impacted people from diverse backgrounds. These categorizations shed light on the varying degrees of vulnerability among victims. The first category comprises individuals with limited knowledge or understanding of VAs who inadvertently become targets of these fraudulent activities. The second category includes individuals with some knowledge of VAs but are still susceptible to falling victim due to the complex nature of these scams. Lastly, there are those who willingly participate in these schemes, enticed by the prospects of attractive financial gains. It is essential to recognize these different categories of victims to develop tailored strategies for prevention, education, and support, thereby mitigating the risks posed by cryptocurrency-related scams in Sri Lanka. These categorizations have been established through a combination of data collected from social media platforms, strategic analysis, and information provided by LEAs.

The Resolution and Enforcement Department of the CBSL is actively involved in the identification and enforcement of prohibited schemes, including those related to VAs. Through their diligent efforts, the Resolution and Enforcement Department works towards identifying individuals and entities engaged in fraudulent practices and takes appropriate enforcement actions.

Fraudsters employing pyramid and Ponzi schemes in Sri Lanka lure individuals to invest their cryptocurrency on their platforms and encourage them to invite others to join. Existing members receive fixed benefits on a daily, bi-weekly, or monthly basis, as well as incentives for recruiting new members. However, scammers often delay the refund process when members attempt to withdraw their benefits. In the initial stages, they may use new members' funds to pay back previous participants. But when there is insufficient cash or cryptocurrency inflow to support their fraudulent activities and the number of withdrawal requests rises, scammers typically vanish, abandoning their business.

Scammers of the ICO type promote a new cryptocurrency and typically receive payments for the new coins in the form of USDT payments. Once users purchase ICO tokens from these scammers, they are provided access to a cryptocurrency wallet that displays their ICO tokens. Despite the scammers' assertions of storing the coins on blockchains, most often, there is no associated blockchain. The wallet interface is also a counterfeit system created by the scammers. After collecting their funds through the ICO project, the scammers shut down their systems or allow them to remain idle.



Figure 3: Highlights of the Risk Assessment of Virtual Assets and Virtual Assets Service Providers

