Digital Currencies
Governance Group

Digital Currencies and Money Laundering:

Why and how is Crypto safer than fiat?

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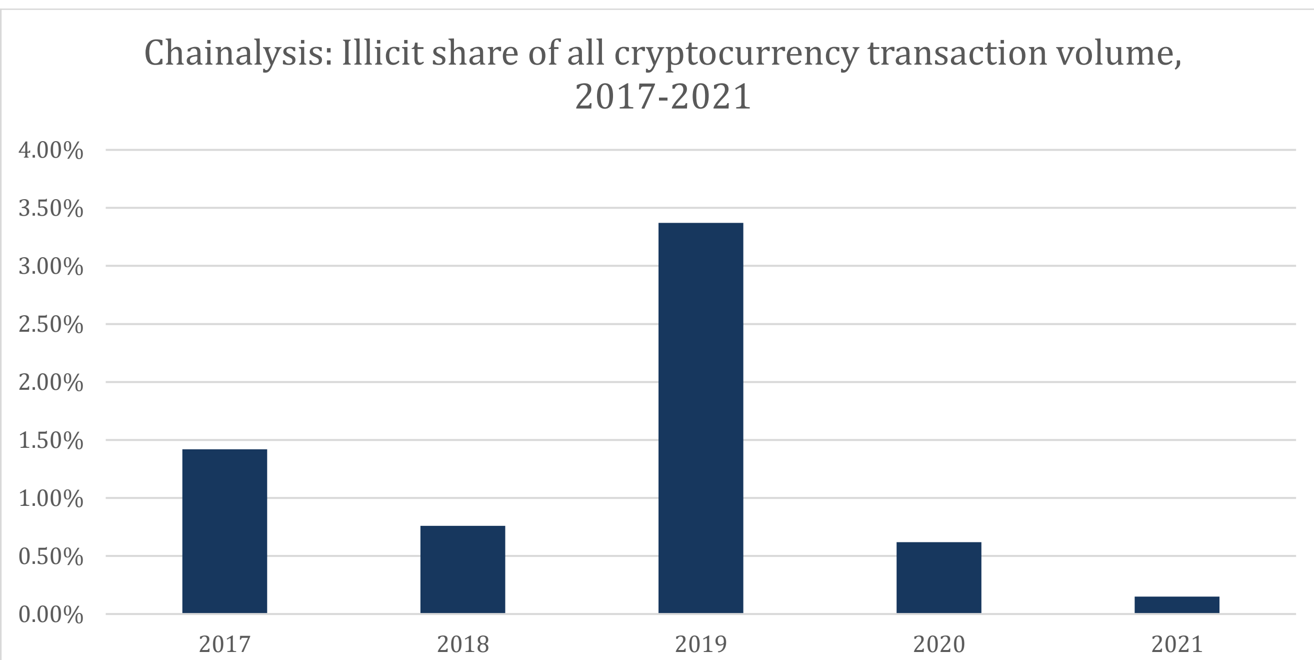
1. What is Money-Laundering?

Money laundering is a criminal activity whereby money generated in illicit ways appears to have been generated by a legitimate source. The aim of the process is to allow for the efficient use of money that has been obtained illegally. For this purpose, money is usually deposited in legitimate financial institutions as to appear to have been generated through legally-sound activities. The process usually involves three steps: placement, layering, and integration: "dirty money" is placed into the legitimate financial system, then, through a series of transactions called “layering”, the source of the money is concealed. In the last phase - “integration”, the seemingly “clean” money is withdrawn and utilised for the purposes intended.

2. Are digital currencies a tool for facilitating money laundering?

The digital currency industry has been widely suspected and particularly criticised for being a tool facilitating money laundering, with a focus on activities such as stolen funds and scams. However, according to the latest Chainalysis 2022 Crypto Crime Report, with the growth of the industry, a steady downward trend can be observed – the illicit activity share of the entirety of cryptocurrency transaction volume in 2021 has been recorded the lowest in the last 4years.



The data clearly demonstrates that the fraction of cryptocurrency usage used for criminal/illicit activities is decreasing with increased mass adoption. Alongside novel cryptoasset regulations being adopted across jurisdictions, crypto asset exchanges are also implementing sophisticated security measures. Coupled with the fact that transactions on the public blockchain are trackable and transparent, money laundering through crypto-asset transactions becomes increasingly difficult.   On the other hand, private banking transactions remain hidden.

Drawing the line, according to statistics, it is false to assume that the main use case for cryptocurrencies is for illicit activities, and the legitimacy of legal crypto transactions taking place on regulated exchanges cannot be downplayed. If crypto operators are compliant with upcoming regulations on crypto and are licensed and monitored by a designated competent authority, there is no reason to believe that cryptocurrency transactions are inherently riskier or more prone to ML risk than fiat transactions.

3. Fiat Money VS Digital Currencies

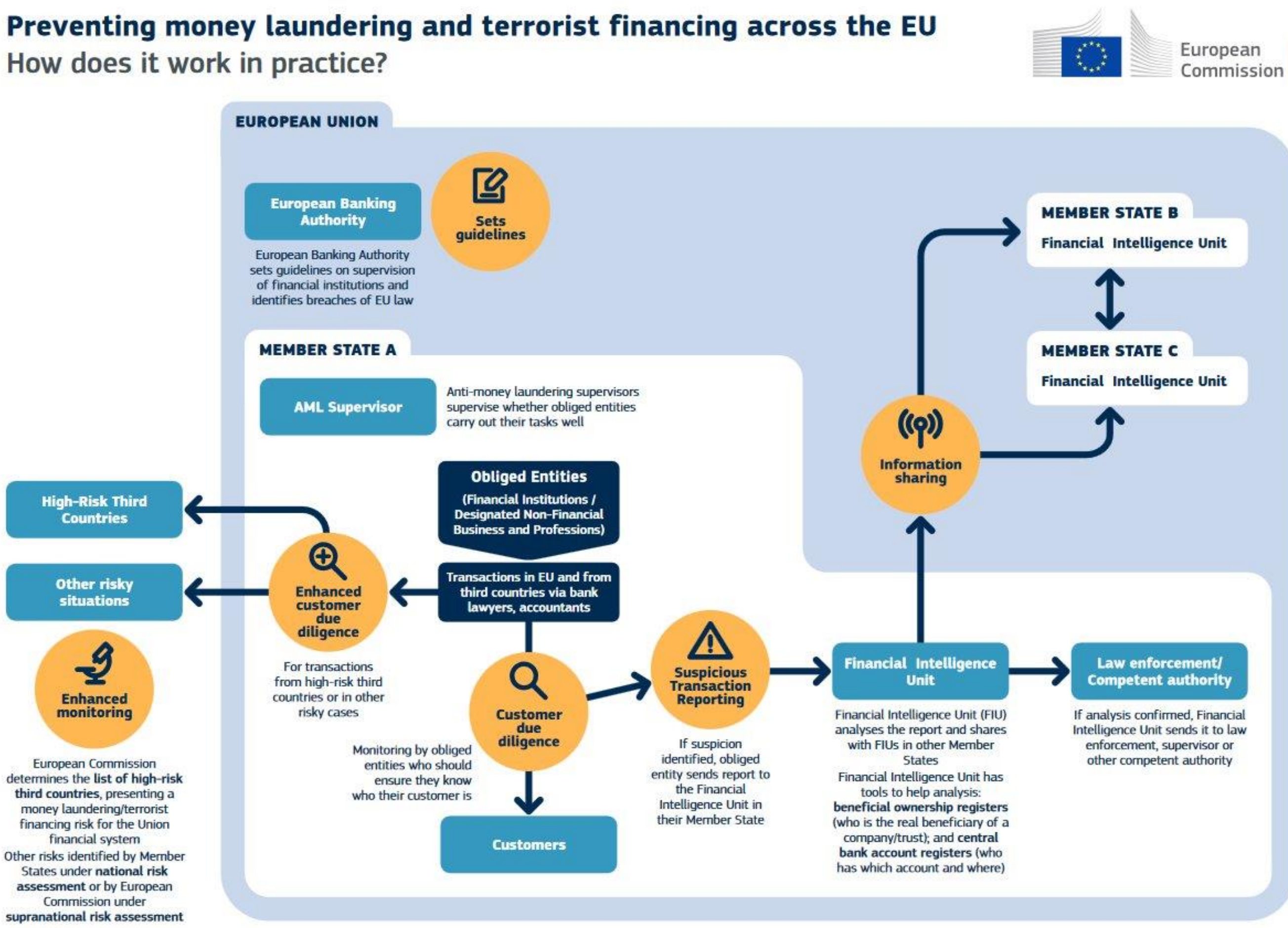
The anonymous nature has led many critics to believe that cryptocurrencies are the perfect tool for criminals to hide their trails due to the anonymity granted by Blockchain technology. However, Chainalysis and the United Nations Office on Drugs and Crime pinpoint that illicit transactions and financial crimes facilitated through fiat are significantly larger scale than those facilitated through crypto.

Europol's latest report on the Evolution of Criminal Finances juxtaposed the use of digital currencies and fiat money for financial crime and concluded that, in line with the Chainalysis 2022 report, cryptocurrencies used for money laundering make up a very small fraction of the overall cryptocurrency economy and, importantly, it is comparatively smaller than the fraction of illicit funds in traditional finance. To sum up, these reports clearly demonstrate that the use of fiat money is still dominant for financial criminals.

4. Fighting Money Laundering crimes is more effective when cryptocurrencies are used

The 2022 Chainalysis Report highlights that cryptocurrencies and exchanges can bring immense value to building a more sustainable and effective AML framework. Employing Blockchain analytics can improve and build upon established law enforcement and investigative mechanisms for fighting money laundering. Furthermore, centralised exchanges can cooperate with law enforcement in a frictionless, transparent, and sustainable long-term manner through advanced risk-based approaches, Blockchain analytics and Know-Your-Transaction procedures. They employ state-of-the-art means of monitoring incoming and outgoing transactions, as well as observing the traceability of deposits to ensure the history of a transaction is clean and non-related to ML activity.

Blockchain technology, being a transparent ledger, provides a way to identify illicit transactions in a manner of minutes. In the case of illicit activity, the centralised exchange immediately freezes the funds when anything suspicious is flagged, in cooperation with law enforcement, hence they have the ability to be rapidly responsive in relation to suspicious activity. As suggested in the graph below, prevention of illicit transactions is a multi-layered process, which crypto operators can facilitate in a manner of minutes. This brings immense value to preventing money laundering and terrorist financing and helps make existing practices more efficient.



Source: European Commission (2018)

Hence, it is false to assume that cryptoasset transactions are inherently riskier in terms of money laundering, as:

- Cryptocurrency transactions are traceable
- Blockchain technology keeps a record of every transaction that has been processed, and once a transaction has been confirmed it cannot be changed or deleted

- Crypto businesses have AML risk management built in their very core

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