NUPI

Policy Brief 10 · 2013

Enduring Challenges in the Governance of Money Laundering

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Introduction

The governance of money laundering relies on a complex multi-actor framework of organizations, national bureaucracies and private institutions at the global, regional and national levels. This framework is dense and prescriptive and has led to a wide range of anti-money laundering (AML) policies and practices over the past thirty years. The dedicated AML intergovernmental body, the Financial Action Task Force (FATF) has been at the centre of activities, providing an institutional framework for key states to coordinate policy, and producing global standards. In 2012, it adopted the revised '40 Recommendations', and has published methodological guidance for their adoption. Standards have evolved from the FATF's early work on identifying problem areas and documenting needs and procedural best practice, to a recent focus on risk assessment and effectiveness. Its work is diffused through a network of regional bodies, and, in the European Union, transposed into AML directives. Mutual evaluations of country AML standards complement this process, with a new round to be commenced shortly.

While the institutional capacity of AML has been consolidating, and policies and practices have been adopted globally, controversies and challenges remain with respect to definitions and effectiveness. Money laundering is the process of disguising the illegal origin of the financial proceeds of crime. Rules and laws originated in law enforcement concerns with narcotics, but a wide spectrum of crimes has been added to the list of 'predicate offences' for money laundering, ranging from illegal trafficking to tax evasion. Attempts at quantifying money laundering have proved challenging, as the secretive and illegal nature of the processes involved results in scarce, incomplete and generally unreliable data. This makes it difficult to assess effectiveness of AML policies; policy rhetoric and official assessments of success tend to focus on detected cases and the subsequently available legal and financial stories. As powerful as those cases can be in highlighting the links between finance and crime, they do not address the key challenges of definition and measurement. Since its beginnings in the 1980s, the governance of money laundering should be viewed in a broader context that includes financial governance (ensuring the integrity of the financial system and a competitive level playing field for financial institutions) but also crime governance (tackling crime in relation to drugs, trafficking or corruption), and global coordination of foreign policy and national security concerns. The latter is particularly in evidence with the introduction of an officially sanctioned focus on problem countries and politically exposed persons in AML methodologies, and the inclusion of terrorist financing (2001) and the financing of proliferation of weapons of mass destruction (2012) in the FATF framework.

A further set of challenges for proponents and critics of today's AML framework involves assessment of the usefulness and effectiveness of AML policies and practices. This brief outlines some persistent challenges for FATF and the key jurisdictions driving the FATF agenda, including the private sector, and examines some policy effects among the rule-takers.

The quest for effectiveness

FATF recommendations aim to provide a comprehensive framework for tackling money laundering across the financial and business sectors, offering guidance for the appropriate AML structures at the national level and for international cooperation. The recommenda-

tions also specify the content of AML rules – from the definition of money laundering predicate offences and the discussion of confiscation provisions, to the adoption of preventive measures in due diligence, reporting and correspondent banking. Further recommendations cover transparency and beneficial ownership of legal persons and arrangements. Key departures in the 2012 FATF revisions concern a more sustained focus on beneficial ownership, the introduction of tax offences as money laundering predicate offences, and the expansion of a risk-sensitive framework for analysing exposure to money laundering. An additional important change is a move away from technical 'paper' compliance to include assessments of effectiveness of implementation.

The next steps for FATF include monitoring the adoption of its revised recommendations. To this end, it has, in 2013, issued new methodology on compliance. This covers, as before, technical compliance issues of process, but also new ways to assess whether a jurisdiction's AML system is effective, i.e. produces the expected results with respect to agreed defined outcomes. The challenge is to promote practice that is not too prescriptive, but still ensures fairness. The fourth round of mutual evaluations will serve as a test for this ambitious exercise in terms of coherence and consistency across jurisdictions. It may well require a shift in thinking from public sector officials.

Another challenge for FATF is to deliver on its commitment to risk assessment. While the revisions and FATF's global focus have greatly enhanced the geographical scope and the range of financial activity covered by AML provisions, there has been disproportionately little attention to the heightened AML risk within the financial sectors of core FATF countries. Large financial systems may not need special rules, but a risk-based approach implies closer scrutiny. This is related to broader questions of fairness and proportionality. For example, FATF has recently placed greater emphasis on issues of financial inclusion and is committed to better access for marginalized groups to formal financial services. It also faces continuing calls for a more representative membership. FATF is an explicitly political organization in its membership and practices, but is regularly criticized for the over-representation of European members and the absence of certain key jurisdictions (especially from the Middle East).

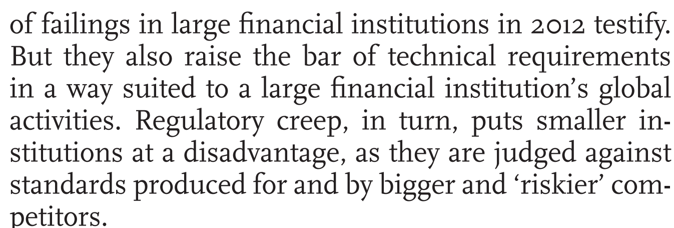
AML and the private sector

Risk assessment, while 'new' in public policy terms, is something that financial institutions claim to do well. They have reputational and legal incentives for taking AML measures seriously. Over time, AML legal requirements have necessitated the establishment of dedicated AML units, continuous training, and investment in compliance software. Predictably, the view in the private sector is that at least some of these efforts are disproportionate and far from cost-effective. Even with attention to AML temporarily waning with the onset of the global financial crisis (especially as a cost priority within financial institutions), compliance procedures were maintained and reinforced for fear of official reprimand. In addition, in order to reduce uncertainty and avoid harmful attention to their reputation, large and smaller banks have over time adopted additional pre-emptive measures, inadvertently contributing to a regulatory creep and making the AML framework more cumbersome and costly.

Despite the adoption of risk-based principles in the AML regulatory approach, and even the formalization of risk-based thinking in the 2012 revision of the FATF recommendations, costs affect small and large institutions disproportionately. Major actors in the financial industry have the resources and organizational capacity to adjust; some big banks have also had sufficient common interests in the governance of money laundering to enable them to take the initiative and create appropriate standards by establishing the Wolfsberg Group of Banks. The group, created in 2000, issues global AML guidelines for international private banks, focusing at first on correspondent banking relationships but lately expanding its work to include guidelines on matters such as screening and monitoring of clients and transactions.

Large financial institutions are also where AML practices are being professionalized. AML compliance has developed in three ways. At the senior level, revolving doors from law enforcement agencies and 'Big 4' professional services firms feature strongly, as compliance departments look for unique skills and expertise in the areas of investigation and forensic accounting. The junior and mid-career levels are increasingly populated by staff who follow harmonized training and acquire globally recognized qualifications in AML. Several professional associations have been created to provide these services, in turn building a global community of compliance experts through 'road shows' including training events, workshops and conferences, with a special focus on capacity building in less advanced jurisdictions. Finally, the Big 4 have a harmonizing effect on practices too, while IT and other technical capacity is standardized with a small number of firms providing the necessary software to financial institutions.

These trends amount to a professionalization process which helps to strengthen the relative standing of compliance departments within financial institutions – albeit not without struggles, as the high-profile exposures



of failings in large financial institutions in 2012 testify. But they also raise the bar of technical requirements in a way suited to a large financial institution's global activities. Regulatory creep, in turn, puts smaller institutions at a disadvantage, as they are judged against standards produced for and by bigger and 'riskier' competitors.

AML and the Developing World

Although the FATF was founded exclusively by developed countries, and these countries still comprise a large majority of its membership, FATF standards are global and have important implications for developing countries. If the FATF members are the rule-makers, the developing countries are the rule-takers. The 40 Recommendations have been diffused beyond FATF members by a network of nine regional satellite organizations (referred to as FATF-Style Regional Bodies). In addition, AML standards have been incorporated in both World Bank and International Monetary Fund assessments of all countries' financial systems. Today there are only a handful of countries that have not yet begun to introduce the standard package of AML measures summarized above. For developing countries, the AML regime provides some positive opportunities, particularly when it comes to fighting corruption – but the widespread imposition of a policy framework designed for developed economies, yet now more often applied in a developing context, gives grounds for concern.

At the behest of the G20 and with World Bank support, in recent years the FATF has taken an interest in the use of AML tools for combating corruption, especially large-scale cross-border corruption. Many of the surveillance and investigative measures introduced to tackle the proceeds of, for example, drug crime, are also useful in following the illicit financial flows associated with corruption offences like bribery and embezzlement. This move by the FATF is particularly welcome, as corruption offences are a major type of financial crime in developing countries. The broader effects of large-scale corruption (even extending to the head of state looting the country's assets, like Abacha and his family in Nigeria, Ben Ali's family in Tunisia, and the Suharto family in Indonesia) are widely held to damage national development. If AML policy can reinforce the anti-corruption agenda, that would be a very valuable contribution.

However, there are concerns about the suitability of the standard AML policy blueprint for developing countries, and the manner in which FATF rules have been imposed upon developing country rule-takers. These rules were initially designed in and for the developed countries that largely make up the FATF club. Even in the context of North America and Europe, how much difference AML standards have made in reducing crime since they were first introduced is an open question, a fundamental uncertainty that explains the recent move to assess actual effectiveness instead of mere technical legal compliance. Although hard evidence is scant, it seems that effectiveness is even more questionable in developing countries. Several aspects particular to developing economies are likely to hinder the operation of the standard AML system. Much or perhaps even most economic activity may take place in the informal sector, with transactions typically conducted with cash or barter in ways that leave little or no trace. People may not have a fixed address, or the identity documents (like a passport and utility bills) required to open a bank account or otherwise engage in the formal financial system. In this case, AML rules may have the unintended effect of contributing to financial exclusion. Finally, the opportunity costs of implementing AML policies are likely to be greater in the developing world, given the plethora of other competing priorities for government funds, including those necessary to meet basic human needs. This may parallel the phenomenon noted above, whereby smaller firms find it disproportionately more expensive to conform to new regulatory requirements than larger firms.

Beyond the operational effectiveness of FATF standards in developing countries is the manner in which these standards have been diffused. AML rules may bring benefits to poorer countries, and aid and technical assistance are used to defray the costs of implementation. However, it seems that many developing countries have been pressured into adopting AML standards, rather than willingly introducing this system as a way to meet national goals. Countries do not have a choice of remaining outside the AML system, and the majority must implement rules they have had no say in drawing up. The FATF is not a formal treaty body and thus its 40 Recommendations are soft law rather than formally binding international law, but there can be real penalties for non-compliance. In particular, on the instructions of the G20, the FATF has resorted to a strategy of blacklisting countries that have not committed to its standards, or have committed but are judged to be making insufficient progress in implementation. The countries thus targeted are almost always non-FATF developing states. Most of them have very little in the way of an international financial sector, and would seem to pose little or no threat to the international financial system. Countries that refuse to come into line after being blacklisted may be subject to sanctions such as being excluded from global financial transfer networks, and private firms may be less willing to transact with a blacklisted country or its firms.

Conclusions

Having spread the system of rules designed to counter money laundering across the world and deep into the private sector, FATF is now looking to strengthen the impact of this system by directly assessing effectiveness. This shift of focus is welcome, indeed overdue. Substantial challenges remain for the FATF, and for the broader global AML industry that has grown up around it. Although this system is now in its third decade, its effectiveness is essentially unknown. There are concerns that a policy package designed for developed countries may be unsuitable for most developing countries, particularly if they have been pressured into compliance. More positively, the recent emphasis on the potential for AML systems to fight corruption is to be encouraged.

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This Policy Brief is part of a series of briefs published by the Systems of Tax Evasion and Laundering project funded by the Research Council of Norway (NORGLOBAL, project ES477322).

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