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Research Report

Combating Money Laundering and Terrorist Financing

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- **What are the international policy standards in the fight against money laundering and terrorist financing?**
- **To what extent do countries comply with those standards?**

Summary: International policy standards in the fight against money laundering and terrorist financing are set forth by the Financial Action Task Force (FATF) recommendations on Anti-money laundering (AML)/Combating the financing of terrorism (CFT) policies. While those standards are very high and require, for example, financial businesses to strictly pursue the “know your customer principle”, countries compliance with the standards is low. In putting efforts in increasing compliance and harmonizing enforcement, however, the costs (both in terms of resources as well as reduced privacy rights) have to be taken into account.

POLICY BRIEFING

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Combating money laundering and terrorist financing

Introduction

Money laundering has been high on the agenda of governments and law enforcement authorities for already about 20 years, while it has been linked to terrorist financing in the aftermath of the airplane attacks on the New York World Trade Center on September 11, 2001. Since then, the regulations imposed on countries' financial systems intended to thwart money laundering have been viewed as key components also in the fight against terrorist financing. What have initially been strategies to destroy the laundering of money, predominantly stemming from illicit drug trafficking, are now also used to curb the financing of terrorism. As such, the anti-money laundering (AML) focus of transnational bodies like the Financial Action Task Force (FATF) has been extended to combating terrorist financing (CFT). This has been prominently witnessed by the issuance of the FATF's nine special recommendations on terrorist financing, in addition to the previously existing 40 recommendations on money laundering.

In this Policy Briefing, we first give an overview on the standards and policy recommendations set forth by the FATF and FATF-style regional bodies, which together constitute the most important international organization in the fight against money laundering and terrorist financing. Moreover, we review the existing empirical evidence on the compliance of countries with these standards. We finally offer some conclusions and policy recommendations.

International standards in the fight against money laundering and terrorist financing

The set of 40 policy recommendations on money laundering define the principles by which countries, financial institutions as well as some designated non-financial businesses (i.e. casinos, real-estate agents, lawyers, notaries etc.), should act, but are also intended to leave flexibility such that they can be implemented in the various different constitutions and institutional frameworks (Johnson, 2008). The recommendations are not legally binding, however, a majority of countries have made a political commitment to apply them (Gardner, 2007).

In terms of contents, the FATF's 40 recommendations cover the following:

- Legal systems
- Institutions
- Financial-sector measures
- Non-financial sector measures
- Informal sector measures
- Entity transparency
- International cooperation

The recommendations addressing legal systems call for criminalizing money laundering and imposing substantial punishment, while the institutional recommendations require endowing financial intelligence units and other investigators with all available information, technical equipment as well as enough financial resources in order to carry out their work.

The central issue of the FATF's 40 recommendations is "customer due diligence" or the "know your customer" principle in the realm of financial-, designated non-financial as well as informal businesses. In the course of applying it, anonymous accounts are to be eliminated; customers to be identified, records of transactions for at least five years to be kept and to be made available to the competent authorities upon request, and authorities are to be notified if suspicious transactions occur.

By calling for entity transparency, the FATF requires that information on financial institutions and their customers etc. should be made available to the authorities and financial intelligence units. By calling for international cooperation, the FATF urges to share this information with other countries' authorities and not to deny information sharing on grounds of bank-secrecy laws etc.

The "know your customer" principle is a key issue within AML/CFT efforts

In addition, the FATF recommends that countries criminalize money laundering as well as "wilful blindness" and negligence, and that punishment for such crimes should be one year of imprisonment or higher (Gardner, 2007). Moreover, the FATF calls for endowing the authorities with the legal power to identifying, tracing and confiscating laundered money, and it calls for increasing international cooperation and making information on cross-border financial flows available to central banks and multilateral financial institutions (FATF/OECD 2010a).

After the airplane attacks on the New York World Trade Center on September 11, 2001, the FATF has issued its nine special recommendations on countering terrorist financing. They list the actions which are according to the FATF necessary in the fight against terrorist financing and the FATF calls for their implementation in conjunction with the 40 recommendations on money laundering discussed above (Johnson, 2008). In particular, the nine special recommendations on tackling terrorist financing urge countries to [1] ratify all relevant UN resolutions, [2] criminalise terrorist organisations, activities and financing, [3] allow for the freezing and confiscation of terrorist assets, [4] report suspicious transactions related to terrorism, [5] provide international co-operation in matters related to terrorists, [6] subject alternative remittance systems to the same oversight as the banking sector, [7] strengthen customer identification requirements on wire transfers, [8] make sure non-profit organisations cannot be used to launder terrorist funds and [9] put in place a system to record and detect cross border transportation of

currency and bearer instruments (FATF/OECD, 2010b)

Compliance with the AML/CFT policy recommendations

More than 150 member countries of the FATF or the FATF-style regional bodies have been evaluated against commitment to the 40 recommendations as well as the nine special recommendations within the recent years. Evaluation was done by either self-assessment or mutual investigation. While self assessment is carried out on the basis of a yearly questionnaire, mutual evaluation is done by experts on law, financial regulation, law enforcement and international cooperation from other countries and takes place on-site (Johnson, 2008). In such evaluations, countries are assessed with respect to each single recommendation or special recommendation and categorized as being either “Non-Compliant”, “Partially Compliant”, “Largely Compliant” or “Fully compliant”. If one assigns the values 0%, 33%, 66% and 100% to the above listed assessments and then calculates an average score over all recommendations one yields, for EU member states, the results displayed in Table 1.

Table 1: Average compliance among EU27-countries

Recommendations addressing...	Average compliance
Legal systems	55.7%
Institutions	67.3%
Financial sector	55.2%
Non-Financial	23.8%
Informal Sector	65.4%
Entity Transparency	53.5%
International Cooperation	74.7%
Total money laundering (AML)	59.8%
Total terrorist financing (CFT)	50.8%
Total AML/CFT	58.2%

Source: IMF (2011) and own calculations

As can be seen, the assessed EU-countries' average compliance with the recommendations is low and varies considerably with respect to the issues being addressed. For example, compliance with institutional

standards as well as recommendations addressing international cooperation is above average, while compliance with recommendations covering the treatment of non-financial businesses is particularly low.

An econometric analysis explaining countries' compliance by a set of macroeconomic, institutional and financial variables produces the following results.

First, countries with higher economic development appear to show higher compliance levels. The IMF (2011) sample includes 46 advanced economies with an average compliance level (over all AML/CFT recommendations) of 56.8 percent. The 115 emerging economies, on the contrary, score 37 percent on average. GDP per capita (expressed in Purchasing Power Parity) is a significant explanatory variable with a positive coefficient, as expected.

Compliance with international AML/CFT standards must be evaluated against its costs and benefits

Second, stronger domestic governance (i.e. a better regulatory framework) has a statistically significant positive impact on compliance. Furthermore, countries with lower control over corruption tend to have lower compliance scores.

Third, countries with efficient banking sectors (measured by the net interest margins) are estimated to have, on average, significantly higher levels of compliance with the FATF recommendations.

Fourth, however, compliance levels do not correlate with a country's involvement in the global drug business (measured i.e. by UNODCs index of contribution to the global drug problem). If, however, the involvement in the global drug business is interpreted as a proxy for money laundering (ML) and terrorist financing (TF) risk, this means that there are countries with high levels of compliance, but still high risk of ML/TF, and vice versa. This raises the question whether focusing (exclusively) on compliance with the FATF recommendations brings about advancements in thwarting ML/TF (IMF, 2011).

Policy recommendations

To sum up, we must conclude that compliance with the FATFs recommendations on treating money laundering and terrorist financing is low. However, in a discussion of the evaluation results it must also be stated that an evaluation where complex systems like countries' legal and institutional structures are rated in four different categories is not likely to be capable of processing all relevant information, nor is it likely to be fully objective.

It is also fair to note that the standards requested by the FATF and its regional bodies are high and their establishment requires considerable amounts of financial as well as human resources and might, in our opinion depending on the laws in place before implementation, also considerably restrict privacy rights. With the advantage of higher probabilities to detect money laundering and terrorist financing comes the disadvantage that surveillance of the population, including the recording of financial data increases. The choice of an appropriate and bearable extent of surveillance is to be made in a political process. Thus, increasing compliance with the FATF recommendations is, although an obvious, but not too simple a conclusion. Rather, the costs and benefits of further increasing AML/CFT efforts must be carefully taken into account. The frequently suggested (e.g. van den Broek, 2011) shift from a rule to a more flexible risk-based approach, which leaves more discretion to the supervised financial and non-financial businesses, shows promising results in this context (Ross and Hannan, 2007). It can be considered worthwhile to further pursue it. With respect to the EU countries, in harmonizing enforcement of compliance among EU member states still a lot has to be done (van den Broek, 2011).

Credits

This EUSECON Policy Briefing was authored by Stefan Haigner, Friedrich Schneider and Florian Wakolbinger from the Johannes Kepler University Linz. The views expressed in this briefing are the authors' alone.

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