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The limits and possibilities of current approaches

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The limits and possibilities of current approaches

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Abstract

This paper attempts to clarify the links between illicit financial flows and corruption, and how corruption may be tackled by stemming such flows. For this purpose, it clarifies the terminology surrounding illicit flows, describes the impact of such flows, outlines the techniques used to launder them (with a particular focus on laundering of the proceeds of corruption), and critically analyses existing policies designed to tackle illicit flows. This paper contributes to the regulatory debate that is emerging in response to the financial crisis, as the accepted wisdom of deregulated global financial markets is being challenged. A major change in approach to tackling illicit flows is recommended. Such an approach should be more evidence-based, and consider the costs and benefits of policy choices. It should also specifically go beyond the current reliance on anti-money laundering policies and embrace more fully other policies to tackle illicit flows – including good governance reforms to tackle corruption as a source of illicit funds, but also more decisive efforts by rich countries that shelter secrecy havens or the proceeds of grand corruption.

This paper's main conclusions are the following:

- The subject of illicit flows (like corruption) is clouded by a lack of terminological clarity, which obstructs an effective policy debate.
- According to all credible evidence, illicit flows are a phenomenon on a massive scale. They have a major negative impact, particularly on developing countries, while the net effect for rich democracies may well be positive.
- Illicit flows are intimately linked to large-scale corruption. Acknowledgement of this is important in order to clarify the extent and ways in which corruption may be tackled via policies to stem illicit flows.
- Policies to tackle corruption through addressing illicit financial flows have been focused primarily on anti-money laundering (AML) policy, namely the identification of politically exposed persons (PEPs), and reporting and investigation of suspicious transactions involving them. However, there is very little evidence on the impact or effectiveness of AML regimes, partly due to the fact that they have never been subject to any serious regulatory impact assessment [1] or cost-benefit analysis [2] – depriving policy makers of key arguments for or against their use. Proper analysis would likely highlight *inherent* limitations in AML - especially in countries with serious problems of corruption.
- Moreover, AML regimes are only one of a number of policy approaches to tackling illicit flows, and they may be less important than the role played by secrecy jurisdictions in facilitating illicit flows. Although there are signs of a toughening in the stance of the international community towards such jurisdictions, they remain a

[1] Regulatory impact assessments are studies prepared to examine the potential impacts arising from proposed government regulations, with the aim of promoting more balanced decisions that trade off problems against wider economic and social goals. They also serve to inform decision-makers so that they can decide on new legislation.

[2] Cost-benefit analyses are processes put in place to weigh the expected costs and benefits of particular interventions to decide whether the intervention should take place.

prime conduit for the proceeds of grand corruption from developing countries, and are located primarily within or under the jurisdiction of rich developed countries.

- Current policies to tackle, prevent, or address illicit flows – and by implication to tackle corruption by hindering such flows – should therefore be based on an evidence-based approach to policy selection, a better balance between different policy instruments (including an emphasis on good governance policies to prevent the corruption that yields illicit flows), and an equitable allocation of the costs of implementing such policies between rich and poor countries.

Contents

Introduction

The issue of illicit financial flows has become particularly relevant for international development agencies. The volume of illicit flows massively exceeds aid funds[3], and a large proportion of these flows are likely to be proceeds of corruption, at least in the least developed countries. This implies that poor achievements in development terms are linked to problems beyond the particularities of each developing country and linked to the existence of mechanisms at the international level.

This paper is prepared in light of this reality: that current global interconnectedness – and the developed country actors behind it - plays a decisive role in the spread of a problem (corruption) that shows no signs of receding despite all collective efforts. The paper clarifies the links between illicit financial flows and corruption, and the terminology surrounding the issue. It also explains the impact of such flows and outlines the techniques used to launder them with a focus on laundering proceeds of corruption. Following a critical analysis of the existing policies and standards designed to tackle illicit flows, a major change in approach to policy formation is recommended, based on evidence and cost-benefit analysis.

1. Clarifying concepts

Key points of this section:

- Key terms are unclear
- Flows are defined as illicit under three conditions
- Neither informal flows nor capital flight are necessarily illicit
- Secrecy jurisdictions play a key role in facilitating illicit flows and should not be conflated with the terms ‘tax haven’ or ‘offshore financial centre’

The literature on illicit financial flows is troubled by imprecision of key terms. Clarification of terms is not a nicety to be respected merely for academic purpose. It is a necessary condition for a proper discussion of policy options in fighting corruption by tackling illicit flows.[4] These issues will be addressed by clarifying terminology throughout the paper.

Illicit financial flows

For the purposes of this paper, illicit financial flows are those illegally earned or transferred. If one or more of the following conditions is fulfilled, then such funds are considered to be illicit:

i. The transfer itself is illegal;

[3] Some researchers estimate that the amount of illicit flows leaving developing countries in 2006 reached between USD 850 billion and 1.06 trillion; by contrast, the 22 member countries of the OECD Development Assistance Committee provided USD 103.9 billion in aid in 2006 (Fontana 2010).

[4] The terms illicit financial flows and illicit flows will be used interchangeably in this document, though it is understood that the idea of ‘illicit flows’ can encompass a much broader set of assets than merely financial assets.

ii. The funds are proceeds of illegal activity;

iii. Legal obligations relating to the funds, such as payment of tax, have not been observed.

An illicit flow may take place within a country's borders – for example, USD 800 million of the funds looted by former Nigerian President Sani Abacha was recovered within Nigeria. Very often, however, illicit flows will take place across national borders, as a primary aim of such flows is usually to hide the funds involved in a secure location beyond the reach of domestic law enforcement bodies.

Given the complexity, it is not surprising that grey areas exist in the identification and estimation of volumes of illicit flows. The most obvious example is proceeds of tax avoidance. Tax evasion is generally understood as a violation of tax law, while tax avoidance is seen as "an activity that a person or a business may undertake to reduce their tax in a way that runs counter to the spirit and the purpose of the law, without being strictly illegal" (Fuest and Riedel 2009, 4). While such practice may not be illegal, campaigners against secrecy jurisdictions regard it as "clearly abusive, in so far as it challenges the will of elected parliaments" (Christensen 2009, 5). This issue complicates the definition of illicit flows. Whether estimates of illicit flows include the proceeds of tax avoidance as well as tax evasion is likely to have a major impact on the size of such estimates.[5]

For terminological purposes, it is important to distinguish illicit flows from at least three other key concepts:

- **Informal flows**. Not all informal flows are illicit. Many cross-border flows are legitimate remittances sent home by workers abroad through underground banking systems. Such systems may be used simply due to difficulties faced by such persons in opening bank accounts, or because the recipients of such flows (typically poor relatives) have no bank accounts (McCusker 2005).

- **Capital flight**. The term capital flight is often used as a synonym for illicit flows. However, capital flight is generally understood as the movements of fund abroad in order to secure a better return or protect them, often in response to an unfavourable event in the country of origin (Kant 2002, 354). Capital flight may be legal or illegal. In the former case – for example where an investment fund transfers assets from domestic government bonds to safer government bonds in a different country – capital flight will be recorded on the books of the entity transferring the capital, and returns on the investment are likely to return to the source country. Illegal capital flight tends to be unrecorded and typically of proceeds of illegal activities – in other words illicit flows.

- **Money laundering.** Money laundering is a process to disguise the source of criminally derived proceeds to make them appear legal. Money laundering is a specific legal concept that includes only the proceeds of a set of predicate criminal offences, which are defined by the laws of a given country. Funds originating from other criminal offences may not be used to build a case of money laundering in that

[5] For an interesting sample of legal tax avoidance schemes used by major UK companies, see for example "Firms' secret tax avoidance schemes cost UK billions", The Guardian, 2 February 2009. http://www.guardian.co.uk/business/2009/feb/02/tax-gap-avoidance (accessed 16 May 2010).

particular country, although such funds may well be illicit as defined by this paper. This is important for practical purposes, as anti-money laundering regimes suffer from the fact that the range of predicate offences on which a money laundering prosecution may be based varies across countries, and does not always include corruption and tax evasion. Put another way, conflating illicit flows and money laundering may tend to encourage over-reliance on anti-money laundering policy (AML) to tackle illicit flows.

- **Secrecy jurisdictions** and **the links between corruption and illicit financial flows** are two other important common terms in this area and will be addressed in more detail in sections 3 and 4, respectively.

2. The size and impact of illicit flows

Key points in this section:

- Although estimates vary considerably, they indicate that the volume of illicit flows is massive
- The impact of illicit flows is also asymmetric:
    - Outward illicit flows almost certainly exceed inward flows of aid to developing countries
    - Corruption probably accounts for a larger proportion of illicit flows coming out of least developed countries dependent on aid
    - Illicit flows have a much greater direct economic impact and impact on the functioning of the state in developing countries
    - Illicit flows are a central component of the world economy, and corruption cannot be fought effectively in developing countries without developed countries playing their part to stop flows of the proceeds of such corruption

The available evidence on illicit flows suggests that they are a massive phenomenon with a major impact on the world economy and the countries from which they originate. However, the impact is strongly asymmetric. Despite losses in tax revenues, advanced market economies may enjoy net benefits from illicit flows, as laundered money from elsewhere gets to be invested in financial centres located in rich economies. By contrast, these flows have a devastating impact on poorer countries. This asymmetry and the impact illicit flows have on the state will be discussed below after a brief introduction to issues related to the magnitude of the problem.

2.1. Size

Illicit flows are by nature poorly recorded or unrecorded, and therefore difficult to track. Estimating the total size of such flows means including a wide range of activities from company tax evasion conducted via transfer mispricing to the proceeds of crime including corruption, and is still something no model has achieved successfully.

Despite the limitations of existing models, since the mid-1980s, researchers have been working to improve methods for estimating the size of illicit flows (Fontana 2010). In the

absence of an agreement on the issue of including tax avoidance in such estimates (see Section 1), we note where relevant estimates include such flows.

- Baker has estimated that illicit flows – specifically proceeds of i) crime such as drugs trafficking and theft, ii) 'looted money' from embezzlement, bribery and other corruption, and iii) 'commercial money', i.e. movement of funds in various way (including via trade mispricing), primarily to avoid tax – amount to between USD 1 trillion and USD 1.6 trillion per year, with around half (i.e. between USD 500-800 billion) originating from developing countries (Baker, 2005, 165; Christensen 2009, 9).
- The breakdown of sources of these funds vary. Baker estimates that around USD 500 billion comes from criminal activities, USD 20-40 billion from corruption and USD 500 billion from tax evasion. Global Financial Integrity (2010) estimates that 60%-65% of the total is from 'commercial tax abuse' – in other words, essentially tax evasion by companies with international operations.
- However, Chaikin and Sharman argue that in developing countries, which generally have much smaller financial centres and less sophisticated organised crime, corruption is often the major source of funds to be laundered (Chaikin and Sharman 2009, p. 27). Moreover, disentangling corruption from the other sources of funds available for laundering is very difficult. Proceeds from corruption and from tax evasion may be intrinsically linked, for example where a multinational company in the natural resources industry negotiates favourable tax conditions in a poor country using informal payments to government officials. Finally, in least developed countries, corruption understood as the explicit misappropriation of public resources (such as aid funds embezzled, kickbacks received or theft from state coffers) present the added benefit of being already in an easy form to be transferred abroad, requiring simply the use of a lenient international financial system – whilst transforming other physical resources into financial assets before hiding them abroad requires more complex transactions.
- Global Financial Integrity estimates that from 2002 to 2006, between USD 850 and USD1 trillion in illicit funds flowed out of developing countries.
- The African Union has estimated that 25% of GDP of African countries (around USD 148 billion) is lost to corruption every year (U4 2007). Various researchers have argued that despite large volumes of aid and borrowing, Africa is a net creditor to the rest of the world (Christensen 2009, 16; Boyce and Ndikumana 2001; Cerra et al 2005) due to illicit flows, and that illicit flows far outweigh debt and aid relief.
- Nidkumana and Boyce (2008) estimated net capital flight of USD 420 billion (in 2004 dollars) from 40 African countries for the period from 1970 to 2004. This figure underpinned the authors' claim that Africa is a net creditor to the world: on average, the region's assets held abroad were 2.9 times the stock of debt they owed to the world at the time of the study. Their data includes both licit and illicit flows, although the authors question the legitimacy even of legally acquired assets when these are held by African elites abroad in secrecy havens.
- Cobham (2005) has estimated the total loss to developing countries from tax evasion and tax avoidance at USD 385 billion per year. However, the assumptions underlying

this estimate have been questioned by other researchers (for example Fuest and Riedel 2009) for a number of reasons. For example, they claim that losses due to tax evasion and avoidance are estimated on the implicit assumption that appropriate policies would lead to all of the losses being recovered, whereas in fact the shadow economy statistics on which tax evasion losses are calculated include illegal activities that could not be taxed anyway. Christian Aid (2008) has estimated a USD 160 billion loss to developing countries from two types of tax evasion/avoidance - transfer mispricing between multinational corporations, and falsified invoicing between formally unrelated companies.

Unless existing estimates of illicit flows are fundamentally flawed, it would seem reasonable to assume that illicit flows are larger than those estimates, given the furtive nature of many of the activities that produce them.

2.2. Overall impact

Gauging the impact of illicit outflows is as difficult as estimating their size. The effects of illicit flows are many and complicated. Unger identifies 25 different effects of money laundering – which by definition involves illicit flows – ranging from distortion of consumption and investment, promotion of corruption and bribery in financial institutions and other sectors of the economy, as well as undermining political institutions (Unger 2007, chapters 6-7). It is generally accepted that illicit flows have severe negative economic consequences for developing countries. While some of the effects of money laundering may, in theory, be calculable, others are not, in particular the knock-on effects of money laundering in encouraging further crime and the impact on political institutions. Worse, many of the effects may interact in a vicious circle: for example, if money laundering enables corrupt politicians to safely hide proceeds of corruption, this will help them to retain power by shielding them from proper accountability, which may further enable them to corrupt the institutions responsible for detecting money laundering and crime, and so on.

Two specific impacts are of central relevance for this paper: the asymmetric consequences of illicit flows for poor/developing countries on the one hand and rich countries on the other, and the long-term effect of illicit flows on the state and democratic institutions, which is particularly problematic for poor countries.

Asymmetric consequences

The figures and estimates relating to illicit flows indicate strongly that the impact of such flows is far more severe for developing countries than for rich ones. If, as Baker estimates, around half of all illicit flows come from developing countries, illicit flows from such countries must, by definition, account for a far higher proportion of GDP than in rich countries.

There is a consensus that high-level, large scale corruption yields large sums of money to be laundered. This is consistent with the argument that corruption accounts for a far higher share of illicit flows from poor countries than from rich countries. By contrast, although developed countries suffer losses from illicit flows through tax evasion, the same countries are usually the recipients of illicit funds that need to be laundered (Kar, Cartwright-Smith and Hollingshead 2010), not least because they often also harbour secrecy jurisdictions that benefit from illicit flows. Moreover, the effects of tax evasion in developed countries are unlikely to be so great as to fundamentally undermine the state (for example, affecting the

provision of public services), whereas it is widely accepted that illicit flows from developing countries do just that. For example, Unger states that the Netherlands most likely profits from money laundering due to the large amounts of laundered money invested in the country (Unger 2007, p. 135). The disproportionate impact on developing countries is a central reason why illicit financial flows should be on the development agenda.

Damage to the state

Some of the most damaging effects of illicit flows – and which cannot be captured solely in numerical terms - are the impact of such flows or related activities on state institutions. Again, these effects are disproportionately felt in developing countries. Such flows have a massive negative impact on economic development, in terms of the public goods that could have been provided using such funds (World Bank/UNODC 2007, 11-12). For Africa, illicit flows may exceed the amount of foreign aid coming in by a factor of 100% (Kar and Cartwright-Smith 2010). For a continent in which large swathes of the population continue to live below the poverty line, this diversion of resources is an alarming problem.

In addition to the direct impact of illicit flows on the provision of public goods, these may undermine the stability and credibility of the domestic financial system itself and also of the institutions of the state itself. These effects include but are not limited to:

- Undermining, through corruption, of the institutions (such as banks, central banks, financial intelligence units, police, prosecutors and courts) that are responsible for detecting, investigating and prosecuting illicit flows.
- Undermining of democratic institutions, where illicit flows facilitate the disposal of the proceeds of corruption, undermine mechanisms of accountability and enforcement, and thereby contribute to the maintenance of corrupt elites in power.
- Undermining the capacity of the state to perform its key functions, from social services to the provision of security to the population.

2.3. A central component of the world economy

Illicit flows are a central and integrated component of the world economy, and undoubtedly so if flows from tax avoidance and evasion are included. Some of the reasons why this is the case include the following:

- The sheer size of illicit flows makes them a phenomenon that is neither peripheral nor isolated.
- The illegal and criminal activities that yield illicit flows are probably expanding (Naim 1995).
- Illicit flows are very often mingled with licit funds in the process of laundering, as one of the mechanisms by which their origin is disguised.
- Likewise, the criminal activities that give rise to illicit proceeds are very often conducted together with entirely legitimate activities – both in a physical sense (for example hiding contraband shipments in ordinary fruit shipments) and in an accounting sense (the same legal entity conducting licit and illicit activities) (Reed 2009).

- Secrecy jurisdictions – a standard intermediate or final destination for illicit funds – play a major role in the world economy. According to certain estimates, 50% of world trade is routed through secrecy jurisdictions despite their accounting for only 3% of world GDP (Christensen 2009, p. 4).

Such flows are a covert but international aspect of manifestations of corruption. With few exceptions (such as in the case of international asset recovery efforts), corruption has been mainly fought as a phenomenon within the geographical borders of particular countries, for example through the creation of new institutions (such as anti-corruption commissions) and a wide range of anti-corruption policies. These international components of corruption have been largely unaddressed until recently.

To employ a simple analogy, this might be seen as a battle in which the soldiers on the right side were allowed to fight only within certain physical limits, while the enemy could run loose, unhindered by borders. Worse, the enemy also receives shelter from the same countries which criticise the soldiers of the right side for fighting the enemy ineffectively. Without implying that countries where corruption is endemic should abdicate responsibility for fighting it, this clearly indicates that a share of the fighting must take place abroad and that those responsible for regulating the jurisdictions to which corrupt persons shift the profits carry a portion of the blame.

3. Illicit flows: main mechanisms and channels

Key points in this section:

- Illicit flows = money laundering if predicate offences are inclusive enough
- Money laundering is conducted in three different phases: placement, layering, and integration
- There is some evidence that proceeds of corruption are laundered using simpler laundering methods
- Secrecy jurisdictions and corporate service providers play a fundamental role in enabling the safe disposal of illicit funds

This section outlines briefly the ways in which persons benefiting from illicit funds dispose of them. The primary focus is on how funds are laundered: following the points made in Section 1, illicit flows may be equated with money laundering to the extent that the predicate offences for the latter are sufficiently inclusive. It is reasonable to assume that the mechanisms for disposing of the proceeds of non-predicate offences are broadly similar.

3.1. Money laundering phases and techniques

Money laundering is classically divided into three main phases which may, but do not necessarily, follow each other in chronological order:

- Placement, in which illicit funds are placed into the financial system;
- Layering, in which a range of transactions/movements of the funds are carried out in order to attempt to disguise their origin;
- Integration of the laundered funds back into the mainstream economy.

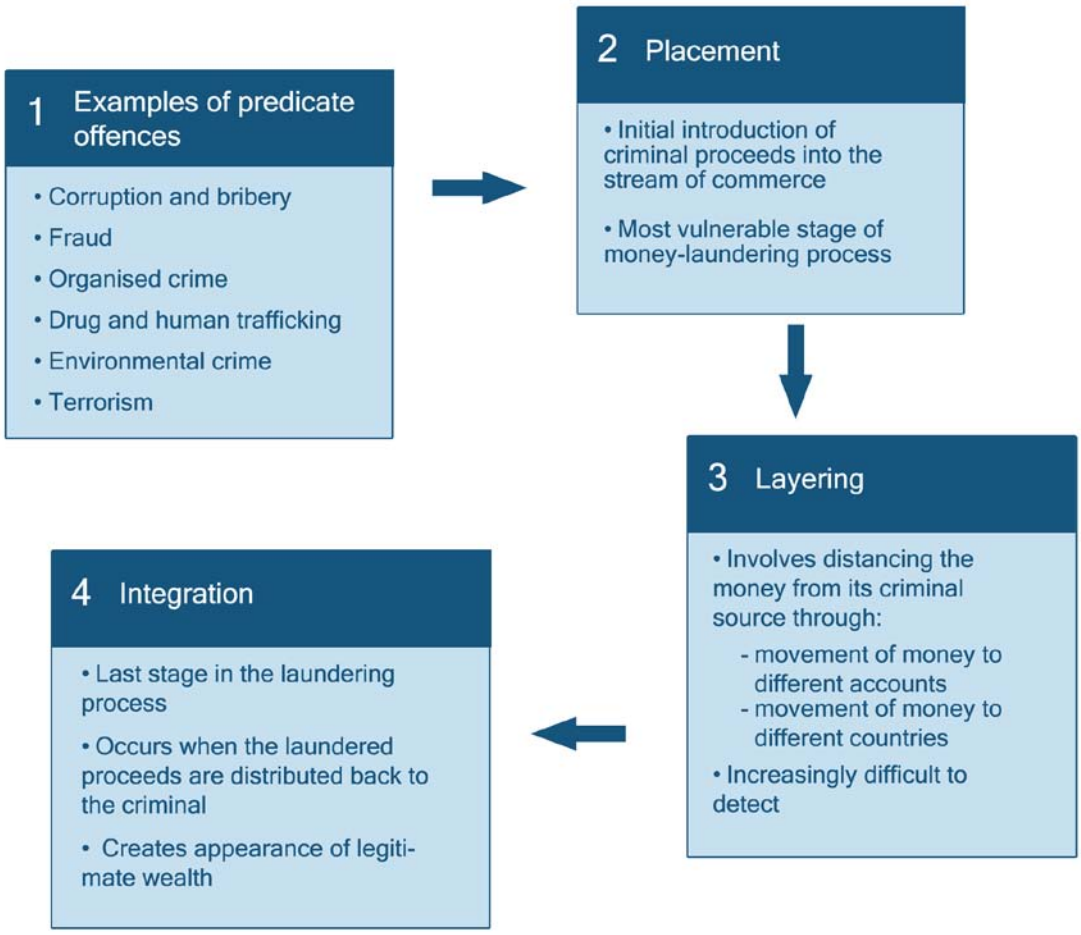
Each of these phases may be conducted through a number of different techniques. This paper does not elaborate in details on these different phases, as this has been done elsewhere (Unger 2007, Chapter 5). The phases and techniques are summarised in Table 1 and Figure 1 usefully illustrates the money laundering cycle:

Table 1: Main money laundering techniques

Placement	Layering	Integration
• Breaking large deposits into smaller ones • Currency smuggling • Travellers' cheques • Gambling, casinos	• Correspondent banking • Bank cheques and bank drafts • Collective accounts • Payable-through accounts • Loan at low/zero interest rates • Back-to-back loans • Money exchange offices • Money transfer offices • Insurance market • False contracts and documents • Fictitious sales and purchases • Shell companies • Trust offices • Special purpose entities/vehicles • Underground banking • Foreign currency black market	• Capital market investments • Derivatives • Real estate acquisition • Catering industry • Gold market • Diamond market • Buying jewels • Purchase consumer goods for export • Acquisition of luxury goods • Cash-intensive business • Using currency to supplement apparently legitimate transaction • Export-import business • Acquisition and smuggling of arms

Source: Compiled from Unger (2007) Chapter 5

Figure 1: The money laundering process:



Source: Adapted from UNODC and World Bank 2007, 14

3.2. Methods used to launder proceeds of corruption

In general, money laundering techniques include activities varying from simple wire transfers to accounts in secrecy jurisdictions on the one hand, to complicated business transactions involving shell banks (banks set up by one entity with no real clientele), trusts with undisclosed beneficiaries and hedge funds, on the other. There is some evidence that corruption proceeds are laundered using relatively simple methods. Reuter and Truman (2004), analysing 580 money laundering cases, found that while wire transfers were used as the laundering mechanism in 25% of cases and that laundering of proceeds of bribery and corruption "rel[ies] heavily on wire transfers and use[s] significantly fewer typologies of laundering mechanisms." (UNODC and World Bank 2007, 13-14).

However, it should be noted that the direct proceeds of corruption may often be linked to other, more sophisticated, money laundering operations, for example involving businesses in which corrupt politicians have obtained stakes, or proceeds of illegal businesses for which corrupt politicians may provide a protective 'umbrella' (non-enforcement guarantee) in return for bribes.

In addition, advocates for greater transparency of secrecy jurisdictions argue that mispricing of imports and exports may also be used by corrupt officials to shift money abroad in a

manner that cannot be detected. For example, an official in developing country X establishes a facade export/import business to shift money abroad. Or s/he may privately purchase goods or services from multinational Y at an artificially inflated price, shifting illicit proceeds of corruption out of the country (Global Witness et al 2009) – with other mispriced or fictional transactions taking place to enable the official to recoup abroad an agreed share of the funds lost through the initial overpricing.

Even if wire transfers were the most common method used for laundering proceeds of corruption, there is little doubt that money laundering methods have evolved and will continue to do so. Launderers will always react and adapt to limits imposed on using old methods, underlining the importance of regular research and analysis to update existing typologies and strategies to combat money laundering practices.

3.3. Secrecy jurisdictions and corporate service providers

Policies to combat money laundering and illicit flows have been heavily oriented towards AML regimes. These are based on mechanisms designed to detect suspicious financial transactions and identify the beneficiaries of such transactions. However, the literature shows that a fundamentally important role in the disposal of illicit funds is also performed by two other facilitators: secrecy jurisdictions and corporate service providers.

Secrecy jurisdictions

The term secrecy jurisdiction has emerged as an attempt to clarify the issues surrounding what have typically been labelled as offshore financial centres or tax havens. These terms themselves lack clear definition. In fact, they are misleading both in the sense that 'tax haven' refers to only one possible characteristic of such jurisdictions among many,[6] and 'offshore' implies that jurisdictions facilitating tax evasion or the concealment of financial flows are typically island locations separated from advanced market democracies.

The central characteristic of a secrecy jurisdiction is that it is a legal jurisdiction that provides secrecy to entities that do not in fact operate within its physical space (Murphy 2009). This secrecy is created through a range of regulations designed for entities that are not normally physically resident in the jurisdiction itself. These include laws that allow a low degree of transparency in the establishment and accounting by corporate entities, the creation of trusts whose real beneficiaries remain anonymous, zero or low tax rates and minimal exchange of tax information with other tax jurisdictions, banking secrecy, and barriers to exchange of information on criminal matters. Low or zero tax rates are not the only – and for some not the main - attraction of such locations, particularly for laundering proceeds of corruption. Most often, the obscurity of ownership associated with these jurisdictions is the feature most appealing to their clientele.

An important consequence of terminological imprecision is that the use of the term 'offshore' helps shield from attention jurisdictions that facilitate illicit flows, yet are clearly onshore – for example Switzerland, the City of London, and Delaware in the United States. Focusing on the geographical location of jurisdictions tends to distract attention from the key aspect of

[6] For example, Christensen (2009, 2) states that "[T]ax havens are… major and integrated features of globalised financial markets, operating as a corruption interface between licit and illicit cross-border financial flows". The citation appears, however, to refer to much more than favourable tax legislation.

secrecy. According to the US General Accounting Office, in 47 of the 50 US states, it is impossible for authorities concerned to establish the real ownership of shell corporations established in Delaware (Chaikin 2009, 78). In addition, many offshore jurisdictions are effectively governed by advanced democracies. The UK is the prime example with its Crown Dependencies such as the Channel Islands (Alderney, Sark, Jersey, Guernsey), and British Overseas Territories such as the Cayman Islands. Although these jurisdictions provide information and evidence to law enforcement and to prosecutors from around the world on a regular basis, their regulatory frameworks provide foreign entities registering corporate vehicles there (such as trusts) with a level of secrecy that makes the initiation of legal proceedings unlikely in the first place.

The upshot of this is that, according to some researchers, the total contribution to money laundering of small states is probably relatively small, with most cash deposits (licit and illicit) ending up in financial institutions in developed countries and not in the usual island states associated with the offshore centre concept.[7] This may be partly because the criminal acts which give rise to illicit proceeds mostly take place in rich industrialised countries, but they are also linked to the fact that rich countries have fiscal and corporate regimes which provide one set of rules for residents and another (much more liberal) for non-residents (Unger 2007, 192). The strictness with which AML regimes have been forced onto developing countries contrasts with the leniency shown towards secrecy jurisdictions in advanced market economies, although attitudes to such jurisdictions may be hardening due to the financial crisis.

The confusion over secrecy jurisdictions may be seen in the existence of multiple 'black' and 'grey' lists. The table below provides some existing lists, the term used by each organisation/government producing the list to refer to such jurisdictions, and the countries that fall under that category accordingly.

[7] See for example: Unger 2007, 191; Kar, Cartwright-Smith and Hollingshead 2010.

Table 2: Grey or black? Lists of secrecy jurisdictions around the world

Organisation	Countries
FATF* - 'jurisdictions that pose a risk in the international financial system'	Angola, Antigua and Barbuda, Azerbaijan, Bolivia, Democratic People's Republic of Korea, Ecuador, Ethiopia, Greece, Indonesia, Iran, Kenya, Morocco, Myanmar, Nepal, Nigeria, Pakistan, Paraguay, Qatar, São Tome and Principe, Sri Lanka, Sudan, Syria, Trinidad and Tobago, Thailand, Turkey, Turkmenistan, Ukraine, Yemen
OECD** - 'jurisdictions committed to implementing internationally agreed standards which have not yet substantially implemented'	Andorra, Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Dominica, Gibraltar, Grenada, Liberia, Liechtenstein, Austria, Belgium, Brunei, Chile, Marshall Islands, Monaco, Montserrat, Nauru, Netherlands Antilles, Niue, Panama, St Kitts and Nevis, St Lucia, St Vincent & Grenadines, Samoa, San Marino, Turks and Caicos Islands, Vanuatu, Guatemala, Luxembourg, Singapore, Switzerland
US Department of State*** - 'jurisdictions of primary concern'	Afghanistan, Antigua and Barbuda, Australia, Austria, Bahamas, Belize, Bolivia, Brazil, Burma, Cambodia, Canada, Cayman Islands, China, Colombia, Costa Rica, Cyprus, Dominican Republic, France, Germany, Greece, Guatemala, Guernsey, Panama, Paraguay, Philippines, Russia, Singapore, Spain, Switzerland, Taiwan, Thailand, Turkey, Ukraine, United Arab Emirates, United Kingdom, United States, Uruguay, Venezuela , Zimbabwe
Brazil's Ministry of Finance**** - '*tax haven jurisdictions*'	Andorra, Anguilla, Antigua e Barbuda, Dutch Antilles, Aruba, Ascension Islands, Bahamas, Bahrain, Barbados, Belize, Bermudas, Brunei, Campione d'Italia, Channel Islands (Alderney, Guernsey, Jersey and Sark), Cayman Islands, Cyprus, Singapore, Cook Islands, Costa Rica, Djibouti, Dominica, United Arab Emirates, Gibraltar, Granada, Hong Kong, Kiribati, Labuan, Lebanon, Liberia, Liechtenstein, Macau, Madeira, Maldives, Man, Marshall Islands, Mauritius, Monaco, Montserrat, Nauru, Niue, Norfolk, Panama, Pitcairn, French Polynesia, Queshm Island, Western Samoa, Easter Samoa, San Marino, St Helena, St Lucia, St Pierre and Miquelon, St Vincent and Grenadines, Seychelles, Solomon Islands, St. Kitts and Nevis, Swaziland, Switzerland, Oman, Tonga, Tristan da Cunha, Turks and Caicos, Vanuatu, British Virgin Islands, American Virgin Islands

* As of 10 February 2010, FATF had two lists of countries 'which pose a risk in the international financial system'. The compilation of countries here combines both lists.

** The OECD produced a 'grey list' in September 2009 on jurisdictions surveyed by the OECD Global Forum in implementing the internationally agreed tax standards. This list includes the countries that had not substantially implemented the standards by that date.

*** Jurisdiction of primary concern, as published in February 2009.

**** As published by the Brazilian Federal Government in June 2010.

Corporate Service Providers

A key role in facilitating the use of secrecy jurisdictions – whether by criminals or by mainstream corporations[8] - is played by so-called corporate service providers (CSPs). These are facilitators that set up, service and sell shell corporations, trusts and similar corporate vehicles (Chaikin 2009, 75). Such may be ordinary law firms, perhaps with affiliates in secrecy jurisdictions, banks themselves ('private banking' is an obvious example of a type of service that may occupy dubious territory), specialised companies mediating the purchase of off-the-shelf shell companies, and so on. When investigating how the US laws apply to foreign PEPs and how the latter might be circumventing such laws to bring illicit money into the United States, the Permanent Subcommittee on Investigations of the US Senate recommended in 2010 that closer attention should be paid to lawyers, realtors, escrow agents, lobbyists and professional associations. These were crucial facilitators in the process of bringing illicit funds into the US in the case of four prominent politicians investigated, despite the country's anti-money laundering regime.

4. Money laundering and corruption

This section underlines the close links among corruption, illicit flows and money laundering. This has important policy implications that up to now have not been elucidated sufficiently.

Key points in this section:

- Symbiosis but separation: corruption facilitates money laundering, and money laundering enables corruption to pay off; policy regimes to tackle corruption and money laundering should therefore not be separated to the extent they currently are
- Corruption and money laundering are linked in three main ways, each of which has key implications for policies to fight corruption through anti-money laundering efforts:
    - AML has the potential to be effective against large scale corruption involving elites who are no longer in power
    - Money laundering is usually detected *after* predicate offences, but corruption itself may help perpetrators guarantee that an illicit practice is not established as a predicate offence in the law
    - There are important limits on the extent to which AML can function as an international mechanism for holding elites accountable

[8] See for example the results of a Guardian newspaper investigation into the shifting of profits abroad by major UK corporations (Guardian 2009).

4.1. Symbiosis? Elaborating the links between corruption and illicit flows

Since the end of the 1980s, corruption and illicit flows (understood as money laundering) have both seen rapid development in the form of binding international standards and monitoring mechanisms (see box 3 on International Conventions on Money Laundering, p.24). However, the two problems have to a large extent been addressed separately, and this has filtered through to the separation of concrete policies and institutional frameworks at the level of individual countries. This is dysfunctional if

> *Corruption and money laundering are symbiotic: not only do they tend to co-occur, but more importantly the presence of one tends to create and reciprocally reinforce the incidence of the other. Corruption produces enormous profits to be laundered, estimated at more than $1 trillion of illicit funds annually, funds that are increasingly laundered in the international system. At the same time, bribery, trading in influence and embezzlement can compromise the working of anti-money laundering systems. (Chaikin and Sharman 2009, 1)*

The apparent implications are clear: that anti-money laundering regimes can play a more significant role than they do now in fighting corruption, and that special attention should be directed at policies to ensure the integrity of AML systems to protect them from corruption. For example, Chaikin and Sharman suggest stronger efforts to impose obligations on FIU officials to declare their assets, although Section 6.6 of this paper presents a rather more sceptical view about efforts to shield FIUs from political pressure.

While there is undoubtedly a close relationship between corruption and money laundering, it is important to elaborate the nature of this relationship in more detail in order to yield sound policy conclusions. We suggest that corruption is linked to money laundering in one or more of the following three ways:

- **As the source of proceeds (e.g. bribes) that constitute illicit funds to be laundered.** There is a rich body of evidence on the scale of looting of public resources from developing countries, for example by former leaders such as Ferdinand Marcos of the Philippines; former Nigerian President General Sani Abacha, and President Mobuto Sese Seko of Zaire. A common denominator of these cases is the way in which the illicit proceeds of corruption were channelled to bank accounts in foreign countries, typically jurisdictions with high levels of banking secrecy, and in all cases, large amounts of money were recovered after they left power. Tackling illicit flows clearly has potential in dealing with high level corruption of this kind.
- **As a means of facilitating the creation of illicit funds**, for example through the corruption of tax administrations so that they ignore evasion of taxes or other financial obligations. The most obvious example is where a tax administration official gets a bribe to either make a ‘favourable’ interpretation of tax regulations that lowers a person’s/company’s tax burden, or to turn a blind eye to straightforward tax evasion.
- **As a means for enabling an illicit flow itself by the corruption of institutions with anti-money laundering obligations**, for example where entities with AML

obligations collude with clients in order to not fulfil such obligations (i.e. a bank official does not notify suspicious transactions to the relevant authorities because they receive bribes from individuals involved in the activities that generate the illicit funds, or the business is too lucrative) or where FIUs are prevented from performing their role, and are compromised by politicians (e.g. are not provided with sufficient independence, legal powers or resources), implying that the political system itself suffers from more widespread systemic corruption.

Box 1: Corruption as a source of illicit flows into rich countries

In 2004, an American jury convicted Pavel Lazarenko, former Ukraine Prime-Minister (in office from 1996 to 1997), of laundering, in the US, millions of dollars acquired illicitly in the period that followed the collapse of the Soviet Union. He was sentenced to 9 years imprisonment for laundering USD 20 million through US banks and will be deported after finishing his sentence, which would be in 2015 if he serves the full term (Egelko, 2009). Lazarenko's case was the first in the US in which a senior politician of a foreign jurisdiction was put to trial in an American court for crimes committed in his own country. His charges for laundering money, a violation of US law, were based on the crimes of stealing and extortion, both committed in Ukraine. Punishing violations of foreign laws in the US helped Ukraine enforce its own laws, while the country was strengthening its own judicial system (Spence, 2005). The US ruling also helped to reinforce an anti-corruption message in the Eastern European country, as the American judge's signal was clear: the US government would make life difficult for those trying to launder illicit monies through the US.

Egelko, B. (2009): Ukrainian ex Prime-Minister's sentence reduced, *San Francisco Chronicle*, San Francisco, US, November 19 (http://articles.sfgate.com/2009-11-19/bay-area/17181632_1_sentence-appeals-court-ukrainian-prime-minister).

Spence, M. (2005): American Prosecutors as Democracy Promoters: Prosecuting Corrupt Foreign Officials in US, Policy Comment, *The Yale Law Journal*, July 3. (http://www.yalelawjournal.org/images/pdfs/302.pdf).

4.2. Policy implications

Distinguishing different forms of corruption linked with illicit flows leads to important points concerning the use of AML policies to tackle corruption.

Grand corruption

Policies focused on tracking illicit flows are likely to be more useful against corruption where relatively large amounts of money are involved. Petty bribery - a phenomenon which plagues the lives of millions in many countries – is much less likely to yield detectable illicit flows unless one official receives large numbers of small bribes that then need to be laundered. This is so because policies designed to tackle illicit financial flows unavoidably have to focus primarily on transactions larger than a certain size. Small bribes are also more likely to remain as cash outside the banking system.

Incumbent elites

Up to now, cases of illicit flows being discovered or funds being recovered – for example in the case of the former heads of States listed above – almost always occur after the beneficiaries have left power. Typically, the end of a regime has resulted in a fundamental

change of power and revelations of stolen wealth. This raises questions about the extent to which policies against illicit flows by themselves can be a direct deterrent to corruption among incumbent elites, although there are a few examples to the contrary (see Box 2).

Box 2: Is it possible to hold incumbents to account?

In 1999, a Geneva magistrate froze USD 84 million in bank accounts held by offshore corporations that were controlled by senior Kazakh officials. The US government alleged that the accounts contained illicit kickbacks sourced from multinational oil companies. Kazakh officials denounced the freeze order as a violation of sovereign immunity, arguing that the accounts were official government accounts opened on the basis of a government decree. The Federal Tribunal, Switzerland's highest court, ruled that 'funds held in a privately-owned offshore account, claimed by the head of state of Kazakhstan to be public money, could not be considered *a priori* to be state funds deposited for legitimate purposes. This judicial decision precipitated negotiations between the Kazakh, Swiss and US governments, which ultimately resulted in the return of the money to Kazakhstan to be used for development purposes under World Bank supervision.

Chaikin, D (2010): International anti-money laundering laws. Improving external accountability of political leaders, *U4 Brief* 4:2010. http://www.u4.no/document/publication.cfm?3775=international-anti-money-laundering-laws-improving

Illicit flows are detected because of predicate offences - not the other way around

In addition, until now researchers focusing on the issue have been unaware of cases in which the detection/discovery of illicit flows was a factor leading to the fall from power of any corrupt politicians or to any prosecution for corruption – whether in an authoritarian regime or an advanced democracy. Sharman (2006, 13-14) suggests that even in the United States, where up until the time he was writing there had been perhaps a thousand convictions in total for money laundering,

> *[M]any if not most of these were used to increase the sentence of those detected and charged with predicate offences. It is certainly difficult to find a fall in the drug trade or international terrorism that can be attributed to the success of 'following the money'.*

Corruption preventing the establishment of a predicate offence

The second type of corruption in the three-way breakdown – the corruption of revenue administrations to facilitate the creation of illicit funds – creates an extra complication. Where corruption enables individuals or companies to evade tax without being pursued, no predicate offence will be established.

More generally, corruption of law enforcement institutions will in general enable those who commit predicate offences to avoid pursuit and/or conviction, thereby facilitating the laundering of the proceeds. In other words, if a criminal bribes an officer of a law enforcement institution to escape conviction for a criminal offence, this would automatically prevent any prosecution for money laundering, because the latter requires that the committing of a (predicate) criminal offence has been proven.

The capacity of AML regimes to work as an international accountability mechanism

Politicians – particularly powerful and corrupt ones – might enjoy legal immunities in addition to influencing enforcement institutions in their own countries in order to escape the law. However, foreign countries may not and need not necessarily recognise that immunity (Chaikin 2010). In situations where the courts and other government institutions in the country of origin of illicit funds are compromised, institutions in the funds' recipient country may be able to initiate investigations. This was the case, for example, of the investigation by the London Metropolitan Police of former Nigerian state governors Joshua Dariye and Diepreye Alamieyeseigha (Beggan 2009).

However, when such funds are identified, repatriating them may involve financially and sometimes politically costly exercises for the countries concerned. An example can be found in the recent imbroglio in which the governments of some German states purchased stolen information on 20,000 Swiss bank accounts of German citizens in order to recover evaded taxes, which in turn led to a diplomatic spat with the Swiss government (Bloomberg 2010). This suggests that, in addition to good functioning of the technicalities of AML regimes, countries must be willing to deal with the political fallout of such processes.

5. Policies for tackling illicit flows: the menu of options

Key issues in this section:

- Efforts to tackle illicit flows tend to be oriented towards anti-money laundering regimes, and options for tackling corruption by combating illicit flows tend to be discussed in similarly narrow terms
- A much broader range of policies to tackle illicit flows is available and necessary, including mutual legal assistance, asset recovery, and policies to reduce the secrecy space that facilitates illicit flows
- Policies to reduce secrecy include ensuring transparency of ownership of corporate entities and trusts, reforming international accounting standards, ensuring sufficient cooperation on tax matters, and regulation/self-regulation of corporate service providers

This section outlines the policies that are available to address the problem of illicit flows, with a particular focus on doing so to tackle corruption. It also summarises the international obligations and standards that are in place to combat illicit flows, and the policies that are actually in place. The following range of policy approaches may be pursued in order to tackle illicit flows.

5.1. General restriction of capital flows

Illicit flows occur predominantly through the mainstream financial system: indeed, the main objective of money laundering is to enable the funds involved to move within the financial system without raising suspicion. Key factors underlying and facilitating illicit flows are therefore the size of the financial system and its mutual interconnectedness. In particular

where funds can be moved across borders legally, quickly and with few or no bureaucratic restrictions, money laundering is – all other things equal – simply easier.

By implication, one set of mechanisms for reducing the space for illicit flows and money laundering are restrictions on capital flows. Such controls were the norm rather than the exception until the 1980s, when a wave of liberalisation underpinned a revolution in the world financial system. Such liberalisation involved the scrapping or loosening over physical currency controls, exchange rates and cross-border financial flows. While such liberalisation has generally been accepted as a means for boosting efficiency and allocating global capital more efficiently, it has also culminated in a situation where huge funds may be transferred via the Internet at the push of a button. This has clearly facilitated international illicit flows and money laundering.

5.2. Anti-money laundering policies

Since the late-1980s, anti-money laundering policies have become the dominant policy instrument worldwide for tackling illicit flows. Such policies have been described clearly and in detail elsewhere (World Bank 2009, IMF and World Bank 2006, part B), and this section only summarises their main elements.

Anti-money laundering policies have been entrenched through a combination of non-binding and binding international instruments. The core non-binding instrument has been the 40 Recommendations of the Financial Action Task Force (FATF 2003), which were originally drawn up in order to combat the misuse of financial systems to launder the proceeds of the illegal drug trade, but have become the main set of global standards for the fight against laundering of proceeds of crime in general.

Box 3 International Conventions against Money Laundering

FATF standards reflect several international conventions, in particular:

- The 1990 Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime, which in 2005 became the Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime and on the Financing of Terrorism (Council of Europe 2005)
- The 1998 Vienna Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (United Nations 1998)
- The 2000 Palermo Convention Against Transnational Organised Crime (United Nations 2004)
- The 2003 United Nations Convention against Corruption (UNCAC 2005, Articles 14, 23) also addresses the issue of money laundering

Taking into account the focus of this paper on illicit flows linked to corruption, the FATF Recommendations and/or the Conventions contain the following six main requirements.

- **Criminalisation of money laundering.** All international standards require the criminalisation of money laundering. In general, standards call for the widest range of criminal offences to be included as predicate offences.

- **Record keeping**. The FATF standards require financial institutions to keep records of all transactions for a period of at least five years.
- **Customer Due Diligence/Know Your Customer.** Financial institutions should not allow anonymous accounts or accounts held in obviously fictitious names. Moreover, the FATF elaborates detailed requirements concerning the due diligence financial institutions should conduct on new clients and other clients in certain situations. One of the most important requirements is to identify the beneficial owner of a customer that is a legal entity – that is, the "natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted… [incorporating also] those persons who exercise ultimate effective control over a legal person or arrangement" (FATF 2003, 12).
- **Politically exposed persons**. Financial institutions should conduct additional due diligence with regard to politically exposed persons (PEPs), defined by the FATF as "individuals who are or have been entrusted with prominent public functions in a foreign country, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials." On the basis that PEPs are inherently vulnerable to corruption and therefore a higher risk category of persons from the point of view of money laundering, financial institutions should:
    - have appropriate risk management systems to determine whether the customer is a politically exposed person;
    - obtain senior management approval for establishing business relationships with such customers;
    - take reasonable measures to establish the source of wealth and source of funds;
    - conduct enhanced ongoing monitoring of the business relationship.
- **Notification of large and/or suspicious transactions**. FATF and other Conventions require that financial institutions and a range of non-financial businesses and professions report certain transactions to the appropriate authority (Financial Intelligence Unit, FIU). Specifically, transactions that exceed a certain size must be reported or when the institution has reasonable grounds to suspect that the funds involved are the proceeds of criminal activity. Provided corruption is a predicate offence for money laundering in a particular country, such notification also applies to the proceeds of corruption.
- **Establishment of a system of regulation and oversight**. In order to oversee the fulfilment of the above and other requirements, international standards require the establishment of a FIU to process such notifications and forward them to law enforcement bodies where appropriate.

The FATF standards have spread to the majority of countries in the world, typically through their incorporation into regional or global conventions. Several regional bodies were set up around the FATF standards, in particular:

- The Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL)

- The Asia/Pacific Group on Money Laundering
- The Caribbean Financial Action Task Force (CFATF)
- The Middle East and North Africa Financial Action Task Force (MENAFATF)
- The Eastern and South African Anti-Money Laundering Group (ESAAMLG)
- These organisations pursue AML agendas and specifically monitor member countries' fulfilment of FATF recommendations. Currently, more than 180 countries have agreed on AML/CTF standards.

5.3. Seizure and recovery of assets

In addition to criminalising flows of the proceeds of criminal activity (money laundering in a legal sense), a further set of measures involving the seizure and recovery of assets are already in place.

Seizure of assets

Seizure of assets in general can be of two main types: seizure of the actual proceeds of crime based on a criminal conviction, which is a standard instrument of criminal law but depends on the establishment of a clear and proven link between criminal acts and specific proceeds; and non-conviction based seizure. The latter typically allows prosecutors to file a civil suit for the sequestering or confiscation of assets based on 'reasonable suspicion' rather than proof of criminal activity. Non-conviction based seizure procedures often allow a partial reversal of the burden of proof whereby the subject of the suit must prove the legal origin of assets or forfeit them. This approach has gained ground since it was first established in the United States in the 1970 Racketeer Influenced and Corrupt Organizations Act. A number of other countries now allow non-conviction based seizure of assets, including the United Kingdom, Italy, Switzerland and Albania.

Box 4: Seizing assets when you can't seize the offender

Efforts to recover assets stolen by a public official usually depend on a criminal conviction of the offender. However, that is not possible to obtain when the wrongdoer flees the country, for example. In such situations, a civil case can be pursued enabling a country to recover stolen assets without a criminal conviction. This is achieved through a direct action against the property of the offender, provided that the State in question proves that the assets are proceeds of crime. This was the case of an investigation carried out in the UK against Joshua Dariye, former governor of the Plateau State in Nigeria (1999 to 2007).

In 2003, an investigation about credit card fraud in London led the Metropolitan Police to Dariye, and an investigation of funds he was laundering in the UK (around USD 5 million), via associates and front companies. Despite being arrested in London in 2004, Dariye fled England after being released on bail and, for years, was able to avoid an international arrest warrant due to his constitutional immunity as a Nigerian Governor.

However, the British Crown Prosecution Services (CPS) filed an international freezing order for his assets outside of Nigeria. With the collaboration of the London Metropolitan Police and the CPS, the Nigerian Economic and Financial Crimes Commission (EFCC) was able to start two civil cases in a London court. These civil cases allowed the EFCC to recover a

house and around USD 8 million from multiple bank accounts in London. In 2007, after Dariye stepped down from office and lost his political immunity, the EFCC was finally able to prosecute him in Nigeria. The case against Dariye is currently pending at the Federal High Court.

Sources: Personal interviews and Asset Recovery Knowledge Centre (http://www.assetrecovery.org/kc/node/e82843b7-b4c6-11dd-a1f9-7986f5e51dc8.17).

Recovery of assets

In the context of illicit flows across national borders, a vital component of asset seizure is the international recovery of assets derived from criminal activity. The United National Convention against Corruption (UNCAC) was a milestone in this area and devotes substantial space to the establishment of internationally binding obligations regarding asset recovery:

- Chapter V of UNCAC requires States Parties to offer "the widest measure of cooperation and assistance" relating to the return of assets acquired through criminal offences covered by the Convention.
- Article 52 reiterates a number of anti-money laundering requirements present in the FATF standards, particularly relating to the identification and monitoring of PEPs by financial institutions where they hold accounts. It also calls on States Parties to consider several other measures, including for example the declaration by 'appropriate public officials' of foreign accounts over which they hold right of signature or an interest.
- The convention requires Parties to enable other States to initiate civil actions within the first country's courts and to implement confiscation orders issued by another State Party. In order for claims to be recognised, the general standard of proof is that the requesting Party provides a 'reasonable basis'. If a treaty does not exist between States Parties to cover issues of asset recovery, then the Convention is to be regarded as such a Treaty.

5.4. Mutual legal assistance in criminal matters

For the recovery of assets involved in cross border criminal cases of money laundering and/or proceeds of corruption to be possible, mutual legal assistance (MLA) is a necessary condition. The key international document in this area with respect to fighting corruption is the UNCAC, whose articles detail requirements for the provision of the widest measure of MLA relating to investigations, prosecutions and judicial proceedings relating to offences covered by the Convention. The Convention also states that banking secrecy may not be used as grounds for refusing to grant mutual legal assistance.

5.5. Restricting the secrecy space

This paper has underlined the role of secrecy jurisdictions in harbouring and therefore facilitating illicit flows. A number of important policy approaches may be pursued to reduce the extent to which such jurisdictions can be used for the purpose of concealing illicit flows, including the proceeds of corruption.

Transparency of beneficial owners and trusts

A fundamentally important mechanism for reducing the secrecy space is the pursuit of transparency regarding the identity of beneficial owners of corporate entities, including trusts. Corporate entities may be used for illegitimate purposes such as hiding illicit funds, especially where it is difficult or impossible to identify their beneficial owners.[9] FATF recommendations 33 and 34 deal with the need for adequate information on beneficial ownership to be available on a timely basis both for legal persons and trusts[10] respectively.

However, these standards do not require such information to be publicly accessible, and the result is that a fundamental factor facilitating illicit flows is an indefensible lack of transparency that "encourages corrupt activities and creates asymmetric access to important market data" (Christensen 2009, 19). To address it, public registries have been suggested as a source of increased transparency, although some would argue that such registries would have to be justified in countries that are signatories to the European Convention on Human Rights, in order to avoid violating the individual's right to privacy.

Accounting standards

Tax evasion accounts for a large share of international illicit financial flows and a large proportion of international tax evasion is achieved through transactions within multinational companies,[11] i.e. conducted between subsidiaries of one parent company using manipulated prices in order to move profits from the location where they were earned to a location where there is a zero or low tax rate on profits. This practice is known as transfer mispricing. Such practices are made easy due to the fact that under current International Accounting Standards (IAS), multinationals do not have to produce accounts that show earnings broken down by country. Consequently, there are increasing calls for IAS to require multinationals in particular to show clearly their earnings country by country.

Cooperation on tax matters

Organisations campaigning for more stringent measures to combat illicit flows argue that tax evasion and corruption are also strongly linked: proceeds of corruption held in secrecy jurisdictions are not only illegal income but are also untaxed. In light of this, international cooperation between tax authorities is potentially an important instrument that may enable authorities in countries in which a corrupt official resides to uncover untaxed income deposited by that official in another jurisdiction.

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[9] For more on such entities and how they can be misused, see OECD 2001 and FATF 2006.

[10] A Trust is a legal entity that can hold title to property for the benefit of one or more persons or entities. The person who sets up the trust is called the Creator, Donor, or Settlor. The person or entity that manages the Trust assets is the Trustee. The Trustee can only use the assets and proceeds from the Trust for the benefit of the people the Trust is set up to benefit (the Beneficiaries), never for his or her own profit. These parties to the Trust need not be different people.

[11] According to Global Witness et al. (2009), around 60% of total world trade consists of transactions within multinationals.

International tax cooperation takes the form of exchange of tax information,[12] which is typically established though bilateral agreements on the avoidance of double taxation. The Global Forum on Transparency and Exchange of Information (a framework within the OECD to discuss exchange of tax information between OECD and non-OECD countries) has set up a peer review group that is monitoring progress towards full and effective exchange of information among member countries. The purpose is to identify mechanisms to speed up the negotiation and conclusion of agreements to exchange information.

5.6. Regulation and self-regulation of intermediaries/corporate service providers

Section 3 underlined the key – and if anything growing - role played by the range of private sector intermediaries or corporate service providers (CSPs) in the facilitation of illicit flows. At least four mechanisms could be, or have been, employed to attempt to reduce this role.

Licensing CSPs. One way to 'tame' CSPs is to subject them to licensing requirements, including requirements for the fitness of persons operating them. The Isle of Man introduced licensing in 2000 through a law based on applying 'a test of fitness and properness in the key areas of integrity, competence and solvency' that has been widely regarded as a model for other secrecy jurisdictions (Chaikin 2009, 79-80). [13]

- **Extending AML reporting requirements**. Another measure to reduce the role CSPs may play in facilitating money laundering would be to include them in the range of entities which are required under anti-money laundering legislation to report suspicious transactions and conduct customer due diligence.
- **Transparency of ownership**. Despite several of the FATF's recommendations being applicable to non-financial business and professions, FATF (2006) emphasised the need for data related to ownership of CSPs to be made available to the authorities in the countries where such corporate service providers are located, as well as to authorities in interested countries.
- **Self-regulation and industry/professional standards**. Where corporate service providers do not exist primarily to facilitate the stashing away of illicit funds or to hide business activities behind a veil of opacity, self-regulation may also be an important tool for raising corporate standards. Self-regulation is something that is likely to go hand-in-hand with the other two mechanisms (transparency and extension of AML reporting requirements); without them, it is unlikely to have any significant effect on CSPs whose *raison d'être* is to enable criminals to launder money.

[12] There are two types of agreement on exchange of tax information – exchange on request and automatic exchange. The former is a feature of double taxation treaties and has been advocated by the OECD through its model Agreement on Exchange of Information in Tax Matters. The latter is much less common, but exists, for example, between the USA and Canada and within EU member states.

[13] For details of the Isle of Man's licensing framework see http://www.fsc.gov.im/policy/regcsps.xml

6. Anti-money laundering regimes: a problematic consensus

Key issues in this section:

- AML policies are the result of encroaching international standards rather than a cost-benefit analysis of their effectiveness
- AML regimes are only as effective as their weakest link, and exhibit shortcomings, some of which can be overcome but some of which are inherent
- Inherent shortcomings include mechanisms for monitoring politically exposed persons, the vulnerability of FIUs and other institutions and reporting entities to corruption or undue influence, and the risk of abuse of AML powers

The AML regime described in Section 5.2 remains by far the dominant worldwide mechanism to tackle illicit flows. This section provides an overview of the main weaknesses of such current policies, with particular focus on the AML approach as a means of preventing the laundering of proceeds of corruption.

AML policies have been subject to damning critiques, which it is beyond the scope of this paper to assess.[14] A key argument is that the problems of AML in practice reflect not only deficiencies in implementation, but also a fundamental absence of mechanisms for assessing the effectiveness of AML policies and inherent limits in the approach itself. Critiques tend to implicitly assume that any lack of effectiveness of AML is a problem that may be solved through modifications of the regime itself. This paper will argue that this is too optimistic.

6.1. The absence of criteria of effectiveness

AML policies are notable for the fact that no criteria or benchmarks have been formulated for assessing their effectiveness in practice (Sharman 2006). Neither the organisations that have been behind the rapid spread of AML policies, nor countries that have implemented them have employed indicators that could measure the success of an AML system such as statistics on money laundering prosecutions or attempts to track developments in the scale of money laundering itself in response to AML policies. The various institutional mechanisms for monitoring implementation of FATF standards do so by simply comparing the implementation of local legal and institutional frameworks to the standards, without any reference to the impact of such implementation, for example.

Neither have there been any serious attempts to conduct a regulatory impact assessment prior to the introduction of AML regimes (Sharman 2006). This is perhaps unsurprising given the binding nature of AML policies, but does not make the absence of meaningful impact evaluation any less of a problem.

The lack of criteria and mechanisms for judging the effectiveness of AML regimes is particularly worrying for at least three reasons. First, AML has emerged in an evolutionary fashion, beginning as a mechanism in the USA to track the proceeds of drug crime, yet ending

[14] For example see Naylor (2007).

up with a far wider scope. Second, AML policies are expensive and are largely carried by the private sector. Third, there is little clear evidence that AML policies have had any impact in stemming the scale either of money laundering or the crimes that yield proceeds to be laundered. Most developing countries have not recorded a single money laundering conviction so far, and there is little evidence that money laundering convictions even in the USA have led to a fall in the incidence of predicate offences such as drug trafficking.

With respect to the effectiveness of AML in yielding corruption convictions, the story is no better. An OECD Mid-term Review on implementation of the OECD's Anti-Bribery Convention notes that suspicious transaction reports in the countries under review have not led to bribery investigations, and the report does not mention any particular bribery convictions (Chaikin and Sharman 2009, 29 and 34-35).

It should be noted that assessing the impact of AML regimes is complicated by the fact that such regimes are also designed to deter and/or disrupt criminal activity pre-emptively rather than actually yield statistics on impact indicators such as funds frozen, persons convicted and so on, which only assess performance in terms of crimes already committed. In other words, the impact may not be measurable or even visible. It therefore remains important to devise criteria or indicators to attempt to gauge the effectiveness of AML in deterring money laundering. Where an AML regime is evaluated as being an effective deterrent, a further complication is that this might lead to money laundering activities being displaced to jurisdictions with weaker legislation or enforcement.

The failure of AML to have an impact on corruption is not just confined to OECD countries and is due to:

- Insufficient protection of financial intelligence units and law enforcement bodies from corruption or political influence.
- Insufficient implementation of key components of AML requirements, including customer due diligence (CDD) and know your customer (KYC) procedures, as well as suspicious transaction reporting (STRs). In particular:
    - With regard to CDD/KYC, the definitions of politically-exposed persons (PEP) are insufficiently clear and too broad.
    - With regard to STRs, corruption offences are often not included in FIU typologies of money laundering, making cooperation with entities specialising in fighting corruption less likely.
- A bureaucratic disconnect between AML and anti-corruption efforts in general, with FIUs and anti-corruption bodies tending to be too separated, both institutionally and operationally.
- Insufficient international cooperation, such as routine intelligence sharing between FIUs in different countries.
- Preoccupation of rich countries with using AML to tackle drug crime and terrorist financing, and insufficient priority attached to corruption as a major source of money to be laundered from the developing world.

Chaikin and Sharma'sn recommendations to address these issues follow accordingly from the problems identified. In the opinion of the authors, however, the perspective outlined above – essentially that the lack of success of AML is because of poor or insufficient implementation,

which can therefore be addressed through adjustments in AML regimes – fails to go to the heart of the problem. In our view, AML systems, like any other policy approach or instrument, suffer from inherent flaws and limitations, which should be factored into policy discussions as fundamental constraints rather than as technical barriers that can be removed or solved.

6.2. The 'weakest link' problem

One major background factor that must be taken into account when discussing the functioning of AML systems is the problem that such systems are likely to be only as effective as their weakest link. This is true in two different senses – with respect to the AML system itself, and also with respect to the other systems that need to function for AML outputs to be properly used.

- In order for an AML system to generate suspicious transaction reports (or suspicious activity reports) to law enforcement bodies, all the different requirements of an AML system need to be fully implemented. This means that reporting entities (such as banks) need to conduct extensive and sophisticated customer due diligence to identify clients who may be vulnerable to corruption - including politically-exposed persons but not necessarily limited to them, involving internal detective work of the beneficial owners of other corporate entities. They then need to identify suspicious transactions involving such persons. Such transactions may need not to involve large amounts of money, and may be isolated and difficult to identify using any set typology (for example, tax evasion may be easier to identify as it is more likely to involve a continuing or regular set of transactions).
- If we assume that reporting entities perform their job perfectly, generating SARs to FIUs that also work adequately and lead to appropriate prosecution and conviction, a number of other systems also need to function well: police, prosecution, courts and tax authorities.
- In the case of international transactions, it will also be necessary for law enforcement institutions to have sufficient access to information on bank accounts, ownership of corporate entities and trusts located in secrecy jurisdictions. It will be necessary for mutual legal assistance to function between the countries involved, including cooperation in efforts to recover assets.

The following sections present a number of reasons why the conditions outlined above are unlikely to be fulfilled. The reasons for this are partly problems of implementation (i.e. are potentially resolvable), but in our view several are inherent or partly inherent.

6.3. Predicate offences

One set of problems that prevents AML regimes from functioning effectively concerns predicate offences, which differ across countries (Unger 2007, chapter 2). For example, Germany does not include tax evasion as a predicate offence for money laundering purposes, while in Greece and Italy, tax evasion are not even criminal offences. Corruption is an ML predicate offence only in Australia, China, India, Indonesia, South Korea, Malaysia, Singapore and Thailand, and only four countries (Australia, Japan, Korea, and Singapore) have criminalised the bribery of foreign public officials. The latter is an added complication:

countries generally only include foreign public officials in their definitions of PEPs (if they have one).

The UN Convention Against Corruption requires that active and passive corruption, embezzlement, and misappropriation or other diversion of property by public officials are made predicate offences for money laundering. Whether criminalisation of trading in influence, abuse of function, illicit enrichment and corruption in the private sector are to be predicate offences is optional. The FATF requires a range of offences within the category of 'corruption and bribery' to be included as predicate offences. Divergences in predicate offences will therefore still be present, even with the full implementation of international conventions. This presents two barriers to prosecuting money laundering:

- Where a country does not include all serious crimes as predicate offences, third parties (e.g. banks) who participate in laundering can defend themselves in not submitting SARs by stating that they could not be sure that funds were proceeds of one of the specific offences to which AML provisions apply.
- Corruption may be prosecuted and convicted not through 'corruption provisions' such as bribery, but through other offences such as fraud, tax evasion or other malpractice – for example, 'misbehaviour in public office' in the United Kingdom. Unless all countries adopt an 'all-crimes' approach, where all criminal offences with penalties exceeding a certain threshold are predicate for money laundering purposes – an unlikely event - investigations will still be vulnerable to variations in predicate offences. Corruption offences proper (i.e. bribery offences) are by nature among the most difficult to prosecute, raising a question mark over how much can really be achieved by including them as predicate offences for money laundering.

6.4. Politically exposed persons

The concept of PEPs is clearly of relevance to fighting corruption by tracking illicit flows of proceeds of corruption. For example, the Basel-based International Asset Recovery Centre lists a number of cases of prominent officials, almost all from developing countries, whose assets have either been recovered abroad, or who are the subject of proceedings to recover assets. It is not difficult to subscribe to the view that it would be a good thing if such individuals were monitored more carefully by financial institutions through which they conduct transactions.

The core anti-corruption component of AML systems in regards to corruption is the requirement for conducting enhanced due diligence and continued monitoring of PEPs. However, the PEPs regime suffers from several problems which prevent it from functioning as a meaningful element of corruption prevention. First, there is no agreed definition of what a PEP is. FATF explicitly limits PEPs to individuals with prominent functions in a foreign country, while UNCAC defines PEPs (without employing the term itself) as "individuals who are, or have been, entrusted with prominent public functions, and their family members and close associates", widening the definition to include those close to a prominent official, while leaving open whether these should include domestic or foreign officials. The widespread tendency of countries to include only foreign officials in their PEPs definition devalues the whole objective of monitoring prominent public officials. Another key problem is the difficulty of defining how wide the circle of PEPs should be:

- While prominent politicians may seem obvious candidates, their actual vulnerability to corruption will vary dramatically across countries, depending on the extent to which they exercise hierarchical control within their institutions.
- Junior officials may enjoy extensive opportunities of enrichment, for example officials in charge of procurement in any large municipality. This is presumably the reason why the EU Anti-Money Laundering Directive (EU 2005) explicitly states that sub-national officials should be considered as PEPs on a risk-sensitive basis.
- Assets may be diverted to family members, friends or other close associates (see box below).

One way to tackle part of these problems is by extending the PEP definition to a wider circle of persons (as the UNCAC definition suggests), and to end any distinction between foreign and domestic PEPs. However, this implies an exponential increase in the number of persons whom financial institutions would be obliged to monitor. To address some of the other problems, it is also suggested that financial institutions should conduct periodic reviews of their PEP customers, and that there should be no set limit on the time a PEP continues to be regarded as such by the financial institution after leaving office (Greenberg et al 2009).

Box 5: Cracks in the system: Failing to identify PEPs' associates

A French arms dealer, Pierre Falcone*, connected to the Angola president José Eduardo dos Santos, was able to access US bank accounts (through the Bank of America) for 18 years transferring suspicious funds into the country, without being adequately identified as a close associate of a PEP. In 2007, after the Bank of America was the subject of a US Senate inquiry (which had identified USD 60 million in suspicious transactions involving US accounts related to Falcone and his family), the arms dealer was finally properly identified as a PEP by the bank, and his accounts were closed.

* Pierre Falcone had a remarkable political influence in Angola. His connection to President dos Santos started with the *Angolagate*, in which dos Santos got assistance for arms purchases during the Angola civil war. Among other privileges for his support to dos Santos, Falcone was given a diplomatic Angolan passport and was once a member of Angola's delegation to UNESCO.

6.5. Compartmentalism: the disconnect between anti-corruption and anti-money laundering policies

An important obstacle to AML policies functioning as a mechanism to prevent or tackle corruption is the fact that AML regimes and anti-corruption policies tend to be disconnected. The emergence of AML and anti-corruption from different policy communities has tended to institutionalise a separation that results in the failure of FIUs to communicate with anti-corruption bodies and vice-versa. As indicated under section 6.1, FIUs tend not to include corruption in their typologies of money laundering scenarios for use by FIU staff and reporting entities. Although AML standards have become more integrated into international anti-corruption standards – particularly through the UNCAC – and there are increasing calls for a more integrated policy approach (particularly from the StAR Initiative and the Asia-Pacific Group on Money Laundering), such efforts still remain "more aspiration than reality" (Chaikin and Sharman 2009).

6.6. FIUs and law enforcement: independence, capacity and corruption

In order for AML systems to generate information that may then be used to initiate criminal proceedings against allegedly corrupt officials, the FIU, police and/or prosecution and courts must be not only sufficiently competent and specialised to process such cases, but also sufficiently resistant to corruption and/or political interference.

A key problem here is that FIUs lack a basis – whether in legal tradition (the independence of the judiciary) or in international standards (such as standards for supreme audit institutions) – in which to anchor themselves firmly. Indeed, there are several models for FIUs, ranging from administrative (where the FIU only processes information received from reporting entities and forwards to law enforcement bodies as appropriate) to law enforcement where the FIU is embedded within the prosecutor's office or judiciary.

Box 6: Examples of FIUs

The Financial Crimes Enforcement Network (FinCEN), in the US, is hosted within the Treasury, and is one example of an administrative FIU. The Unidade de Informação Financeira (Financial Information Unit) in Portugal is hosted by the Judicial Police and has police powers, while the Dutch FIU presents a hybrid model, and is established to be operationally independent from the institution in which it is hosted, the Department of International Police Information of the Netherlands Police Agency.

6.7. Intrusiveness, enforcement powers and the risk of abuse

A major issue relating to AML – and even more to the non-conviction based procedures for forfeiting assets - is the trade-off between the benefits of such policies in terms of their impact on money laundering and the potentially negative human rights consequences of such policies, in particularly the following:

- AML mechanisms may be put to ulterior uses by governments that do not respect democratic standards, for example to prosecute or freeze the funds of political opponents, monitor the activities of non-governmental organisations and so on. For example, the conviction, in Russia, of Mikhail Khodorkosky (once Russia's richest man and a political opponent of then-President Vladimir Putin) in 2005 for fraud, and the initiation of a further prosecution in 2009 for embezzlement and money laundering are widely regarded as primarily politically motivated.[15]
- The impact of non-conviction based procedures, in particular the lowering of the standard of proof required to initiate seizure of assets and, in some cases, the reversal of the burden of proof (whereby persons in possession of assets alleged to be proceeds of crime must prove the legitimate origin of such assets or have them confiscated). For example, a new Law on Preventing and Striking at Organised Crime and Trafficking through Preventive Measures against Assets that came into effect in Albania in January 2010 allows confiscation of assets to be initiated on the basis of

[15] See for example Parliamentary Assembly of the Council of Europe (2009).

"reasonable suspicion, based on indicia" of involvement in any of a specific list of criminal acts.

These concerns are serious ones, and they will typically be more serious in countries where incumbent politicians or high-level officials are more likely to be engaged in criminal activities and money laundering. Despite this, they are rarely taken into consideration when advocating AML regimes, or where they are acknowledged, the appropriate conclusions are not drawn. For example, Chaikin and Sharman state that "…if governments could be trusted to exercise these powers and their other prerogatives wisely, impartially, and with restraint, there would be no need for anticorruption strategies in the first place", yet are in favour of the extension of such powers. The very fact that FIUs or prosecutors are vulnerable to corruption or political influence is a *prima facie* reason to be careful about giving them draconian powers.

6.8. Corruption of reporting entities

In addition to the inherent vulnerability of FIUs and other enforcement institutions to political pressure and corruption, a more widespread threat to the functioning of AML policies is corruption involving reporting entities such as banks. For example, in connection with efforts to recover assets looted by the Marcos family and held in Swiss bank accounts, in 1999, the Philippines filed a complaint relating to alleged corruption and involvement in money laundering of Swiss bankers, lawyers and government officials (Chaikin and Sharman 2009, 178).

Corruption/collusion of reporting entities or their tolerance of money laundering may be something that can be tackled by better supervision (for example the role of Central Banks in the case of banks) or stronger efforts to tackle private sector corruption. However, another perspective is to view corruption of reporting entities as a natural side-effect of the attempt to impose upon them the supervisory and enforcement roles that follow from AML regimes. In other words, the AML regime itself *creates* new risks that need to be addressed through law enforcement or other efforts.

6.9. Mutual legal assistance and asset recovery

Effective mutual legal assistance, including in requests for assets to be sequestered or confiscated, is a clear condition for illicit flows to be tackled effectively. Global standards relating to mutual legal assistance in the areas of corruption and money laundering have become significantly more stringent as a result of the UNCAC. However, as the experience of Europe shows, achieving improvements is a very difficult task.

- The Protocol to the EU Convention on Mutual Legal Assistance in Criminal Matters signed in 2001, which required assistance involving information such as bank records, was a key step. However, as of mid-2009, five EU states had still not ratified the Protocol.
- The Second Protocol to the European (Council of Europe) Convention on Mutual Legal Assistance in Criminal Matters, which contained important provisions to promote mutual legal assistance even in cases where the offence concerned is not illegal in one of the states involved, was opened for signature in 2001. As of mid-2009, only 18 of the 47 Council of Europe member states had ratified it, not including France, Germany, and the UK.

- According to evidence collected by the UK House of Lords European Committee, mutual legal assistance between countries that have ratified the protocols is "relatively rare", partly due to the time taken to secure such assistance.

The difficulties of securing mutual legal assistance are illustrated by cases such as a 2005 request by the Philippines to Liechtenstein, which identified 83 Liechtenstein companies and foundations involved in the laundering of Marcos assets, which had not been answered three years later (Chaikin and Sharman 2009, 179).

To the extent that improving MLA is simply a question of better implementation of existing international obligations, this problem may be resolvable. However, if there are natural limits to MLA based on national resistance to *de facto* foreign encroachment upon domestic policy implementation, this needs to be factored in as a given. For example, one of the reasons the UK has been slow to sign and ratify the Second Protocol to the European Convention is apparently the possibility that it would create opportunities for foreign FIUs to make requests that would result in transactions being frozen in the UK (House of Lords 2009).

6.10. The burden on poor countries: an expensive regime designed for rich countries

Last but not least, the spread of AML systems across the world has taken place with little analysis of the costs of implementing such policies. Considerable criticism has been levelled at the fact that policies whose costs are borne primarily by the private sector (i.e. financial institutions) have almost never undergone any regulatory impact assessment, and that these costs are disproportionally high for poor countries (Sharman 2006, 7-8). To imagine the costs of implementing AML comprehensively, it is sufficient to simply read FATF Recommendation 8:

> *Financial institutions should pay special attention to all complex, unusual large transactions, and all unusual patterns of transactions, which have no apparent economic or visible lawful purpose. The background and purpose of such transactions should, as far as possible, be examined, the findings established in writing, and be available to help competent authorities and auditors.*

These costs are in addition to the costs to the government of setting up and maintaining a Financial Intelligence Unit. Moreover, while AML systems are at least better suited to sophisticated financial systems in rich countries, they are much less suited to poorer countries where a large proportion of transactions take place in cash, sources of identification are hard to come by, bank accounts are difficult to open and so on.

Box 7: Too much of a good thing?

A large number of small states rely on international financial services for a large part of their revenues—and have been encouraged by international financial institutions to do so. However, the upsurge in international pressure to implement AML standards, particularly after the terrorist attacks of 11 September 2001, has led countries like Mauritius and Barbados to start implementing or upgrading costly infrastructure without a proper cost-benefit analysis.

In Barbados, over 27% of the corporate service providers are now considering exiting the market due to compliance costs, according to a study commissioned by the Commonwealth

Secretariat (2008), while Vanuatu spent 4 times as much regulating the financial sector in 2005 than it did in 2000. Chronically aid-dependent Niue, an island in the Pacific, has a population of less than 1500 – but is a proud member of the Asia-Pacific Group on Money Laundering and the Egmont Group of Financial Intelligence Units and has a fully operational Financial Intelligence Unit. These countries' economies simply cannot afford the reputational risks of being considered non-compliant or appearing on a blacklist.

Are the benefits of AML standards imposed on such small economies in proportion to the costs? The Commonwealth study (which included Mauritius, Barbados and Vanuatu, jurisdictions considered to be secrecy havens) suggests that international assistance is required to put in place an infrastructure that was designed for OECD countries and that a more customised approached is needed to share the burden of implementation without compromising the international financial system.

Sharman, J.C and Mistry, P.S. (2008): Considering the consequences: The development implications of initiatives on taxation, anti-money laundering and combating the financing of terrorism, Commonwealth Secretariat, London, UK.

Government of Niue (2008): Niue Country Report, Pilon Annual Meeting, 5-9 December 2008

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6.11. AML problems: not just a question of better implementation

This section has outlined a number of problems of the AML approach to tackling illicit flows. These problems may be divided into three model types, although some will exhibit aspects of more than one:

i. Problems that are a result of imperfect implementation of AML and which can be resolved by improvements in implementation. These include the coverage of predicate offences, coordination of AML and anti-corruption policy, or the costs imposed on poor countries.

ii. Problems that are a result of the failure of other policy conditions to be fulfilled. The key example of this is ineffective mutual legal assistance (and limited asset recovery).

iii. Problems that are inherent to AML regimes and must be regarded as permanent constraints on what AML can achieve. These include the inherent difficulties of securing convictions for corruption offences; the limits of the PEP approach; the vulnerability of FIUs to political interference; corruption of reporting entities; the dangers of intrusion and abuse in the implementation of AML policies and asset seizures; and the very suitability of AML to the needs of poor countries.

Given the limited effectiveness of AML regimes to date, this analysis points to the following conclusion: while some problems may be addressed by fine-tuning AML policies, bigger changes in the current dominant approach are needed if illicit flows (and particularly illicit flows of the proceeds of corruption) are to be tackled effectively.

7. Redressing the balance: a three-pronged approach

Key issues in this section:

- Policies to tackle illicit flows should be based on proper analysis and evidence of the costs and benefits of such policies;
- The AML regime itself requires significant reforms, particularly to facilitate better coordination among FIUs and between FIUs and anti-corruption bodies;
- Concerted efforts should be made to employ the wider range of policies to tackle illicit flows that are available, in particular to reduce the secrecy space.

This final section proposes a set of recommendations on how the approach to tackle illicit flows should be reshaped.

7.1. Evidence and analysis-based policy

It is highly desirable for the AML regime and its implementation in specific countries to be subjected to rigorous regulatory impact analysis – i.e. assessment of the costs of implementation vis–a-vis the expected benefits from regulation. The analysis should not be limited to the direct costs of implementation such as the costs of running an FIU; conducting CDD procedures; and monitoring transactions, but also of any wider costs if banking functions such as higher costs for all clients.

Such an analysis should be conducted in general by the international organisations that have initiated internationally binding standards (the FATF in particular), but should also be conducted by individual countries when they are designing their own AML policies. Analyses by individual countries – especially poor countries - may require direct financial or technical support from the international donor community.

The global analysis in particular should be based on a clear statement of exactly what the objectives of AML are, and this statement should then also be used for three other purposes:

i. To develop indicators of effectiveness against which AML regimes may be judged – for example data on the consequences of SARs, criminal convictions for money laundering, and predicate offences detected through AML, as well as their deterrent effect on criminal activity.

ii. To assess the benefits and effectiveness of AML in general, both in rich and poor countries. Such an assessment should be conducted in spite of the possibility that it yields unfavourable conclusions regarding AML regimes, and appropriate policy conclusions should be drawn. The analysis of AML in poor countries should pay special attention to the suitability of the AML regime to circumstances of poor countries in light of the costs it imposes upon them.

iii. To conduct a wider analysis of the other conditions necessary for AML to have a real impact on corruption. These include mutual legal assistance, and may also include more controversial measures, such as non-conviction based asset seizures. The latter,

if they are to be embraced, should themselves be subjected to proper analysis in order to make an informed judgement of whether their benefits outweigh their risks.

7.2. The AML regime

To the extent that the benefits of AML are shown to clearly outweigh its costs, a number of improvements should be considered:

i. Based on the analysis of the benefits and costs of AML to poorer countries, consider modifications to make AML obligations more flexible in some areas as appropriate. For example, FATF Recommendation 5a concerning customer identification may be very difficult to implement in countries where a substantial proportion of the population has no reliable ID. Such considerations should, however, also take into account the risks of weaker regulations leading to displacement of money laundering activities from rich to poor jurisdictions. This recommendation requires consideration at the level of international organisations, and the FATF in particular.

ii. Based on the same analysis, for international donors at global and local level to devise a mechanism under which poorer countries are provided with systematic financial and technical assistance to implement AML, an area that can be supported by bilateral development cooperation.

iii. Governments should ensure that FIUs and institutions responsible for anti-corruption policy are linked through explicit coordination mechanisms to ensure that AML serves as a mechanism to help tackle corruption, and also that anti-corruption policies serve to protect AML policies from being undermined by corruption. Policies to protect FIUs in particular should go beyond mechanisms such as conflict of interest or asset declaration provisions, to include mechanisms to ensure political neutrality/balance in appointments, job security and so on. Implementing such policies is likely to require financial assistance from donors in low income countries.

iv. Establish a mechanism or forum to facilitate communication and coordination between anti-corruption authorities and FIUs in an international context, in a similar way as the Egmont Group currently does for FIUs alone. This would require inter-governmental initiatives and could be helped by donor assistance to developing countries in participation in such mechanisms.

v. Given the links between corruption and tax evasion (see Section 2.1) and the difficulties of prosecuting corruption offences (see Section 6.3), the explicit inclusion of tax evasion in predicate offences that are required by international standards (mainly the FATF recommendations), notwithstanding unavoidable exceptions for countries where tax evasion is not a criminal offence. A discussion should be initiated to explore whether multilateral agreements are possible in such cases (which include the key secrecy haven of Switzerland) to facilitate the exchange of information on transactions involving alleged tax evasion. This recommendation requires further efforts from international donors, with the OECD as the obvious example given its current efforts in this area.

vi. The inclusion, for FIUs and reporting entities, of typologies of laundering of the proceeds of corruption to enable them to more effectively detect possible flows of such proceeds. Donors can play a key role in assisting with the provision of such typologies, which, if designed well, will take closely into account local realities.

vii. The inclusion, by governments, of domestic officials as politically exposed persons, and proper guidelines for the definition of PEPs, including a clear definition of the role of governments in providing information on who should be regarded as a PEP. A narrow range of persons should be included in PEPs lists to prevent regulatory overload, combined with fully adequate implementation of the duties of customer due diligence and monitoring for those that are included.

viii. Initiatives to push forward the agenda on tackling private sector corruption beyond its currently declaratory phase, including of AML reporting entities. Strong action from international donors including the UN (where Article 12 of UNCAC is of relevance) will be needed to push forward better standards for private sector governance.

7.3. Using the full range of policies to tackle illicit flows: tackling the "secrecy space"

As Section 5 made clear, AML is only one of a range of policies for tackling illicit flows. For the AML regime to have the impact that is expected from it, other conditions need to be met, including the proper implementation of other policies to tackle illicit flows. This is as much or more the case for preventing flows of the proceeds of corruption. Policies in the following areas should be encouraged, and their development initiated/assisted by donors at the international level.

Secrecy jurisdictions

Based on the current state of the policy consensus, the key issue here is to make progress in other policy areas that may be grouped under the heading of opening or reducing the "secrecy space" which facilitates both the creation and concealment of illicit funds.[16] The main recommendation follows those of the UNCAC Civil Society Coalition (UNCAC Civil Society Coalition 2010).

- Consider altering international standards, and specifically FATF Recommendations 33-34, to require that the beneficial ownership of all companies, trusts, foundations and charities are a matter of public record, and not just available to the authorities as the recommendations currently require. Such a change may need to be tailored in order to avoid violating privacy provisions in human rights conventions.
- Introduce into International Accounting Standards requirements to ensure that multinational corporations present accounts that are broken down on a country-by-country basis. The OECD announced in January 2010 that it will publish guidelines on country-by-country reporting, but these will be recommendations only.
- Alter the OECD Model Agreement on Exchange of Information in Tax Matters to include automatic exchange of tax information as the benchmark rather than information on request.

[16] This section does not address more radical solutions such as partial reversal of the extensive liberalisation of capital flows that has taken place since the 1980s, although this may also warrant consideration.

Mutual legal assistance and asset recovery

Rather than expensively attempting to detect, at source, all transactions of illicit funds, the prime concern of developing countries is to recover funds that have already been stolen and concealed abroad. To the extent that AML regimes fail to detect such transactions more concerted efforts should be made to ensure that the requirements of UNCAC are properly fulfilled. These should include the following.

- To create data on international mutual legal assistance to assess the extent to which MLA requests are processed adequately – and in particular the extent to which rich developed countries respond to requests from countries that are actually hurt by illicit flows.
- To integrate AC and AML agendas, drawing appropriate conclusions and recommendations concerning detailed interpretative guidelines for the provisions of UNCAC on mutual legal assistance and asset recovery.
- To push for the implementation of a UNCAC review mechanism that is made public.

Private sector corruption

Given the fact that a significant number of those operating in key professions, including corporate service providers and lawyers, facilitate illicit flows rather than regulating themselves to prevent them, stronger efforts should be made to encourage either regulation or self-regulation as appropriate. Such regulation may be initiated at country level; for example, the experience of the Isle of Man in licensing CSPs on the basis of their observing certain rules and standards. Such examples might also be explored as a basis for a formal international standard or recommendation.

8. Conclusion: good governance and illicit flows

There is a widespread international consensus that illicit flows are a major problem that is integrated into the fabric of the world economy. The AML regime and efforts to facilitate mutual legal assistance and asset recovery are the main mechanisms agreed internationally to make it possible to prevent, detect, investigate, prosecute and repatriate illicit flows. However, the very scale of illicit flows and the apparent lack of success in tackling them to date bring to mind the metaphor of attempting to stop the flow of a large river with a leaking dam. In this scenario, AML policies are analogous to attempting to block holes in the dam with plugs that only work for a very short period. According to a Swiss banker, only 0.01% of dirty money that flows through Switzerland is detected (Christensen 2009, 9).

What follows from this is the straightforward point that while policies to tackle illicit flows directly *may* under certain circumstances provide disincentives for engaging in criminal or illicit activities, the task they are expected to perform is too big unless they are accompanied by efforts to boost and consolidate good governance – from public financial management to the conduct of elections. This is, in effect, a subset of a larger problem (Reed, 2009), which is the excessive orientation of international anti-corruption standards towards law enforcement-based solutions. However, international instruments increasingly incorporate more general and positive good governance standards – UNCAC is a good example – and assistance with improving governance is something that donor organisations are well placed to provide.

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Abstract

This paper attempts to clarify the links between illicit financial flows and corruption, and how corruption may be tackled by stemming such flows. For this purpose, it clarifies the terminology surrounding illicit flows, describes the impact of such flows, outlines the techniques used to launder them (with a particular focus on laundering of the proceeds of corruption), and critically analyses existing policies designed to tackle illicit flows. This paper contributes to the regulatory debate that is emerging in response to the financial crisis, as the accepted wisdom of deregulated global financial markets is being challenged. A major change in approach to tackling illicit flows is recommended. Such an approach should be more evidence-based, and consider the costs and benefits of policy choices. It should also specifically go beyond the current reliance on anti-money laundering policies and embrace more fully other policies to tackle illicit flows – including good governance reforms to tackle corruption as a source of illicit funds, but also more decisive efforts by rich countries that shelter secrecy havens or the proceeds of grand corruption.

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