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Conference report

Building public and private sector consensus on effective measures to combat international money laundering activities

Wednesday 23 January 2013 | WP1242

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The UK Prime Minister's recent speech on the role of open economies, open societies and open governments in advancing trade, ensuring tax compliance and promoting greater transparency in driving global economic growth, provide the backdrop for a closer examination of specific sets of regulations. With transparency and anti-corruption measures for exposing illicit flows playing a key role in the wider global prosperity agenda, this roundtable will examine whether the current international architecture for reporting and prosecuting money laundering activity is delivering on the intended outcomes.

Does more data always equal better results, or are there efficiencies and improvements to be gained by a different approach to regulation and reporting of money laundering activities? Does international policy – and at a more local level, EU and UK policy – match the increasing demands for companies and institutions of governance to deliver results when it comes to identifying barriers to prosperity caused by money laundering?

Key points

- The overall AML/CFT framework is suitable, outcomes need to be improved
- Technical compliance is necessary, but not sufficient – effective implementation is key
- Greater transparency of ownership should improve outcomes, but must not merely impose burdens on the willing and compliant
- Financial institutions must improve their game, but good work should not go unnoticed
- Greater guidance and consistency on data protection issues – nationally and internationally – would be welcome
- Senior levels in financial institutions must be held responsible, with appropriate criminal and regulatory sanctions used to change behaviour, both personally and corporately

" There is broad consensus that the framework…is suitable (or, at least, no one has been able to devise a better system)."

Can the international framework be made to work, or is fundamental reform required?

1. The international framework to combat money laundering and the financing of terrorism has evolved over more than 25 years. The international standards are expressed primarily through the Financial Action Task Force (FATF) Recommendations, which were first issued in 1990. The FATF recently reviewed the standards, culminating in the publication of its revised 40 Recommendations in February 2012 following wide consultation, not only with its members and observers such as country governments and international organisations, but also with relevant industry bodies and civil society organisations.

2. There is broad consensus that the framework, relying as it does on legal and institutional structures, preventative measures, and powers of competent authorities, is suitable (or, at least, no one has been able to devise a better system). However, it is clear that money laundering continues to take place on a large scale by international organised crime, local criminals, in grand corruption and tax crimes – and that terrorist groups continue to raise, move and utilise money. Recent scandals in the banking system have given the perception that banks are paying not much more than lip service to their obligations. Stolen assets are still not being returned to countries from which they have been looted. It could, therefore, be argued that the anti-money laundering/counter-terrorist finance (AML/CFT) framework is as good as it can be, but it has failed.

3. Such arguments are, to an extent, naïve – the causes of crime and terrorism cannot be addressed by an AML/CFT system alone. Assessing the effectiveness of the measures implemented globally through the FATF standards is problematic for several reasons, not least because there has been no explicit statement of the objectives of the system, tied to measurable outcomes. A considerable body of academic research has failed to provide measures of the amount of money laundered. Even if this was possible, allocating any reduction to the effects of the AML/CFT system, rather than to a host of other social effects and crime/harm reduction initiatives, would be very difficult.

4. However, this is not to say that focusing on the expected outcomes of particular aspects of the system, and measuring their effectiveness, is not a worthwhile endeavour. One point of view is that the current system is over-engineered, and is trying to achieve too many things; (and with increasing demands put on it, such as counter proliferation and tax crimes) focusing on specific issues, with greater cooperation between policy makers, supervisors, enforcement and (crucially) the financial industry to address them, may provide useful, measurable results. On the other hand, the requirements imposed on financial institutions can be seen as conceptually simple – they should know their customers at the outset of their relationship, monitor them to see if their behaviour is as expected, and report them to the authorities if it is suspicious.

5. One area where the FATF has been effective is in achieving a high level of implementation of their Recommendations at the national level. This has been achieved through the mutual evaluation system and initiatives to help and support countries implement robust AML/CFT systems, and also the use of sanctions (such as naming countries with deficiencies) through the International Cooperation Review Group (ICRG) process.

6. However, there is a now clear understanding that technical compliance with the standards is merely a necessary, but not sufficient, step towards an effective regime. There will be a real shift in focus to evaluating the effectiveness of implementation, alongside continued assessment of technical compliance, which might be characterised as focusing on the outcomes the system delivers, rather than the inputs. The FATF is working on producing new methodologies for evaluating the standards. The focus on effectiveness will provide a challenge to assessors, who will have to be capable of understanding if legal provisions or systems and controls are delivering the right result,

if future evaluations are not to be more 'tick box' exercises.

Beneficial ownership

" The right to privacy has to be balanced against the public good of greater transparency"

7. The system could benefit from a more serious collective effort on beneficial ownership, i.e. who ultimately lies behind - and benefits from - legal structures such as companies and trusts. There is no doubt that criminals use complicated corporate structures to move and hide their assets, and greater transparency in this area would, in theory, make it more difficult for them to launder money and easier for the proceeds of crime to be recovered. However, corporate structures and trusts have many legitimate uses (and are also used in the increasingly murky area of tax avoidance, where moral rather than clear legal obligations are increasingly cited by governments). The right to privacy has to be balanced against the public good of greater transparency, and any measures introduced must not penalise the legitimate and compliant users of such arrangements, through greater costs, whilst having little effect on organised crime and 'kleptocrats', who are often one step ahead of the law.

8. Hitherto, the onus has often been on financial institutions to obtain beneficial ownership information on their customers, with no corresponding requirement on those customers to either have it available or, indeed, to supply it. In the FATF's review of their standards, they found that there was very poor compliance with the elements relating to beneficial ownership in their Recommendations and very different views (both in legal frameworks and stakeholders' opinions) as to what beneficial ownership should actually mean. In seeking greater clarity, the new Recommendations adopt a tiered approach, beginning with direct or indirect control through ownership, shareholding or influence, and where this is impossible to ascertain, looking at the natural persons who actually control the activities of the company. However, in seeking to balance conflicting objectives and reach consensus, greater flexibility has been given to the approach individual jurisdictions may adopt than in other areas.

9. To some, this approach may create more problems than it solves, as inevitably some countries will have weaker measures than others, and by utilising those jurisdictions criminals will be able to frustrate the purpose of the Recommendation. One view is that no flexibility should be allowed and all companies should be required to declare their beneficial ownership and this information should be freely available publically. Others regard this as too onerous a burden on legitimate companies, particularly small ones, which would have little appreciable effect on criminals and their activities.

Data protection

" There is a genuine tension between two aims of public policy, the right to privacy and the need to know."

10. Another area where both the public and private sectors have found difficulties is in the relationship between AML/CFT requirements and data protection. The FATF have not been able to address directly data protection issues, but clearly their recommendations must deliver compliance with the principles of data protection. There is a genuine tension between two aims of public policy, the right to privacy and the need to know. Data protection requirements should operate in pragmatic and proportionate ways to achieve their aims, and the authorities should work with organisations that hold data to enable them to comply, rather than acting to punish them after the fact.

11. In recent years, the increased use of technology in AML/CFT has meant the amount of data being collected, analysed and stored has increased enormously. Hundreds of thousands of reports are made by the financial and other sectors each year to the authorities, and although this has a cumulative intelligence value, it must be balanced against individuals' rights when no action is being taken on the majority of reports. In the UK, the Information Commissioner's Office has worked with the Financial Intelligence Unit to draw up retention guidelines, with reports over six years old, and which are no longer relevant, being required to be destroyed. The private sector is gathering ever more data on their customers and their activities – this may be justified by the AML/CFT requirements placed upon them, but carries obligations to handle the

data correctly and keep it up to date.

12. There should be no sense that either data protection or AML/CFT over-rides the other. Rather the requirements should be capable of being met concurrently. AML/CFT and data protection supervisors should work together and recognise the difficulties the private sector may have. On the other hand, they may choose the best enforcement option – a bank failing to keep information on its high risk customers up to date could be regarded as failing to comply with one of the principles of data protection, but the obvious failure to mitigate serious money laundering risks may be the more serious infraction.

13. Limitations on the ability to transfer data across borders have serious implications for consolidated risk management in groups, such as global banks, which form part of the FATF Recommendations. The sharing of personal information between different institutions is even more problematic. However, data protection must not be allowed to be used as an excuse for inaction – for example, the restriction on transferring data outside the EEA is not absolute, it can be done with adequate safeguards such as safe harbours. If the will is present, it is should be possible to find a way to balance the need to protect data with transparency and the need to know or share. The private sector would derive more confidence in such arrangements with greater guidance from the authorities and internationally consistent standards.

Banks – most of the problem or most of the solution?

" failures have occurred and need to be understood and addressed, but it should not be lost that banks provide by far the majority of suspicious activity reporting and also work with law enforcement to solve real crimes"

14. Recent high profile enforcement actions, particularly by US authorities, have put banks, particularly large global banks, in the spotlight, and there is a growing perception that they are failing to adequately discharge their AML/CFT responsibilities, both as required by law or regulation and as good 'corporate citizens'. However much the actions of certain banks (and individuals within them) might merit criticism at times, there is a danger that demonising the sector will create a polarised situation, which will damage relationships between the banks and the authorities. Clearly, failures have occurred and need to be understood and addressed, but it should not be lost that banks provide by far the majority of suspicious activity reporting and also work with law enforcement to solve real crimes, often in a slightly grey area of close cooperation. This good work is often hidden and may not be even known about at board level. It is possible that focusing on the banking sector, with their ability to pay and absorb large fines, will result in missing real risks manifest in other sectors and result in defensive over-reporting by the banks.

15. However, some observers feel that even the recent fines of multi-hundreds of millions of dollars do not go far enough to change the behaviour of, or within, banks, although they clearly have put the AML/CFT compliance risk on the agenda of senior management and boards. Supervisors should also take responsibility for changing behaviours, by ensuring that those people trying to do the right things inside banks, such as compliance departments, are heard and given the authority they require to do the job. It is easy to talk of 'banks' not doing the right thing, but they are institutions made up of different departments, with competing objectives, not organisations acting in one mind. The root causes of failure need to be understood and addressed – more direct and personal punishments for senior bank officers, such as imprisonment, may be part of the solution, but cannot form the only approach.

16. Banks have invested heavily in systems and people, and no doubt will continue to do so (prompted by enforcement actions). Tuning those systems and training those people to work effectively and efficiently to address the real risk (that banks' facilities are abused by criminals), rather than to merely address the compliance risk should be a joint responsibility of both the sector and the public sector. There continues to be a feeling of information asymmetry on both sides, and a better appreciation of knowledge and capabilities would improve the outcomes.

" An increased focus on the risk-based approach allows for flexibility and innovation in achieving the required outcomes, but this is difficult to implement."

Improving outcomes

17. The revision of the FATF standards, and the consequent introduction of a 4th EU Directive on money laundering and national legislation/regulation, provides an opportunity to 'reboot' the AML/CFT system. This opportunity must not be lost in squabbles over detail or a 'push-me, pull-you' debate on policy. It is easy to find fault, less easy to agree on effective measures. Ultimately the goal must be to find ways to achieve the objectives of the AML/CF system, not in criminalising the sectors seeking to comply. It was felt that allocating more resources to enforcement of compliance issues, rather than investigating money laundering, sends the wrong signal.

18. An increased focus on the risk-based approach allows for flexibility and innovation in achieving the required outcomes, but this is difficult to implement. Firms must be encouraged to find ways to address their actual ML/TF risks, not just focus on a 'tick box' approach to compliance hoping to avoid sanction, but this requires support and understanding from the authorities, and a consistent approach to supervision. It can also only be predicated on a good understanding of risks. The old approach of saying that firms best understand their own risks has not always proved useful. Shared research on the risks and ways to approach them is one approach, with better sharing of suitable intelligence, based on a good understanding of what can be achieved.

19. Some banking supervisors are now focusing on how to foster ethical behaviour in banks, or at least how to balance ethical behaviour with the need to make profits for their shareholders. Certainly there is a need to change some behaviours, and there are many tools available to try. The big 'stick' approach of massive fines and threats of imprisonment is one, but finding some 'carrots' to reward better behaviour and individual responsibility is more difficult. Building the concept of ethics and 'doing the right thing' (not just being compliant) into financial sector training, with links to rewards such as promotion and bonus is one approach. Another potentially useful avenue would be to explore the use of accreditation to work in the industry, or to make more use of regulatory powers to ban individuals, temporarily or permanently.

20. A greater focus on outcomes must be welcomed. The system as it is configured at the moment places a lot of emphasis on the 'know your customer' stage and in producing reports for the authorities. Many of these reports are not investigated and their cumulative intelligence value has not been particularly well demonstrated. Greater emphasis on monitoring by institutions, informed by good intelligence, should produce fewer, better reports for action. If bulk data is needed for analysis, other ways should be found of obtaining it, with new legislative tools if the current comprehensive set is not sufficient. Similarly there must be good dialogue with the reporting sectors outside, both in finding effective policy solutions and in understanding trends and techniques.

Conclusion

21. Although there is a broad consensus between the public and private sectors that the AML/CFT framework is appropriately structured, there is much work to be done to make its implementation effective. The changes resulting from the revision of the FATF Recommendations provide an opportunity for the sectors to work together to agree on what is appropriate to achieve the objectives of the AML/CFT regime and how effective and efficient measures can be made to work; and how success can be measured.

22. A joint understanding, albeit from different perspectives, of the risks the system is designed to mitigate (and an acceptance that on its own it cannot eradicate money laundering, terrorist finance or any other threats) is key, and this can only be achieved in close cooperation, not independent assessment of risk.

23. Although some policy makers and supervisors work closely with, and have technical knowledge of, the private sector, greater effort should be made on both sides to build a mutual understanding and cooperation. Works needs to be done to overcome the current suspicion and polarisation, with enforcement designed to change behaviours

and achieve objectives. That said, enforcement of egregious breaches should have serious sanctions, including personal responsibility, where appropriate, as well as corporate punishments. In addition to popular measures such as sending bankers to prison, other ways to deal with miscreant individuals in the industry should be explored.

24. Ways should be found to raise the level of dialogue on policy issues and to increase the flow of intelligence between the public and private sectors. Higher quality reporting from the private sector, and less defensive volume reporting, should be welcomed, but both sides must take responsibility for making it happen. The private sector should increase its focus on monitoring, but can only do so with confidence that the authorities do not see 'know your customer' as a goal in itself. There must be a clear link between all policies and measures taken, in whichever sector, and the achievement of the objectives of the regime, which the forthcoming FATF methodology will hopefully make clearer than ever before.

Fourth European Money Laundering Directive

25. Wilton Park notes that the European Commission has published a proposal for a fourth directive on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing. The fourth directive is based on the international standards of the Financial Action Task Force and it deals with a number of the issues including:

- Beneficial ownership
  Corporations and legal entities, and trustees of express trusts, will be required to hold adequate, accurate and current information on their beneficial ownership. This information must be made available to obliged entities and competent authorities. Trustees are required to declare their status when becoming a customer.

- Sanctions
  A set of minimum principles-based rules to strengthen administrative sanctions for systematic breaches of key requirements of the fourth directive, namely customer due diligence, record keeping, suspicious transaction reporting, and internal controls of obliged entities. The minimum range of sanctions includes public statements, cease and desist orders, withdrawal of authorisation, and temporary bans of members of an obliged entity's management body.

- Data protection
  Clarification of the interaction between AML/CFT and the data protection requirements, recognising the need to strike a balance between preventative measures against money laundering and terrorist financing on the one hand, and protection of the rights of data subjects on the other hand.

  Processing of personal data is permitted in order to comply with the obligations laid down in fourth directive, including carrying out customer due diligence, on going monitoring, investigation and reporting of unusual and suspicious transactions, identification of the beneficial owner of a legal person or legal arrangement, sharing of information by competent authorities and sharing of information by financial institutions. However the personal data collected should be limited to what is strictly necessary for the purpose of complying with the requirements and not further processed in a way inconsistent with Directive 95/46/EC. In particular, processing of personal data for commercial purposes is strictly prohibited.

  The fourth directive includes a maximum retention period of 10 years for records. There is a requirement for group-wide policies and procedures to cover data protection in relation to sharing information within the group, and the directive also recognises the need for the personal data of persons who report, and natural persons who are the subject of reports, to be protected.

- International obliged entities
  Credit and financial institutions which have branches and subsidiaries located in third countries where the legislation is deficient should apply the fourth directive or notify the competent authorities of their home Member State if this is impossible. The European Supervisory Authorities will draft regulatory technical standards to specify additional measures and minimum actions to be taken by firms in this situation. Ultimately the competent authority may request the financial group to close down its operations in the host country, if appropriate.

- Risk-based approach
  The fourth directive recognises that the use of a risk-based approach is an effective way to identify and mitigate risks to the financial system and wider economic stability in the internal market. Evidence-bases measures to be implemented in three main areas:

(i) Member States are required to identify, understand and mitigate the risks facing them, and where appropriate make these risk assessments available to obliged entities to enable them to identify, understand and mitigate their own risks. These assessments are intended to inform the allocation and prioritisation of resources;

(ii) Obliged entities are required to identify, understand and mitigate their risks, and to document and update these assessments. This process must subject to senior management oversight. As regards simplified due diligence, the third money laundering directive was thought to be overly permission so for this reason future decisions on when to apply simplified due diligence will need to be made on the basis of risk, taking into account the non-exhaustive list of factors in Annex II;

(iii) Resources of supervisors can be used to concentrate on areas where the risks of money laundering and terrorist financing are greater. The European Supervisory Authorities have been tasked with issuing guidance on the factors to be applied when conducting risk-based supervision, within 2 years of the date of entry into force of the fourth directive;

(iv) The European Banking Authority, European Insurance and Occupational Pensions Authority, and European Securities and Markets Authority, shall provide a joint opinion on the money laundering and terrorist financing risks affecting the internal market, within 2 years from the date of entry into force of the fourth directive. The European Commission is then required to make this opinion available to Member States and obliged entities.

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