Policing Financial Services

Surveying the Anti-Money Laundering Regulatory Regime

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Summary

The anti-money laundering and combating the financing of terrorism international (AML/CFT) standards were created over twenty years ago by the world's biggest economies. Since then, the standards have become increasingly implemented globally. They have established a regulatory regime in which many different public institutions play a role. The majority of these public institutions are not traditionally involved in crime fighting or counter-terrorism so certain challenges exist, especially for those in developing countries. For instance, the AML/CFT rules dictate how people of all types can connect – or not connect – to the financial sector.

The paper provides an overview of what the standards mean for public institutions and highlights challenges that have surfaced to date. The intended audience is the development community so that it is better informed in its efforts to improve the application and revision of the standards, which is currently underway.

High-level findings:

- The regime that countries must put in place is complex and there are many interdependencies. The effectiveness of the system relies highly on ensuring that all key elements are in place. If one part of the system is missing, it is likely to greatly hinder effectiveness of the rest.
- Interaction between the standard setter and developing countries, especially the poorest, is very little. There has been some improvement in dialogue via intermediary organizations but a direct link has not been established. This will have an impact on how the standards are written as well as their effectiveness in these countries.
- Interpretation of the standards has prompted countries to create regulatory frameworks that are highly data-driven. This means that effectiveness hinges greatly on a country's ability to both collect data from a great number of sources as well as analyze it. Whether this is the right approach for developing countries with low capacity needs to be assessed.

1. Introduction[1]

A New Approach to Fight Crime

The black market for narcotics exploded in the 1970s and 80s, doubling in size several times. Drug trafficking became an organized criminal activity that often spanned international borders. Governments responded by passing legislation to halt not only drug trafficking itself, but the financial backbone on which it relied. Targeting criminal profits is thought to be a powerful weapon for justice – making crime less attractive in the first place. It also arms prosecutors and police with tools to strike at the criminal support network, which includes persons that aid the criminal organization but not directly commit the underlying crime itself (lawyers, accountants and so on). This is reflected in the United Nation's Vienna Convention (1988), which was the first global initiative to stem the tide of illicit profits from the narcotics trade. In the spirit of this Convention, G7 leaders in Paris in 1989 launched a task force to assess past efforts and make recommendations to further prevent the financial system from being abused by drug trafficking organizations. This was the birth of the Financial Action Task Force (FATF). [2]

Anti-Money Laundering was originally an attempt by countries to fight the growing drug trade. It has since expanded to cover many kinds of crime, including terrorist financing.

The FATF rapidly made recommendations to create national systems to detect and stop movements of criminal money. The system would provide intelligence to law enforcement to catch criminals *and* those that supported them. To do this, the FATF recommended that countries take a number of specific measures. Outlined in more depth later in this paper, the measures are far-reaching. They call for parliaments to pass legislation; new powers to be given to a group of public authorities; parts of the private sector to monitor their customers' financial activities and report criminal intelligence data to these authorities; and government agencies to increase their capacity to oversee compliance and cooperate with each other and internationally.

Implementing these recommendations in countries is a lot of work and requires enormous coordination, budgetary dedication and, perhaps most importantly, political willingness. There is no doubt that the drafters of the recommendations were aware of the burden yet they believed the benefits of implementing the recommendations would be well worth the effort.

In 1990 when the FATF first announced its Forty Recommendations it was formed by the G7 nations, the European Commission and eight other countries. Its member and scope has expanded. Today, it has thirty-six members and multiple observers who focus on more than just drug money[3]. There are

[1] The author would like to express great appreciation to the following experts for their efforts to improve this work: Ms. Claire Alexandre (Bill and Melinda Gates Foundation), Mr. Pierre-Laurent Chatain and Mr Wameek Noor (World Bank), Ms. Raadhika Sihin (Alliance for Financial Inclusion), Prof. Louis DeKoker (Deakin University), Mr. Horst Intscher (Former head of FINTRAC Canada), Ms. Maria Stephens (US Agency for International Development), Prof. Bill Mauer (University of California-Irvine), Ms. Joy Geary (Independent), Mr. Mohsin Mohi-Ud Din (Columbia University) and others from intelligence, law enforcement and policymaking who requested anonymity.

[2] G7 Leaders' Communiqué, Paris 1989.

[3] For example, human trafficking, piracy, sexual exploitation, corruption, environmental crime, insider trading, illicit arms sales, fraud, kidnapping, counterfeiting currency, and forgery. In many countries, the laundering of money from *any* crime is prosecutable under anti-money laundering laws.

also FATF-styled regional bodies, which are essentially local FATFs whose combined membership covers most nations on the planet.

Figure 1 Major Moments in AML/CFT International Standard Setting

Toward Standard-Setting

Through the years, the FATF "recommendations" have become the de facto standards for anti-money laundering. They have been revised twice and a third revision is currently underway. The scope of criminal activities whose financial movements are considered money laundering has greatly grown in each revision. Focus is no longer solely on drug profits but other crimes such as human trafficking and illegal logging. Perhaps the biggest, and most controversial, expansion of the standards was after the attacks on New York and Washington in 2001 when combating the financing of terrorism was added to the FATF mission. Resultantly, private entities affected by the standards have been increased. Non-financial businesses and professions and non-profit organizations now fall into their purview[4].

Country compliance with the standards is important. First, the standards are intended to tackle criminal activities that do not respect country borders so global implementation is crucial. Furthermore, countries can experience severe consequences if they do not comply. National AML/CFT regimes are assessed by the FATF, regional bodies, the World Bank and the IMF. The assessments are called "mutual evaluations" because officials from the various bodies recognize each other's findings. Countries that are found to be non-compliant or non-cooperative can face a variety

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[4] Financial Action Task Force. *New Anti-Money Laundering Standards Released*. Berlin. 2003. http://www.oecd.org/dataoecd/45/46/33693678.pdf

of name-and-shame actions against them. For instance, in the year 2000, the Cook Islands were flagged as non-cooperative with the FATF standards. The effect was hard: resulting in foreign banks scrutinizing any transactions that involved the country – and prompted the country to quickly pass legislation and take other measures to become more compliant with the FATF. To appreciate the level of impact, the enormous flight of foreign banks and offshore trusts reduced government revenue from the sector 70% in just the first three years of blacklisting[5]. In Liechtenstein the impact was severe as well; government revenue from the sector dropped in half after two years of being on the blacklist[6]. Since FATF's creation in 1989, dozens of countries have been blacklisted and un-blacklisted[7] and the great majority of those have been developing countries[8].

Estimates on the amount being laundered vary between billions and trillions of dollars but no one questions that criminals use the financial system to move their profits.

What are the standards? The Forty Recommendations on Money Laundering and Nine Special Recommendations on Terrorist Financing can be divided into five parts[9]:

1. **Legal System.** Ensuring that laws give authorities power to prosecute, and investigate criminals; seize and confiscate their assets; and cooperate with each other. Some sample questions that are asked in assessments of country compliance with this part of the standards include: *How extensively does the law define money laundering? How dissuasive are the penalties for it?*
2. **Preventive Measures.** Putting in place a regulatory regime that ensures key segments of the private sector are adequately identifying customers; keeping appropriate records; reporting suspicions to authorities; are supervised properly; have internal audit and compliance systems; and have measures to ensure legal entities (i.e. corporations, trusts, etc.) and are not fronts for criminal interests. Some sample questions that are asked in assessments include: *Are banks required to keep customer records for at least 5 years? Are accountants obligated to report suspicious financial activity to the appropriate authority? Do financial institutions verify customers' identity appropriately?*
3. **Financial Intelligence Unit (FIU).** Establishing an intelligence agency that: analyzes information on suspicious financial activities; identifies leads for law enforcement; supports prosecutors with evidence of illegal funds transfers; cooperates with authorities domestically and internationally to pursue investigations. Some sample questions that are asked in assessments include: *Is the FIU independent? Does the FIU have the authority and resourcing to share intelligence information to other relevant authorities?*

[5] International Monetary Fund. *Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)—Report on the Review of the Effectiveness of the Program*. 2011.

[6] Sharman, J.C. *The bark is the bite: International organizations and blacklisting*. Review of International Political Economy, 16:4, 2009, pp. 587–590.

[7] The formal method of blacklisting countries has changed through time. Formerly the FATF blacklist was called the list of "Non-Cooperative Countries and Territories" but since 2006 all countries have been removed from it. In 2009 the FATF began issuing "statements of concern" to blacklist countries. The effects of either method remain the same.

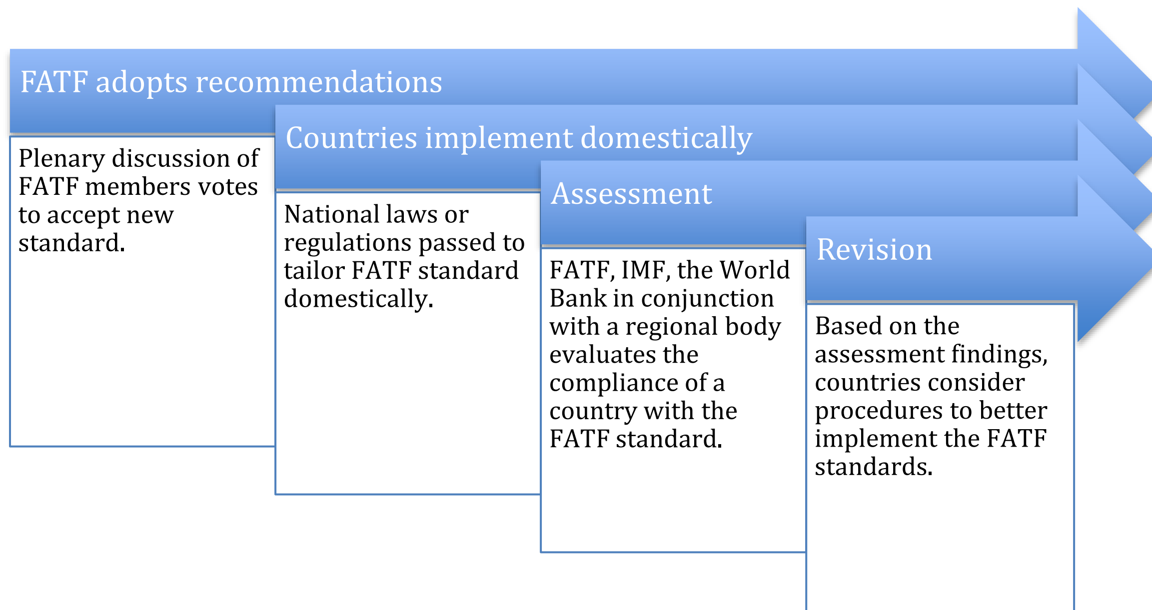
[8] Financial Action Task Force. *Non-Cooperative Countries and Territories: Timeline.* 13 October 2006.

[9] Schott, Paul Alan. *Reference Guide to Anti-Money Laundering and Combating the Financing of Terrorism*. Second Edition. The World Bank and the International Monetary Fund. 2006.

4. **Mechanisms for Cross-border Cooperation**. Creating systems that allow domestic agencies (prosecutors, police and so on) to cooperate with each other across borders. Some sample questions that are asked in assessments include: *Do authorities have an effective way to send and receive information from foreign jurisdictions? Does the country have effective mechanism to respond to a foreign country's request to seize suspected laundered money?*
5. **Additional Elements for Combating the Financing of Terrorism**. These components are intended to complement and build on the AML measures mentioned above. Some sample questions that are asked in assessments include: *Can authorities cooperate with foreign jurisdictions on terrorist financing related issues? Is terrorist financing a crime? Has the country ratified relevant UN conventions on terrorist financing?*

The FATF requirements are extensive and, although stated broadly, some expectations have developed on what is expected of the public institutions involved in implementing them. The following section will outline these institutions and how they fit into the FATF regime.

Figure 2 Implementing the Standards: From FATF to Countries

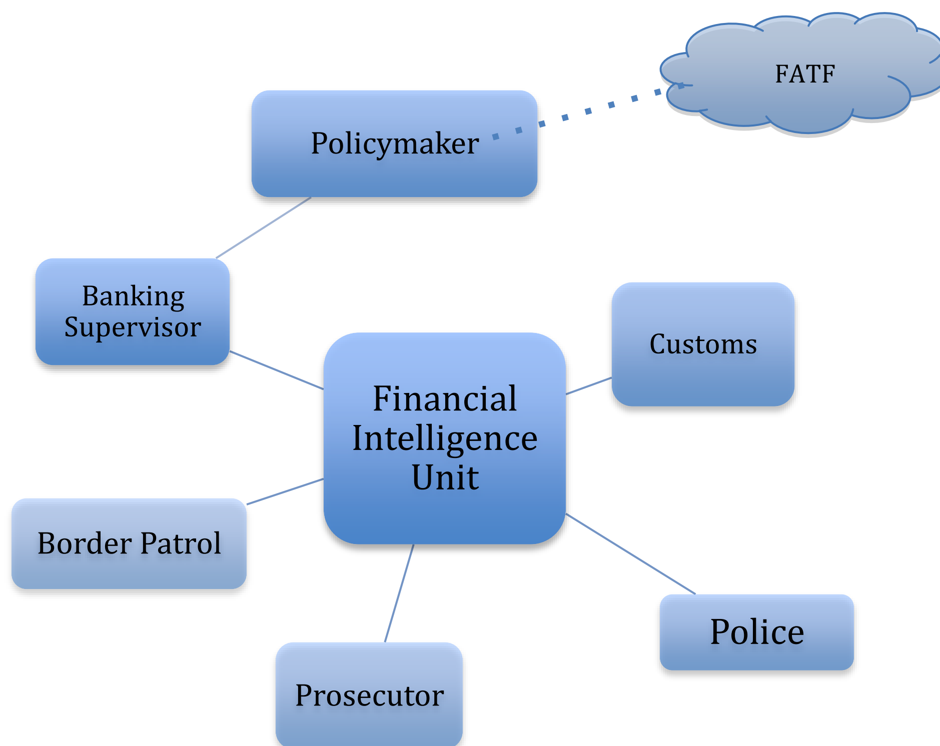


2. The Institutions and What They Do

The FATF regime envisions the participation of a wide group of private entities, familiar with AML/CFT issues. These private players which are financial institutions and "designated" non-financial businesses and professions, should report suspicious customer activity to public authorities and develop internal processes to ensure they are not compromised by criminal interests. Public institutions, in the FATF framework, put the data together to monitor, investigate and ultimately prosecute. They also oversee the private entities to ensure they have processes in place that are robust in preventing their services from being used for criminal purposes.

The different roles that public institutions play in the AML/CFT regime are often similar to those they have in the broader financial regulatory system. For instance, just as the Central Bank (or independent banking authority in some countries) is charged with supervising banks' prudential risk management practices, it frequently does the same for AML/CFT. Countries rolling out the FATF standards through legislation may have to expand the mandate and capacity of public institutions to give them authority to regulate AML/CFT matters. In this section we will outline the key roles each public institution holds in the typical FATF regime.

Figure 3 Mapping the Typical FATF Regime



Policymakers

In most countries the Ministry of Finance, the Treasury or Justice lays out the basic policy framework for the AML/CFT regulatory regime. In some countries this even means it submits draft legislation to parliament that empowers authorities through legal mandate and budget resourcing. In others it

means it writes AML/CFT regulations itself. In still others it may simply approve regulations to ensure their consistency with policy after the Central Bank drafts them.

Whatever its specific task, perhaps most important is that the Policymaker is almost always the institution that determines the risk appetite for the AML/CFT regime. How strict do supervisors have to be with financial institutions? The overall tone set by the Policymaker is ultimately what defines how the regime views what are acceptable risk-taking practices and what are not. If the Policymaker indicates that a certain practice is too risky (i.e. it provides criminals with too much of an opportunity to launder money), the Central Bank or banking supervisor will flag it in banking inspections and rebuke financial institutions that use it.

Box 1 – Example from Latin American Ministry of Finance

In one Latin American country, financial institutions have struggled with a rule to require customers to provide identity documents at all times for payment services. The rule is in place mainly for anti-money laundering purposes. They asked the banking authority in 2010 to issue guidance that would permit some exemptions. The banking authority agreed, informally acknowledging that there are some situations where customer identity documentation would not be necessary. It then drafted a guidance note that would legally clarify when exemptions could be applied.

The standing procedure for guidance notes is that they will be sent to the Ministry of Finance to review, make changes or approve. In this case, the Ministry determined that the guidance was not in line with the country's AML policies (which were designed along its understanding of the FATF standards) and that a full exemption from customer identity document collection would not be acceptable. Because the Ministry sets ultimate policy and determines the country's risk appetite, the guidance was not released.

Source: Fieldwork interviews in 2010

Banking Supervisor

The Banking Supervisor, often the Central Bank or banking commission, translates the high-level policies into specific rules and enforces them in the private sector. It does this by issuing regulations and guidance to financial institutions on what their responsibilities are. Furthermore, the on-the-ground oversight, or supervision, of financial institutions' activities is often through this same public institution so it both makes the specific rules and supervises their application to business.

Most often AML/CFT supervision is included in a Banking Supervisor's work portfolio, however there are a significant number of exceptions to this supervisory model, which will be discussed later[10]. Typically, the Banking Supervisor performs an inspection of financial institutions, reviewing documents, financial records, and interviewing staff and management. AML/CFT is a small – and very often new – part of their focus.

[10] See Chatain et al. Preventing Money Laundering and Terrorist Financing: A Practical Guide for Supervisors. World Bank. 2009. Chapter 1.

It is important to note that the type of inspection can vary greatly depending on the country's development level. Offsite inspections usually occur on a one to two years basis. Onsite inspections are less frequent.

Although onsite inspections offer critical insight into financial institutions, the chronic lack of resources available in developing countries makes offsite inspections the norm. Onsite inspections occur in a few, targeted institutions that are seen as highest priority or where an incident has been raised. Countries vary greatly on the frequency at which onsite inspections occur but it is not uncommon for a medium sized bank to go many years without one[11]. Priority of onsite inspections is set by a number of possible criteria. In some countries, it is on a rolling basis where financial institutions that have not been inspected for the longest time are first up. In others it is based on risk with geography, relative size, product portfolio or other trait making one bank more of a priority for inspection than others.

A broad group of public institutions are involved in implementing the standards. In many cases they require mandate and budget, usually by legislation, to carry out their AML/CFT role.

What happens after an inspection? Banking supervisors issue a report, some of which they share with the financial institution. The report describes the internal systems in place, the level of regulatory compliance and deficiencies and recommendations. Depending on the severity of the deficiency, a financial institution faces either a warning or a sanction. Under the FATF rules, the supervisory authority, usually the Central Bank, has the independence and authority to issue the sanctions itself for AML/CFT violations.

In embryonic AML/CFT regimes that are in absence of a dedicated agency or department to AML/CFT analysis (called a Financial Intelligence Unit, discussed in the next chapter), the supervisor maybe the recipient of suspicious activity reports from financial institutions. When this occurs, it may fall upon the supervisor to assess the risk and determine whether to pass it on to the relevant law enforcement agency for investigation.

Box 2 – Example of the Central Bank of Zambia

Zambia's Central Bank regulates most of the country's financial sector. It has been empowered through the AML law to regulate both banks and other entities involved in currency movement. It also has mandate to supervise the entities that it regulates. Supervisors evaluate the AML controls regulated entities have in place, including customer due diligence measures, transaction monitoring systems as well as staff integrity.

The Central Bank receives regular reports from regulated entities on their activities, including information that may be relevant for AML (if there were any suspicious transactions, etc.) The Central Bank may refer cases to or informally discuss with law enforcement or other relevant public institutions when potential AML issues arise.

Source: Author interviews with Bank of Zambia staff, 2009.

[11] Based on a review of over twenty developing country assessment reports.

Law Enforcement Agencies

Covering a wide swathe of organizations within government is what the FATF calls Law Enforcement Agencies. Law enforcement includes agencies such as the national police, customs officials and border patrol. For AML/CFT, the key requirement is that they are empowered through resourcing and legal authority to investigate potential AML/CFT cases. Their participation is highly important as they can link, or at least provide information that helps link, the underlying crime to the money being laundered. In the case of terrorist financing, police may already be investigating a potential terrorist group/person, which could offer valuable intelligence to combat terrorist financing. For example, border patrol and customs officials are identified as key to prevent cross-border movements of illicit cash.

Ultimately, the FATF standards envision law enforcement as a critical piece of the AML/CFT puzzle. These agencies should be able to retrieve or be provided with enough intelligence and evidence to bring a prosecution forward.

Box 3 Example from Pacific Region Customs Agents

The FATF standards require that law enforcement have sufficient powers to carry out their duties to detect suspicious activity. If agencies do not have legal power to do so, their effectiveness is severely limited.

An instance where this is not the case is a Pacific Rim country where customs agents do not have the authority for search and arrest. They question foreign arrivals but cannot act if they have strong suspicion or even evidence that a person is bringing in illegal substances or criminal monies. To search or arrest the person, they must wait for national police to arrive. It is not uncommon for the suspect to be gone by the time the arresting/searching police arrive.

Source: Author interviews in the United Nations Counter Terrorism Implementation Task Force, 2008.

Judicial Authorities / Prosecutor

Once enough information is gathered to make a case against a suspected criminal or organization, it is passed on to the court system for prosecution. It is critical that prosecutors have legal mandate to pursue AML/CFT cases. This virtually always requires that these crimes be codified in law. The timing and method of involvement of prosecutors varies greatly from country to country. The FATF standards do not specify how cases should be brought to the court system, however sanctions ought to be dissuasive and proportionate.

Lines of communication between the prosecutors, supervisory authorities, police and other relevant bodies (including the FIU discussed in the next chapter) should be established. The prosecutor's case very much depends on the information retrieved from these other public sources yet it is incumbent on the prosecutor to filter through it and extract the evidence that would stand in a court of law. Historically speaking, AML cases have been often put aside while prosecutors concentrate on acting against criminals for the underlying crime instead of the money laundering that came later on. .

Another possible function of judicial authorities is in enforcing compliance. They can do this by supporting the Central Bank or other AML/CFT supervisory authority. In many countries the

prosecutor is called in by banking supervisors when there is a case of severe non-compliance with AML/CFT regulations. Typically the case is a financial institution whose failure to comply is so great that it borders on negligence – or even complicity with criminal interests. The Central Bank may refer the case to be prosecuted in the criminal court system for sanctioning in rare cases.

Other Competent Authorities

Although the FATF standards' primary focus is financial institutions, they also cover a selection of "Designated Non-Financial Businesses and Professions" (DNFBPs). This group includes lawyers, dealers in precious stones, real estate agents and several others. Depending on the risk exposure of each group in a given jurisdiction, countries are instructed to bring them into the AML/CFT regulatory regime. The FATF has a special recommendation for non-profit organizations, calling for a review of the sector to ensure that terrorist financing cannot be carried out through them. Countries that determine that a particular non-financial sector is vulnerable may create or apply existing regulations to bring it into the AML/CFT regime. This means that more regulatory authorities could be involved than the ones listed here. For instance, it is not uncommon for casinos to be regulated by a supervisory body or for real estate agents to be licensed and regulated by a public authority of some kind. Should a particular non-financial business or profession be assessed as vulnerable to criminal abuse, these supervisory authorities may institute AML/CFT rules for the sector.

Box 4 Non-bank Supervision in Botswana and Macao, China

Botswana Non-Bank Financial Institutions Regulatory Agency

To improve coverage of the country's non-bank financial institutions, Botswana passed legislation in 2007 that created a regulatory authority to issue regulations and supervise the sector. As the agency comes into existence, the Bank of Botswana (the central bank) will transfer responsibilities to it. The country assessment that had rated the country generally low in compliance with the FATF standards, predicted that the new agency would give Botswana an opportunity to improve.

Gaming Inspection and Coordination Bureau in Macao, China

The 2001 assessment of Macao's regime found it lacking in oversight of the casino sector. The country took a number of legal steps to ramp up its implementation of the FATF standards in this area, including having the casino supervisory body issue regulations on identifying customers during transactions. The 2007 assessment recognized the advances in AML/CFT, including by competent authorities in the non-financial sectors.

Sources: Mutual Evaluation Reports of Botswana for 2007 and Macao, China for 2001 and 2007

3. Financial Intelligence Units

Certainly the most sweeping institutional shift established under the FATF regime is the Financial Intelligence Unit (FIU). These authorities have flourished throughout the world over the past twenty years as international pressure to implement the FATF standards swelled. An FIU is[12]

> "a central, national agency responsible for receiving (and, as permitted, requesting), analyzing and disseminating to the competent authorities, disclosures of financial information: (i) concerning suspected proceeds of crime and potential financing of terrorism, or (ii) required by national legislation or regulation, in order to counter money laundering and terrorism financing."

Given that the approach the FATF uses to tackle money laundering and terrorist financing is highly data-driven, it is not surprising that it also mandates that an authority be set up to store, evaluate and share data across agencies. The purpose is to minimize fragmentation of the data collected. Criminals abuse the complexity of financial systems to avoid being detected by spreading their illicit activities over several banks, sectors and geographies. As the central repository of relevant information, the FIU can put together these pieces to help law enforcement investigate a case and then assist the judicial authorities bring that case to court.

The standards call for a special intelligence agency, called an FIU, to be established. It analyzes information from public and private sources to spot suspicious behavior and potential evidence for prosecutions.

What kind of information do FIUs receive? FATF standards emphasize the importance of suspicious transaction reports from financial institutions and others. The standards encourage countries to consider cash transaction reporting so when a person transacts above a certain threshold, it is known to the FIU. Moreover, FIUs should have access to financial, administrative and law enforcement data. Specifically, this means information from the Central Bank or banking commission (e.g. bank licenses, banking supervision reports); police and border patrol (data from investigations, criminal records, customs declarations, border crossings); and other authorities (birth records, marriage certificates, company ownership). All these data sources give FIUs a large stock of intelligence to review in order to detect possible money launderers and terrorist financiers and pass it on to law enforcement.

Box 5 – What is the Egmont Group?

Most counties' FIUs are now connected through an informal association called the Egmont Group, named after the location of their first meeting at the Egmont-Arenberg Palace in Belgium in 1995. The purpose of the group is to explore how countries can improve cooperation in AML/CFT and share knowledge and expertise.

Membership is not open to anyone. FIUs must meet the Group's definition of an FIU (see above) and subscribe to the Group's principles. The principles outline necessary measures for confidentiality and how information shared between FIUs can be used.

[12] The definition comes from the Egmont Group of FIUs. www.egmont.org

The Group is informal but meets on an annual basis in a plenary session, which includes FIU heads from its members. Working Groups on particular issues may meet more frequently, however, and present findings or recommendations at the plenary.

Source: The Egmont Group Statement of Purpose as well as the Egmont Group website.

The FATF standards do not specify where an FIU should sit in the government's organization nor whether it should have formal investigative powers. In countries where the FATF standards have not been fully implemented, financial institutions may still report suspicious activity by customers to law enforcement directly or through the Central Bank, which then decides whether or not to report it to law enforcement. Most countries do have a formal FIU; however the type of FIU varies considerably. The following section[13] outlines the three main types of FIUs though this is an arbitrary analysis and several countries have created FIUs that are fusions of all three types described here.

1. Administrative Model
2. Prosecutorial Model
3. Law Enforcement Model

Administrative Model

The most common of all types of FIUs is the administrative model. Administrative FIUs are typically found as an independent or semi-independent agency of the Central Bank or sometimes the Ministry of Finance. FIUs in this model are seen to be an intermediary between financial institutions on the one side and law enforcement on the other. This is a significant advantage of an administrative FIU. Because the FIU is not attached to the criminal justice system and part of a regulator, financial institutions are expected to be more comfortable to disclose confidential information. They know that the FIU's mandate is limited to financial crime investigations and not as far reaching as law enforcement or judicial authorities. Also, this FIU type has a sole focus so there is no risk that other criminal justice issues would take priority away from AML/CFT.

Administrative FIUs are sometimes viewed as weaker because they generally do not have the authority to oblige financial institutions to take action. This can be particularly relevant in terrorist financing investigations where ordering a bank to immediately freeze suspected terrorist assets could be necessary. Depending on the country, administrative FIUs may also be seen as weak due to where they sit in the government's organizational structure. Political interference in an administrative FIU could occur if a politician such as the Minister of Finance has authority to oversee it.

Prosecutorial Model

Administrative FIUs may experience difficulty in robust banking secrecy jurisdictions[14]. FIUs that are under the authority of the prosecutor's office, on the other hand, can be well placed to retrieve

[13] For deeper coverage see *Financial Intelligence Units: An Overview*. International Monetary Fund and the World Bank. 2004.

[14] Places where protections on the account owner's information are so high that their identity and financial activities are nearly impossible to share outside of bank staff.

information from financial institutions where there is a high level of legal protection around financial data. They also have the power to immediately interview, arrest and search suspects. Yet, the fact they have these powers could impede them from having a relationship in which financial institutions feel comfortable to voluntarily disclose information. Banks and others are typically resistant to share information without the trust that the disclosure will not be used against them.

Law Enforcement Model

Another FIU model that is similar to prosecutorial one is a law enforcement FIU. In this type, countries make their FIUs a specialized section of the police force. In such law enforcement models, staffs have all or most of the same powers of the police. This means that they can search, interrogate and arrest suspects. Law enforcement FIUs have access to other kinds of information that other models may not. For instance, information sharing between national intelligence services and police is common, allowing law enforcement FIU to view information that other types may not.

Operationally, the FIU is a key part of the FATF regime. It is the center for intelligence collection, analysis and sharing across agencies.

However, just like prosecutorial FIUs, this makes strong information-sharing relations with financial institutions challenging. They also may lack the right human resourcing to process the enormous amount of specialized financial, compliance or other information that can be crucial in uncovering "dirty" financial institutions that are complicit with criminal interests. If the financial skillset in the police is particularly weak, they may be poorly equipped to identify money laundering through complex financial products such as securities or derivative investments.

Relations Management with the FATF

The FIU is the center for AML/CFT intelligence and domestic and international information sharing but it is almost never the representative to the FATF or FATF-styled regional body. Discussions in the FATF are generally about high-level policies so FIUs do not typically attend FATF meetings. The domestic policymaker, often the Ministry of Finance or Treasury, is the primary representative of the country in the FATF. This makes it imperative that the representative is familiar with the issues on the ground and familiar with the way the regulated sectors work, and the criminal environment of their country. High-level standards set at an international level are useful when they benefit from the practical knowledge of implementing them in practice.

Role in the FATF Assessments

The FATF meets semiannually once in Paris where it is based and once in the country that holds the yearlong rotating FATF presidency[15]. Countries send their representatives to the plenary sessions to debate the listing or delisting of countries on blacklists, interpret the FATF recommendations, identify best practices, launch working groups to study issues and cover other operational issues such as the results country assessments.

Countries are assessed first by themselves in a self-assessment questionnaire and then by different international organizations, including the World Bank, the IMF, a FATF-styled regional body or the

[15] However, sub-groups can meet more often but do not have the authority to change FATF standards.

FATF itself. Teams of experts in law enforcement, financial supervision, law and other relevant matters are assembled. These experts sometimes work at the international organization that is officially leading the assessment teams also include specialists from foreign countries. It is not uncommon for a banking supervisor or FIU staff from one country to be part of an assessment team for a neighboring country, for example.

Countries appoint a lead coordinating agency for their assessment, which is often the FIU (but sometimes others such as the Ministry of Finance/Treasury or Central Bank/Banking Commission). The coordinating agency fills out the self-assessment questionnaire and ensures the outside assessment team has the right access to other domestic authorities and private institutions for interviews, information and documentation. The process is quite an undertaking because of the large amount of time required, number of public institutions involved and the varying level of appreciation each will have for information requests. The level of prestige and authority the coordinating agency has domestically will hold great impact on how well other institutions are committed to the assessment in practice.

Assessments of countries' compliance with the FATF standards are critical. The FIU in most countries coordinates the assessment process but the Ministry of Finance or Treasury usually manages relations with the FATF.

At the end of the onsite assessment visit, the initial findings are usually discussed with authorities before the assessment team's departure. The IMF and World Bank even leave a draft report with authorities just after their team's onsite visit. The coordinating agency offers additional information and may challenge findings of the team. Most differences are resolved before the team brings the Mutual Evaluation Report to the FATF or FATF-styled regional body plenary session for adoption, but it is not uncommon for disputes to be debated for judgment by the plenary itself. Since most developing countries are not members of the FATF, their assessment results are presented at the regional body level. The coordinating agency will typically participate in the debate alongside the Ministry of Finance, the regular representative.

When the assessment is adopted, their representatives will return home with a to-do list based on the recommendations from their assessment report. Developing countries are often tasked with building capacity in AML/CFT institutions, especially in terms of budgetary and human capital resourcing. Timing of the implementation of the recommendations is important. For example, it is of little use to build an expensive FIU data center if financial institutions are not compelled by law or regulation to report data to it. The FATF has released some high-level guidance on what standards to focus on first as countries develop their regime[16].

Assessments are sometimes updated when the domestic framework has changed. Countries that have been cited in the assessment as having a severe shortcoming in its AML/CFT regime – non-existent FIU or no AML law, for example – may make corrections and report them back to the FATF or FATF-styled regional body to issue an update on their assessment. Moreover, recently assessed countries often give the FATF or regional body regular news on progress toward compliance in line with the assessors' recommendations. Since assessments are usually done on average twice a decade

[16] Financial Action Task Force (FATF). *Guidance on Capacity Building for Mutual Evaluations and Implementation of the FATF Standards within Low Capacity Countries.* 2008.

for a country, such interim updates can help countries improve their international standing and reduce any pressure they faced on deficiencies that were reported in the Mutual Evaluation Report.

4. Common Challenges in Developing Countries

The FATF framework is intended to be comprehensive which makes it a challenge for all countries to make themselves fully compliant. In fact, no country has ever been assessed fully compliant with all the FATF recommendations and some recommendations have never been assessed as fully compliant in any country. The legal, institutional, diplomatic steps countries must take are extensive, expensive and require a high degree of buy-in across public institutions. Countries, both poor and rich, struggle to meet all the FATF compliance criteria.

> The standards are difficult for all countries to implement but the challenges in developing countries are particularly hard to overcome.

Moreover, and with some notable exceptions, there is a clear trend positively linking the level of FATF compliance with the level of economic development. Candidly said, wealthy countries generally do better in assessments than developing countries[17]. Reasons behind this trend originate from these countries' approach to and capacity in implementation. It is may also be due to the institutional strategy the standards themselves promoted to mitigate money laundering and terrorist financing[18].

This section aims to highlight these issues and suggests that there is no single cause for the generally poor levels of compliance in developing countries. For instance, even when public institutional capacity is not a problem, countries may still lack the political will to make AML/CFT a priority. This raises the question about the effectiveness of the overall strategy. Is it working? Providing evidence that compliance with the FATF standards significantly reduces crime needs to be a top agenda item for those promoting – and enforcing – the regime internationally. This section covers as such:

- Institutional Capacity
- Coordination among Public Institutions
- Prioritization
- Governance
- The Overall Strategy

Institutional Capacity

There is no doubt that there is a strong connection between a country's institutional capacity and its compliance with the FATF standards. Staff training, numbers and budgetary resources are critical to build the well-functioning AML/CFT regime envisioned by the standards. Developing country governments lack the budgetary resources enable them to create the plethora specialized public institutions that developed countries often have. Moreover, even when some specialized agencies do exist, such as an FIU, they are often under equipped, understaffed or undertrained.

[17] Yepes, Concepcion Verdugo. *Compliance with the AML/CFT International Standard: Lessons from a Cross-Country Analysis*. International Monetary Fund. 2011.

[18] Also mentioned by the IMF is the assessment methodology, which is so comprehensive that it may not permit assessors to focus more on sectors of greatest importance/vulnerability to a particular country. See: International Monetary Fund. *Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)—Report on the Review of the Effectiveness of the Program*. Legal Department. 2011. Page 11.

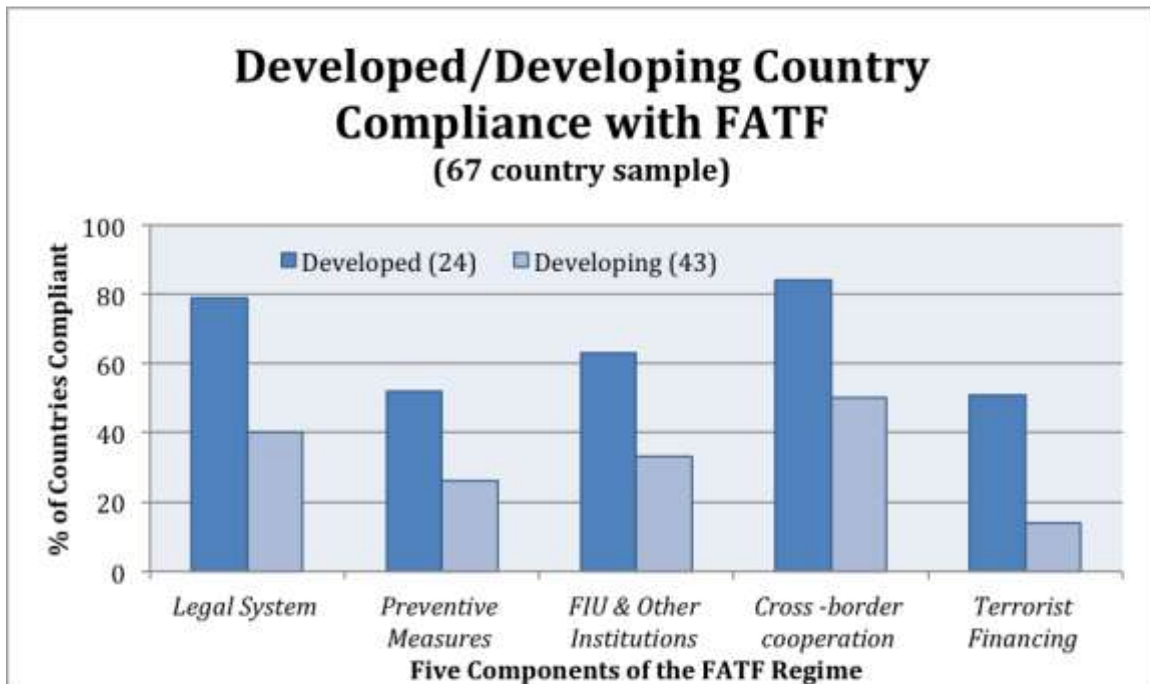


Figure 4 – Author created graph from FATF and World Bank data (2008)

What happens when an agency has insufficient budgetary capacity or staff training to play its role in the AML/CFT regime? This often results in what one African FIU chief jokingly called, "suffocation by paper"[19]. Piles of documents build up: Central Bank reports, suspicious transaction reports from financial institutions, customs declarations, police records and so on can be a lot to review. Without enough trained staff, investigations will be very slow and highly inefficient.

Empirical evidence indicates that the size of the financial sector in an economy is a function of the country's FATF compliance. This is often true even in places where the financial sector is relatively small, which is sometimes perceived as "easier" for public authorities to oversee. Contrary to this view, a recent analysis of 161 country assessment reports by the IMF[20] demonstrates that there is a clear link between a country's compliance with the FATF and the size of a country's financial sector. Countries that have a big (employment number, market size and so on) financial sector are more compliant than those with small financial sectors. This could support the notion that finding enough technical expertise is challenging in the latter group of countries. Even if a country's budget is sufficient to create the public institutions envisioned by the standards, it does not guarantee that there are enough technical experts available to be effective.

Probably a result of budget or expertise limitations, overwhelming process of data is a common part of a banking supervisor or FIU analyst's day in low capacity countries. This makes many tasks overwhelming and incredibly inefficient. FIUs in more advanced countries provide analysts with training; computer access and the documents handled are usually electronic. Adequate skills coupled with technology allow for quick searches of data that provide timely and meaningful responses to law enforcement or judicial system requests. The fast information delivery allows investigations to

[19] Interview with a Southern African FIU head in 2009.
[20] Yepes, Concepcion Verdugo. *Compliance with the AML/CFT International Standard: Lessons from a Cross-Country Analysis*. International Monetary Fund. 2011.

proceed more efficiently. It helps criminal justice officials have what they need to get subpoenas, arrest criminals and successfully prosecute a case. The frequent slowness of FIUs in developing countries often means they provide little support to the other public institutions, which have to rely on their own information silo to proceed.

The FATF approach is highly data-driven. The FIU is expected to have the capacity to store and efficiently analyze huge amounts of diverse data. The fact that developing country FIUs often lack this budget and staff technical capacity contributes to such countries being rated as non-compliant with the relevant FATF standards. Moreover, it is not just an issue with FIU capacity. Many developing countries lack sufficient training of police or border patrol. Judges and prosecutors regularly have too little experience or specialized knowledge to handle the complexities of a money laundering or terrorist financing case. All of these are commonly raised issues in developing country FATF assessments.

Coordination among Public Institutions

But budgetary capacity, experience and training are not the only common hindrances to developing countries. Coordination across the various public institutions is a key element of compliance with the FATF standards. Developing countries sometimes lack the coordinative mechanisms that advanced countries have, which can result in significant inefficiencies and information silos.

Regular dialogue, formal and informal, are key to effective coordination. The evaluation of Yemen, for instance, flags coordination as a major area of non-compliance. The AML/CFT regime does not dedicate sufficient human resources and structure for the public institutions to speak with each other. Although there is an AML Committee, it does not have representation of all relevant public institutions and the public institutions that are on it do not have to cooperate with each other to be made aware of each other's strategy/operations. This is a problem that frequently surfaces in developing countries.

The lack of coordination mechanisms, such as MOUs, among public institutions is a key weakness in AML/CFT regimes in many developing countries.

Similarly many developing countries are cited in their assessments as lacking formalized protocols for coordination even though they may have broad laws that permit or encourage it. For example, the 2009 Bangladesh assessment notes that there are no MOUs between domestic agencies to share information so information sharing is ineffective.

In practice, poor coordination between public institutions can lead to massive inefficiencies. For instance, it is not uncommon for FIUs to either receive too many or too few suspicious transaction reports from a financial institution. In countries where coordination between agencies is good, the FIU will inform the Central Bank or other supervisory authority that a particular financial institution is over-reporting or under-reporting suspicious customer behavior. The supervisor can then review the process with the financial institution and make recommendations to improve its reporting. In countries where coordination is weak, this does not occur. Sometimes, for example, an FIU may "drown" in suspicious transaction reports, unable or too slow to analyze them all. This amounts to a colossal waste of resources and can result in a downgrade in a country's FATF compliance rating.

Certainly the lack of coordination has some root in the poor budgetary resourcing available to public institutions but there are other causes as well. Trust varies greatly among government agencies. In some countries in Latin America, for instance, one can hear one financial authority say they trust one public institution but not another so their willingness to share information will change between the two.

Likewise, agency competition can be a problem. If there is no clear AML/CFT lead authority, several public institutions may try to expand their mandate to cover the gap. Law enforcement may demand that the FIU share all information it has on a particular bank's compliance with AML/CFT but never share information back that would be relevant to the FIU. A disengaged Ministry of Finance that refuses to solicit real-world inputs from the Central Bank or the banking supervisory authority may determine AML/CFT policy that is unrealistic or detrimental.

This is particularly striking when countries perform the FATF-encouraged risk assessment. This process requires inputs and dialogue amongst all the public institutions in the AML/CFT regime. The outputs of the assessment are intended to inform policy and ensure resources are appropriately allocated according to risk. When such coordination does not occur, policies and regulation are unrealistic or even damaging to the AML/CFT objectives.

Box 4 Public Institutions Distrust in an African Country

Public authorities need to share information with each other to be most efficient in the AML/CFT regime. Sometimes they do not because of political allegiance or territorial disputes.

In one sub-Saharan African country in 2008, for example, a new mobile phone financial service was released. The provider was not a bank but the mobile telephone company. Although the mobile operator was currently overseen for its telecom related services by the telecommunications authority, the country's banking supervisor oversaw its financial services.

The two supervisors did not coordinate or share information except in very rare circumstances. The reason behind this is that they each saw themselves as the primary supervisor and that the other should report information into it. In fact, the banking supervisor even mentioned that the telecommunications authority was likely corrupt and controlled by the companies it oversaw so sharing information would be dangerous.

Source: World Bank fieldwork in 2009 and a phone interview in 2010.

Prioritization

Even in places where capacity and coordination is not an issue, a low level of priority for AML/CFT can prevent the regime from being effective. The reasons behind this are sometimes obvious. Developing countries, especially those that are among the poorest or conflict-prone, face policy challenges that they weigh as far more important than AML/CFT. Examples of this abound anecdotally. The head of one Middle Eastern country's intelligence agency said "Terrorist *financing* means nothing to us; terrorists are coming across the border and bringing bombs with them. Our money is better spent buying bomb-sniffing dogs than hiring FIU analysts."[21]

[21] Fieldwork for United Nations Counter Terrorism Implementation Task Force, 2008.

In other developing countries, money laundering and terrorist financing may simply be seen as irrelevant to them. They feel that the FATF objectives are advanced economies' concern related to white-collar financial crimes that are non-existent in their country. Alternatively, they may recognize such crimes occur in their jurisdiction but that they pale in comparison to more severe development needs such as building schools, immunizing children or providing basic, on-the-street police services.

Recognizing countries that see the adoption of the FATF standards as low priority is usually quite easy. An AML/CFT bill that is stuck in parliament for years or an AML law that is in place but has not been practically implemented are some common indications. Donor agencies may even witness signs of this themselves. Development aid may be offered to a developing country to build its FIU or train banking supervisors. In some cases, these funds are never tapped, as the political will to implement the FATF reforms is weak.

Efforts to enhance the place AML/CFT has on developing countries' policy agenda are centered on awareness raising. International organizations like the UN, IMF and World Bank and national governments such as the US and Canada dedicate millions of dollars each years to projects to bring greater awareness of the FATF standards in developing countries. Their goal is to encourage buy-in of the FATF standards by demonstrating the gravity of the problem and how the FATF standards work to tackle it.

Governance

A chronic problem in many developing countries, which affects public sector coordination, is corruption of public officials. FATF's measures are explicitly intended to help fight corruption among other crimes. For example, they require financial institutions to scrutinize the financial activities of politically exposed persons more than normal customers. It is hoped that this enhanced level of surveillance will make bribery more transparent and less attractive.

However, the public authorities implementing AML/CFT measures need to have good governance levels themselves in order to be effective in applying the standards. Overwhelmingly, the countries that need such measures most are those with the highest corruption levels. The chart shows the level of corruption perceived in a sample of sixteen developing countries and the their corresponding level of FATF compliance. There is a clear linkage. Countries with lower levels of corruption are more compliant with the FATF while those with higher levels are less compliant. Empirical data, crossing the FATF assessment ratings and the corruption perceptions index, has drawn a clear picture of the link between the two: the more perceived corruption, the worse it does in implementing the FATF standards.

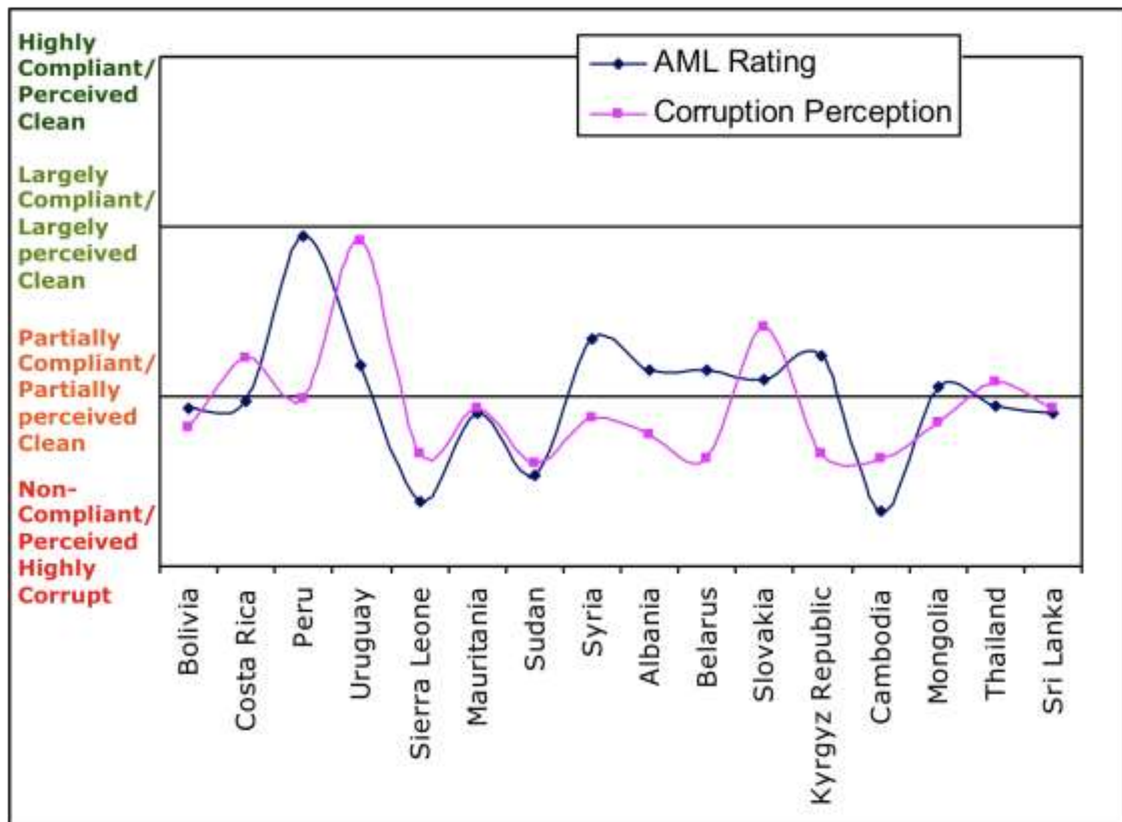


Figure 5 – Klein, Michael presentation to the Cambridge Symposium on Financial Crime (2007) based on data from Transparency International's Corruption Perceptions Index and FATF compliance data from assessment reports.

A separate but growing area of concern is that of the abilities of corrupt public authorities to use their access to AML/CFT data for illicit purposes. This is particularly relevant in AML/CFT as the powers given to public agencies in the FATF regime can be extremely profitable to someone willing to abuse them. Intelligence on financial data, politically exposed persons, the media and others can be used to violate civil rights. This is especially a concern in countries where such rights are already vulnerable. For example, one Southeast Asian FIU head was officially investigated last year over allegations that he had used the intelligence to blackmail journalists and opposition leaders to support political forces.

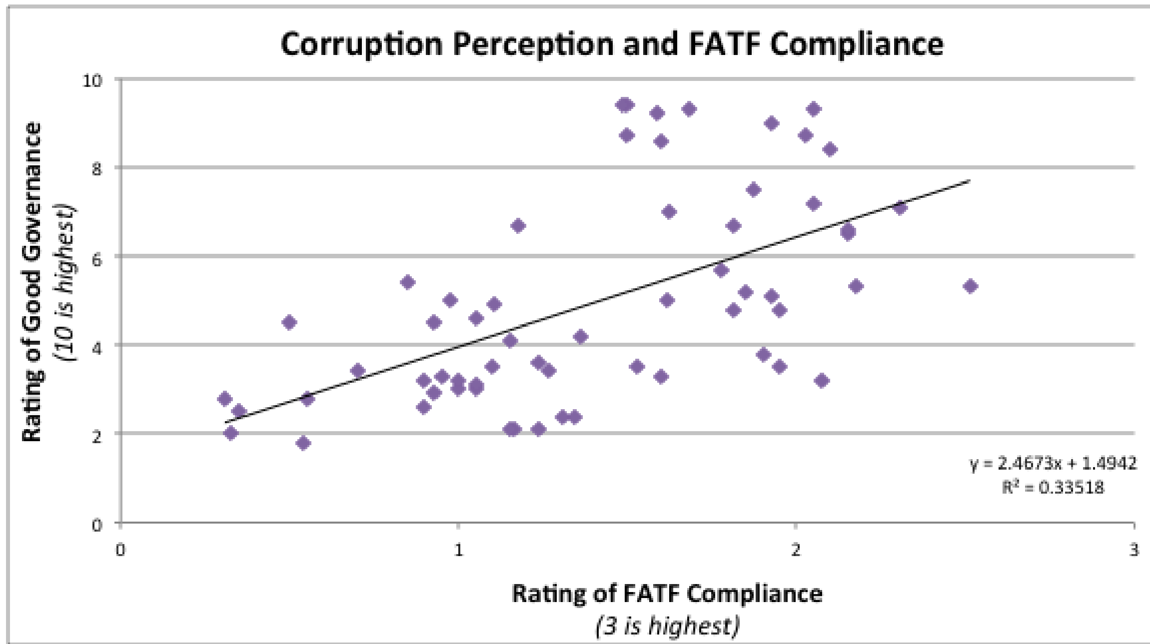


Figure 6 Source data from 67 FATF assessment reports and Transparency International's Corruptions Perception Index 2007. FATF compliance ratings are quantified as Non-compliant = 0, Partially Compliant = 1, Largely Compliant = 2 and Compliant = 3. Transparency International's scoring is 10 is highly clean government decision making and 0 is highly corrupt governance.

The Overall Strategy

At this point we have covered the lack of institutional capacity, coordination, good governance and prioritization that can make AML/CFT authorities ineffective or at least inefficient in their implementation of the FATF regime in developing countries. All of these have been long recognized as being significant impediments to compliance. Yet, there is another aspect that has not been deeply discussed: the strategic approach itself.

The FATF regime requires enormous sums of data to be documented, reported, analyzed and flagged when necessary to the relevant authority. This documentation is to be gathered from a number of sources: customers, financial institutions, accountants, lawyers, real estate agents, and other public authorities. It is intended to be immediately assessed and in the long-term, become part of a larger set of statistics and trend monitoring that the FATF specifically requires countries conduct. The approach presumes that information is verifiable via documentation, something that can have an impact on poor customers as well as charitable organizations that operate in poor countries.

Nevertheless, the standards do not directly address situations in which documentation is unavailable. For example, in many developing countries large segments have no identity document whatsoever. This is particularly prevalent in the poorest of countries and even among the poorest people in middle-income countries. How can a financial institution verify that a new customer is not a known-terrorist financier? And even when customer identity documentation is presented, it is difficult to check whether it is authentic or a fake. One African Central Bank official said, "over 90% of our citizens have an identity card but banks have no way to verify which are valid and which are counterfeit. The national office that holds the records of these ID cards is almost completely running

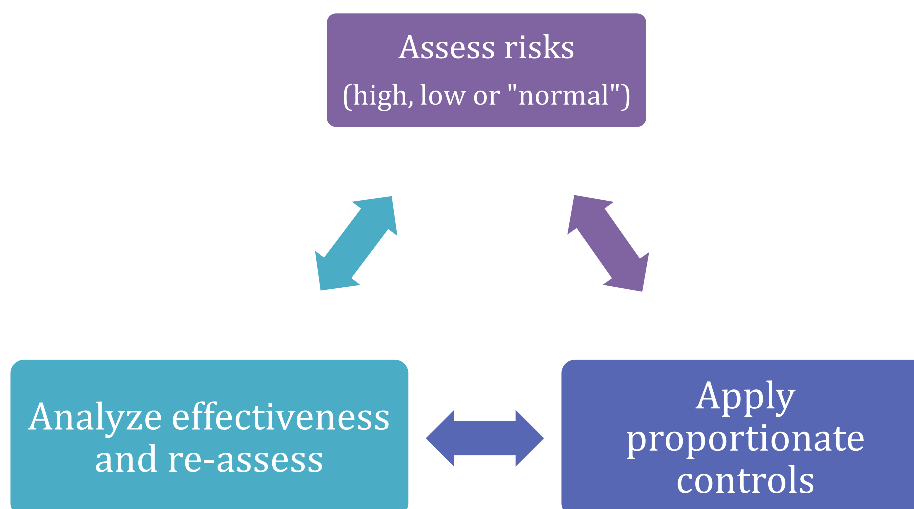
on a paper system so it takes hours for them to verify an ID card number with a name."[22] This issue has recently surfaced in debates centered on expanding access to financial services to the poor but a major rethinking in the data driven strategy has not yet occurred.

Box 5 –Implementing the Risk-Based Approach

A Proposed Solution to Local Challenges

As a solution to local challenges in implementing the standards, discussions on country strategy have often centered on the "risk-based approach" permitted under the FATF standards. The approach permits countries to adjust the burden of certain AML/CFT obligations depending on the risks faced. For instance, if a particular payment type is seen as low risk, the controls may also be low. Alternatively, high-risk situations require more mitigation controls to be in place. A funds transfer between government agencies might be seen as low risk while a large remittance from an unregistered business overseas could be seen as high risk.

Making Controls Appropriate to the Risks



Difficulties Persist

Determining which types of financial activities are high, low or just "normal" risk requires countries to do an extensive risk assessment. This means analysis, expertise and data gathering across multiple sectors and agencies to designate a certain activity's risk level. To date, most countries, especially those in the developing world, have not applied the risk-based approach and although there has been some high-level guidance for applying it in AML, how best to implement it in CFT has not been internationally well established.

Source: FATF Guidance on Financial Inclusion June 2011

The lack of reliable customer identity documents is not the only example of the conflict between the current strategy and the unavailability of verifiable data. Non-profit organizations are flagged in the

[22] Comment by an African country's Central Bank Governor at the *Mobile Money Policy Forum, Nairobi (2010).*

FATF's Special Recommendations on Terrorist Financing as being particularly vulnerable. Countries are to ensure they cannot be used to fund terrorist organizations overseas. Specifically, non-profits are to keep records to verify that funds have been spent legitimately. In the charity sector of advanced economies, this is relatively easy to do. Transactions occur electronically and money is usually traceable. A financial institution or goods supplier would be highly suspicious of a person offering large sums of cash in most advanced economies. Yet, in many developing countries this is not seen as suspicious and in conflict areas where much non-profit money is spent, it is commonplace. Cash is king in such places. Records of transactions are rare.

The risk-based approach is a solution with challenges. Developing countries do not always have the capacity to evaluate the risk of a particular financial activity and may thus apply an overly strict approach, especially for CFT.

Perhaps most surprisingly, it is exactly the situations in which non-profit organizations are needed most are those that pose the greatest FATF compliance risks. Natural disasters, conflict-related emergencies and other events when humanitarian aid needs to be quickly delivered are the same times when it is most difficult to prove that the money is going to legitimate purposes. These emergency situations require quick distribution of charitable funds in large amounts[23]. How to determine whether some of the money is being diverted to terrorist or criminal purposes is very nearly impossible to do yet the FATF methodology does not address such instances.

Lastly, the current global strategy for AML/CFT is highly dependent on financial institutions. In fact, many of the FATF standards apply to such businesses, making them carry much of the burden and cost of implementing the regime. Developing countries typically have a relatively small formal financial system. Most transactions occur through the informal sector, cash or barter, which are methods that give criminals complete anonymity. The more controls to prevent money laundering or terrorist financing that financial institutions need to put in place, the greater the costs associated with using the formal financial sector for everyone. The controls will not only prompt criminals to search for alternatives but general public to do so as well. As the informal sector grows, the ability for AML/CFT authorities to detect and trace illicit money shrinks. This demonstrates the potential conflict between the conservative approaches to the FATF standards and poor nations where the formal financial sector is not well developed. This has recently been increasingly recognized by the FATF[24].

[23] Van Der Does, Emile J. *Nonprofit Organizations and the Combatting of Terrorism Financing: A Proportionate Response*. World Bank. 2010.
[24] *FATF Guidance on Financial Inclusion June 2011*

5. Conclusions and thoughts for the FATF review

It has been over twenty years since the FATF international standards for AML/CFT were established. A candid review of the standards and their implementation in all countries, advanced and developing, is well needed. The issues highlighted in this paper suggest that there is a great need for the review. At a minimum, there is a breakdown in the way the standards are communicated to developing countries such that their implementation is often inappropriate. At worst, the strategy laid out in the standards assumes a level of public sector development to which many poor countries aspire but have not reached.

The idea that certain preconditions must be met to implement global standards is not new in other financial regulatory domains [25] and has been raised occasionally in the FATF[26]. However, there has yet to be a review in the overall approach – is it right for all countries? Specifically, it is critical to prove that implementing the FATF regime will reduce the terrorist financing and money laundering. After the standards have been shown to be effective, then focus should be placed on communicating this to developing countries and working to build their capacity. However, if the standards prove to be inappropriate for low capacity countries, redrafting them ought to be top priority so that focus is placed on meeting the preconditions necessary to make an effective AML/CFT regime.

1. Observation: To get true political buy-in for the standards, it is critical to prove their effectiveness in reducing crime and terrorist financing. It is no coincidence that the countries with the fewest resources are those that are rated least compliant with the FATF standards. The current strategy to fight money laundering and terrorist financing requires great investment in public institutions. Awareness raising, training and staffing are chronic challenges in poor nations.

The FATF standards are unlikely to receive the prioritization by all developing country governments until they are convinced that the standards (a) actually prevent the crimes they are intended to prevent and (b) be as important as more fundamental concerns such as health, education and poverty-reduction. International pressure to implement the standards can only be effective to a point. The standards are intended to be risk-based, not simply a compliance exercise to avoid blacklisting. Their value must be better communicated in order to achieve genuine adoption in developing countries or anywhere. Proving that the standards work to reduce terrorist financing and money laundering will go a long way in strengthening efforts to get the political will often flagged as lacking in developing countries.

Recommendation: Increase developing country representation in the standard setting process. The weak level of developing country participation in the FATF standard setting is something to consider moving forward. Of the thirty-six FATF members, only eight are from developing countries. None are amongst the lowest developing countries as defined by the UN Human Development Index, yet the number of countries in this category represents almost a quarter of those on the planet. As the FATF only reviews assessments of its members, it has very little formal, regular and direct exposure to the issues raised in assessments from developing countries, especially those from the poorest 25%. How to increase representation without making the FATF organization too big and slow is a question that must be considered as well.

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[25] International Monetary Fund. *Financial Sector Regulation: Issues and Gaps,* Monetary and Financial Systems Department. 2004.

[26] The high-level guidance provided in the FATF's low capacity country paper is one such example.

The creation of FATF-styled regional bodies in recent years has been one approach to improve this. The success of these regional groups is very mixed, perhaps an indication that commitment to them and the FATF standards varies greatly across their member countries. These regional bodies are invited to send representation in FATF meetings but are not full FATF members themselves. It is perhaps too soon to say how much impact they will have and how well the poorest countries will see them as useful in intimating their concerns to the FATF. Direct, formal contact between the standard setter and the least developed countries is virtually non-existent.

2. Observation: There are situations in which the implementation of the FATF standards actually increases money laundering and terrorist financing vulnerabilities. Perhaps the best example of this is mentioned earlier regarding access to financial services. As has been said increasingly by FATF Presidents over the past few years and even stated in a recent FATF paper[27], access to financial services and AML/CFT are complementary objectives. Growing the transparent, traceable and monitored formal financial sector is bad for criminal interests that try to move money clandestinely. However, the controls put in place to prevent criminal activity in the formal sector may disrupt legitimate but poor customers as well. This leads to a much bigger informal, cash-based economy where opportunities for those wishing to launder illicit funds are rife.

Other examples have been cited as well such as need to move money quickly into crisis-struck regions. Strict interpretation of the FATF rules can result in a slow down in humanitarian aid to those in need. This can create opportunities for terrorist groups to step in to deliver aid themselves, thus building more support for their extremist cause on the ground.

Recommendation: Amend the FATF standards to make broad access to the formal financial system a priority for countries. Moving from a cash-society to an electronic one is an AML/CFT measure in itself. Overly stringent implementations of the FATF standards have led to “clean” but very small formal financial sectors and very large, intransparent informal ones. The current methodology for assessing country compliance with the FATF standards vaguely references financial inclusion. If greater weight was to be put on this issue throughout the FATF standards, countries would be more inclined to consider the effects of overly tough controls that shrink access to financial services amongst the poor. This would result in a smaller cash-based economy and an overall reduction in risk.

Some developing countries have already begun making policies that are more risk-based but there is little clarity on how low one can go with the AML/CFT requirements. For instance, for very small levels of money some countries have deemed it unnecessary to require customers to prove their identity. These countries have determined that the risk that criminals could abuse these products is extremely low and is far outweighed by the benefit of moving millions of would-be cash transactions to traceable electronic methods. The FATF standards give very little guidance into what the decision-making criteria for this strategy should be. Although some countries have risked non-compliance by implementing such exemptions from the FATF standards, many others have not. Rather, there is much more of a rules-based compliance oriented culture that dominates most countries’ approach, which results in disproportionately strict regulation.

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[27] *FATF Guidance on Financial Inclusion June 2011*

3. Observation: Paradoxically, the same countries that need the risk-based approach most are those that are least able to implement it. The standards require countries to comply based on the risk they face. To understand the risk faced, the standards require national risk assessments be conducted to ensure proportionate regulatory frameworks are in place to mitigate risk and that resources are allocated effectively. The very expectation that a country can conduct an effective risk assessment presumes they have sufficient capacity, expertise and institutional coordination to do it. As noted previously, developing countries frequently have severe deficiencies in all of these areas so an inefficient, rules-based approach to implementing the standards is very often the result.

The challenge of applying the risk-based approach is particularly striking when considering terrorist financing. FATF guidance to date has primarily focused on applying the risk-based approach to fighting money laundering. Since money laundering is inherently about the movement of *large* sums of *criminal* money, regulators and financial institutions are able to identify at least some indicators of high or low risk. However, money that is intended for terrorist purposes can be both *small* and *legitimate*. This makes it very difficult to apply the risk-based approach to combating terrorist financing. Developing – and perhaps all – countries would benefit greatly from deeper clarity on this issue.

Recommendation: Provide solutions to applying the risk-based approach when country capacity is extremely low, especially for CFT. Although high-level principles have been well articulated by the standard setter, how to apply the risk based approach in the poorest of conditions remains unclear. Risk assessments require a lot of work so *specific guidance for the poorest countries* on how to conduct one and then how to determine the adequate level of controls would be very useful.

Final note: Implementing the standards in developing countries remains a huge challenge. How best to improve implementation can happen through two routes. One route is that proponents of the standards improve their communications, demonstrating the real beneficial impact and then, explaining how to implement the standards specifically in low capacity countries. Another route is that of reconsidering whether the standards are the right approach for all countries right now, including the least developed countries. Deciding whether the approach is universally appropriate or that some countries should first focus on the improving capacity, coordination, prioritization, governance as preconditions to FATF compliance is crucial as the standards are reviewed.

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Appendix 1 FATF Members and Associate Members

FATF Members: Argentina, Australia, Austria, Belgium, Brazil, Canada, China Denmark, Finland, France, Germany, Greece, Hong Kong (China), Iceland, India, Ireland, Italy, Japan, Kingdom of the Netherlands, Luxembourg, Mexico, New Zealand, Norway, Portugal, Republic of Korea, Russian Federation, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States of America

FATF Associate Members: The Asia/Pacific Group on Money Laundering, Caribbean Financial Action Task Force, the Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism, Eastern and Southern Africa Anti-Money Laundering Group, Eurasian Group, European Commission, the Financial Action Task Force on Money Laundering in South America, Gulf Co-operation Council, the Inter Governmental Action Group against Money Laundering in West Africa, and the Middle East and North Africa Financial Action Task Force.

Appendix 2 FATF Styled Regional Bodies:

Asia/Pacific Group on Money Laundering: Afghanistan, Australia, Bangladesh, Brunei Darussalam, Cambodia, Canada, People's Republic of China, Cook Islands, Fiji, Hong Kong (China), India, Indonesia, South Korea, Japan, Lao People's Democratic Republic, Macao (China), Malaysia, Maldives, The Marshall Islands, Mongolia, Myanmar, Nauru, Nepal, New Zealand, Niue, Pakistan, Palau, Papua New Guinea, The Philippines, Samoa, Singapore, Solomon Islands, Sri Lanka, Chinese Taipei, Thailand, Timor Lester, Tonga, United State of America, Vanuatu, Vietnam

Caribbean Financial Action Task Force: Anguilla, Antigua and Barbuda, Aruba, The Bahamas, Barbados, Belize, Bermuda, Cayman Islands, Costa Rica, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Montserrat, Netherlands Antilles, Nicaragua, Panama, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname, Trinidad and Tobago, Turks and Caicos Islands, Venezuela, Virgin Islands

Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism: Albania, Andorra, Armenia, Azerbaijan, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Georgia, Hungary, Holy See, Israel, Latvia, Liechtenstein, Lithuania, Malta, Moldova, Monaco, Montenegro, Poland, Romania, Russian Federation, San Marino, Serbia, Slovak Republic, Slovenia, The Former Yugoslav Republic of Macedonia, Ukraine

Eurasian Group: Republic of Belarus, People's Republic of China, Republic of India, Republic of Kazakhstan, Kyrgyz Republic, Russian Federation, Republic of Tajikistan, Republic of Turkmenistan, Republic of Uzbekistan

Eastern and Southern Africa Anti-Money Laundering Group: Botswana, Comoros, Kenya, Lesotho, Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Seychelles, Tanzania, Uganda, Zambia, Zimbabwe

Inter Governmental Action Group Against Money Laundering in West Africa: Benin, Burkina Faso, Cape Verde, Cote d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, Togo

Financial Action Task Force on Money Laundering in South America: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Panama, Paraguay, Peru, Uruguay

Middle East and North Africa Financial Action Task Force: Jordan, United Arab Emirates, Bahrain, Algeria, Tunisia, Saudi Arabia, Sudan, Syria, Republic of Iraq, Oman, Qatar, Kuwait, Lebanon, Libya, Egypt, Morocco, The Islamic Republic of Mauritania, Yemen