OUTLINE FOR CAMBRIDGE

**A Critical and practical evaluation of the efficacy and cost benefit**

**of anti-money laundering laws**

**Lack of a balance in the status quo**

From chapter by Tupman – criminal sanctions are necessary to deter further wrongdoing – reference back to the criminal profit formula. Insofar as the motive to commit crime is predicated upon opportunity for personal profit, deterrence effort is constructed around manipulation of the criminal profit formula (Gnutzmann et al, 2010: 245). The formula is presented in two dimensions - the probability of being caught and the severity of sanction imposed if caught. In similar light, rational choice theory has been applied within criminology (attributed to Cornish and Clarke, 1987) to explain the utility driven decision making of criminal actors in which largely short term benefits (immediate gratification of gain) are considered and weighed against longer term costs (incarceration if apprehended). Verhage and Ponsaers (2009) extend this to consideration of laundering activity and interpret gain as delivery of effective economic purchasing power that is not available from illegal funds.

What Sittlington surfaced is that the real deterrent is not a stretch of incarceration but the loss of assets (particularly civil recovery confiscation for the professional criminal that is most effective. He further showed – as highlighted by Tupman (2015 p xx) that there still exists a distinction between criminals who habituate crime to fund a consumption lifestyle and those that are building for a secure financial future in retirement – seeing an end and change of activity. He also pointed out that rational thought processes are not as strong as theory suggests rather there being emphasis on their credibility. Building their own status.

Regulators force disclosure that would not necessarily take place and the evidence of a jump in disclosure levels after a visit from regulators is apparent in a number of studies (Sittlington, 2015 –Harvey and Lau, 2007, Chong and Lopez-de-Silanes 2007). Harvey and Lau pointed out that banks see little benefit and all the cost in compliance with AML, with sittlington pointing to the same noting that incentivisation sees a share of assets being given to law enforcement, with all the costs (witness some recent hefty fines under the visible deterrence approach of the at least the UK financial regulator)) in the financial sector.

**The costs**

There is a substantial body of scholarly research that raises serious questions on this point (see Harvey, Van Duyne, Levi, …..). The consensus within this group of researchers is that there is little evidence that the benefits of the regime – the way it has developed thus far - outweigh its costs. Professional groups such as lawyers, accountants and notaries as well as representatives of other regulated businesses have also voiced concerns about the increasing level of regulation with its associated costs versus the proven benefits. I have written of the lack of proportionality in the response side of the scale to the AML threat.

The argument of the law enforcement and regulatory community is, understandably, that costs and benefits cannot be neatly quantified in order to compare them and assess the effectiveness of the AML regime. There is certain logic behind this But If one thinks of where it all started and where we are now, expectations from the regulated sector are so far beyond what was originally laid down. This means that cost is so much higher now than four and a half decades earlier.

There have been attempts, particularly among the larger audit and risk management firms, to collect costs data. Such firms have also undertaken surveys to identify trends and establish estimated percentage costs changes. But such surveys capture only costs directly arising from the implementation of AML measures. Banks are not necessarily able and/or willing to provide specific details and a breakdown of AML-related cost. Prior work has deconstructed the balance of very tangible costs and mostly intangible benefits (Harvey, 2004, 2008; Sproat, 200x, 200x) and noted the reluctance by those affected to discuss the costs. Costs data is fragmented across the various parts of the regulated sector and across jurisdictions. Aside from academics, the 2011 Report by Deloitte ‘European Commission, DG Internal Market and Services – Budget Final Study on the Application of the Anti-Money Laundering Directive Service Contract ETD/2009/IM/F2/90’[[1]](#footnote-1) in its review of the operation of the EU AML directive in member states and the experiences on the non-financial professions noted (p.4) that there were implementation problems for small practices; and they also highlighted the cost of compliance.

**And fuzzy benefits**

 One does not need to be a moralist to recognise the moral function of the state as an actor protecting the common people against harm, whether from (physical or spiritual) disease, war and public disorder or crime. History abounds with examples of rulers who took their task of protecting society against harm so boundlessly that the cure was worse than the alleged threat, in particular when spiritual values were at stake. One does not need to go as far as the Spanish Inquisition, which protected society against the threat of heresy, to recognise the effects of ‘boundless protection’. For example, the global policies of drugs (ab)use, organised crime and terrorism in which we find a constant shifting and blurring of the boundaries of implementation (Ruggiero 2003; Hobbs 1998). This is amplified by the state of technique, which allows an ever increasing (and intrusive) monitoring of citizens, all for the general good encompassing any kind of (un)safety. This balancing of interests matters: it is the basis of proportionality. Policies which entail (financial and political) costs to society must be addressed from that proportionality perspective.

Setting aside the threat side of the argument with one observation Alldridge (2003), citing van Duyne (1998), observes that had the amounts of crime-money been near the sums estimated the impact would have been noticeable and to this we would add – if it was as dangerous as suggested by the apocalyptical financial threats promised to visit us for the past 30 years, surely the impact on economies would have also been evident by now.

What is of interest for the purposes of this presentation is to look at the response side enshrined within the Recommendations of the FATF and translated into the legal and regulatory frameworks across the globe. We set about providing insight into proportionality through careful analysis of the way in which the FATF Recommendations are enforced within each participating member state. Thus the importance of the process of mutual evaluations and their associated Mutual Evaluation Reports (hereafter MER). The logic for looking at this process is (a)that huge effort is put into it and (b) we might find evidence within these reports of effectiveness of the whole colossal circus – that there is evidence of curtailing criminal activity.

**The mutual evaluation Circus**

The term ‘effective’ however cannot be assigned an objective quality. No matter the number of times it is used, referred to and apparently measured, one review team’s conclusion about what is effective can and is very different from that of another. It focusses on outputs (in particular STRs/SARs, convictions and asset recovery) and ignores the costs associated with any system (Chaikin,2009, pp. 242-244; Sharman 2008, p. 641). Similarly the rating scales applied against each recommendation whilst using reassuringly measurable terms such as ‘compliant’ or ‘not compliant’.

The stated purpose is to evaluate whether members have ‘effectively’ built up their controls and systems to prevent criminal abuse of the financial system. Simple enough, but each review is expensive to operate – involving a team of four to six ‘experts’ with legal, financial and law enforcement expertise and two members of the FATF Secretariat, IMF or World Bank, protracted visits, meetings and copious reports taking up to a year to complete.

There has been little critical interrogation of this expensive area of the AML framework that sees a ‘one size fits all’ approach across multiple countries of different size, levels of development and thus relative financial sophistication. We find the absurdity of Vanuatu drafting its AML legislation as ‘a word for word copy of the UN model’ right down to provision for non-existent complex financial derivatives (Sharman, 2008 p 642). It is also instructive that Levi and Gilmore (2002) pointed to the differential application in standards whereby the rules and sanctions are enforced more firmly against smaller states than against the USA.

The MERs are not for the faint hearted, we have reviewed reports for 83 countries and all run to hundreds of pages with a (logic-defying) range from Uganda (June 2005; ESAAMLG, 82 pages, 4 evaluators, average compliance rating 1.2, modal compliance rating 1, TI 2.7) to France (February 2011, FATF, 664 pages, 7 evaluators, average compliance rating 2.9, modal compliance rating 3, TI 7.4). Smaller jurisdictions with relatively few profit driven crimes (Iceland, Ireland, Denmark, Sri Lanka) appear to require as much energy of the evaluators as larger countries: it is much ado about nothing and certainly not about a money laundering threat. Visiting each other, not only to conduct (and observe) MERs but then attending (as member and observer) the various (frequent) regional plenary sessions, training and updating workshops sessions is an expensive activity.

The subjective nature of assessment has resulted in evaluation compliance with recommendation rules (inputs) not effectiveness (outputs). Thus there is scant evidence of the evaluators’ attention to prosecutions, convictions and asset recoveries. Consistent with the surreal comedy that was the trade-mark of the Pythons, we observe comments such as this from the Danish MER “The criminalization of the financing of terrorism by Denmark is fully compliant, but Greenland and the Faroe Islands have not yet adequately criminalized the financing of terrorism, terrorists and terrorist organizations.” So the rating is Partly Compliant irrespective of the extremely limited potential criminal infiltration of either Greenland (population 56,000) or of the Faroes (population 49,000) They face a further problem in that for R 6 and 7 it is noted in the text that they are not applicable but are scored 1 (NC) rather than 0 (NA). Indeed the PC rating is the most frequently applied and the most difficult to interpret. Spain in particular has a number of problems discussed in the body of the report in relation to CDD and ML offences. Portugal was pulled up for R32 Statistics PC – it is not possible to assess the effectiveness of freezing of terrorist funds as no funds have been identified for freezing action! But R38 MLA on confiscation and freezing is fully compliant?

Bermuda 4 person team stayed for a 16 day visit! Seychelles FIU has no stats, however the MER doesn’t even mention anything about their lack of stats and the FIU is found to be PC? They also had an 8 man team who stayed for 11 days – this is quite big compared to other country’s e.g. Romania had a 5 person team and stayed for 6 days.

Russia had an 11 man team but produced a report of only 199 pages. Fully compliant with R.26 FIU despite R.30 stating that for the majority of law enforcement/supervisory etc staff specifically devoted to AML was low and difficult to assess?

Sadly the statistics for the majority of the reports are the most difficult thing to get hold of, there being little in the way of what is reported, how it is presented and what it actually says in terms of reports filed, prosecutions and convictions and assets removed.

For many of the reports they are auditing (scoring) the presence of control rather than the actual processes controllability – it is akin to a cleaner’s checklist in a bathroom that is not being filled out!

Modal rating for 40 recommendations for a sample of 83 countries

**Table 1 the Tidy Process of Mutual Evaluation**

|  |  |
| --- | --- |
| Purpose of MER | Assessment of formal compliance with Recommendations and assessment of effectiveness of implementation. Rating for each recommendation as Compliant (C); Largely Compliance (LC); Partially Compliant (PC); and Non-Compliant (NC); Not Applicable (NA). |
| Assessment team | Appointed by FATF Secretariat from FATF members, associate members, FATF-style regional bodies or international organisations with observer status.  |
| Skills | The team will include experts in law, law enforcement and financial regulation with expertise in AML/CFT and includes a member of FATF secretariat. They will not have country specific knowledge |
| Scope of review | Institutional framework; AML/CFT laws, regulations and guidance including both law and regulatory enforcement; assessment of effectiveness of the system to deter ML and CFT |
| Documentation | FATF Methodology for Assessing Compliance with the FATF 40+9 and a Handbook for Countries and Assessors. |
| Approach | Pre-visit completion of a questionnaire, team visit for a period of 2 weeks comprising meetings with government officials and with private sector; post visit drafting of the report in consultation with officials within the country. The report is tabled at and further discussed at one of the Plenary meetings when the ratings can be amended and once consensus is reached the report is published. Within 2 years the inspected country has to report back to the plenary on progress made in addressing identified deficiencies. |

Source: Adapted from Chaikin, 2009 pp 242-244, see also Levi and Gilmore (2002, p 346), Halliday, Levi and Reuter (2014, p 27)

This tabular representation of the MER formula implies a closed end process that is complete at least within two years of the report being accepted. This is in fact far from the end of the matter. Dependant on the approach of the FATF-style regional organisation, monitoring and follow up homework setting continues more or less frequently bearing little relation to the size of country, complexity of financial sector, apparent vulnerability to criminal infiltration or indeed original evaluation. This observation is well illustrated by Table 2 which contains information on the follow up procedure (or its absence) for a selection of countries. From this it can be observed that the CFATF is the most assiduous in the post evaluation follow up requirements that are placed upon individual countries, although it also took a decision at its El Salvador Plenary that all Members who have not exited the 3rd round follow-up process should do so by November 2015. For other countries reviewed under the auspices of APG nothing further appears to be warranted or if it was is not then publically disclosed. MONEYVAL appear to execute the most thorough of procedures including re-visits and reassessments (a mutual evaluation re-examination with the same students and marking scheme but with new markers to gauge improvement). Apparently, should insufficient improvement be evident the headmaster will talk to the parents (in this case the responsible Minister).

**Table 2 the Reality of Mutual Evaluation**

| **Country**  | **Date of MER** | **Regional body** | **Average compliance score**  | **Modal compliance rating**  | **TPI 2006**  | **Follow up reports** |
| --- | --- | --- | --- | --- | --- | --- |
| Colombia | December 2008 | GAFILAT | 3.2 | 3 | 3.9 | One follow up report for 2009 nothing further in public domain |
| Uruguay | December 2009 | GAFILAT | 2.9 | 3 | 6.4 | Four follow up reports from earlier MER 2006 nothing further in public domain after 2009 |
| Paraguay | December 2008 | GAFILAT | 1.5 | 1 | 2.6 | Also evaluated in 2005; two follow up reports both in 2009 |
| Dominican Republic | October 2006 | CFATF | 1.9 | 2 | 2.8 | 13 follow up reports latest May 2015 Looking to the future mutual evaluation it is suggested that Dominican Republic report to the November Plenary 2015 with a view to fully rectify outstanding deficiencies for the third round. |
| Barbados | June 2008 | CFATF | 2.5 | 2 | 6.7 | 13 follow up reports latest May 2015 As a result of the late submission of the matrix by Barbados, the Secretariat was not able to prepare the relevant follow-up report for the consideration of the Plenary. As such, it is recommended to Plenary that the Secretariat should complete the present report by July 15, 2015 and submit it for approval of delegates via round robin process. |
| Anguilla | July 2010 | CFATF | 2.7 | 2 | 1.3(2010) | 7 follow up reports latest May 2015 The El Salvador Plenary decided that Anguilla would remain in regular expedited follow-up and report back to Plenary in May 2015, at which time a determination would be made as to whether Anguilla would remain in regular expedited follow-up or be assigned to another category of follow-up reporting.  |
| Norway | June 2005 | FATF | 2.7 | 3 | 8.8 | 4 follow up and 1 biennial, the last follow up report (fourth) February 2009 recommended that the Plenary exercise its flexibility and remove Norway from the regular follow up process, with a view to having it present its first biennial update in June 2011. That report makes no comment on when the next report be submitted and no others are on the FATF site |
| Belgium | June 2005 | FATF | 3.2 | 4 | 7.3 | 3 biennial reports none of the reports are published, 3rd update was in June 2011, in 2015 Belgium was reviewed under the 4th round |
| USA | June 2006 | FATF and APG | 3.1 | 3 | 7.3 | no documents other than the MER in the public domain |
| Sri Lanka | July 2006 | APG | 1.8 | 2 | 3.1 | no documents other than the MER in the public domain |
| Australia | October 2005 | APG | 2.6 | 3 | 8.7 | No follow up evaluated April 2015 under the fourth round |
| Vietnam | July 2009 | APG | 1.7 | 2 | 2.6 | no documents other than the MER in the public domain |
| Bahrain | November 2006 | MENAFATF | 2.5 | 2 | 5.7 | 4 follow up reports, 4th report in 2012 recommended removal of Bahrain from follow up process to biennial updating |
| Tunisia | April 2007 | MENAFATF/World Bank | 2.4 | 2 | 4.6 | 6 follow up reports, latest June 2014 recommended removal from regular follow up to biennial updates |
| Sudan | November 2012 | MENAFATF | 1.7 | 1 | 1.3 (2014) | no documents other than the MER in the public domain |
| Sierra Leonne | June 2007 | GIABA/World Bank | 1.3 | 1 | 2.2 | 12 follow up reports, latest May 2015 |
| Ghana | November 2009 | GIABA | 1.7 | 2 | 3.3 | 4 follow up reports, most recent, November 2012 |
| Lithuania | November 2006 | MONEYVAL | 2.8 | 2 | 4.8 | 2 biennial reports latest follow up March 2010; 4th full visit 5th Dec 2012 updated the compliance scoring but was not a new MER, this 283 page report revisited some but not all of recommendations |
| Georgia | July 2007 | MONEYVAL | 2.1 | 2 | 2.8 | 2 follow up progress report in July 2008 and March 2010 with a fourth assessment visit under the 3rd round July 2012 and a 466 page report that included reassessment of compliance against recommendations |
| Botswana | August 2007 | ESAAMLG/World Bank | 1.7 | 1 | 5.6 | no documents other than the MER in the public domain  |
| China | June 2007 | FATF/EAG | 2.5 | 2 | 3.3 | 8 follow up reports with recommendation in 8th Report February 2012 to move to Biennial reporting with next report in 2014. This is no in the public domain |

**Notes:**

Country Compliance score translated from: 0 - N/A to Country; 1 - Non-compliant; 2 - Partially compliant; 3 - Largely compliant; and 4 - Compliant

TPI 2006 country assessment rating where scale is 0-10 (corrupt to clean)

GAFILAT: The Financial Action Task Force of Latin America (secretariat based in Argentina)

CFATF: Caribbean Financial Action Task Force (secretariat based in Trinidad and Tobago)

FATF: Financial Action Task Force (secretariat based in France)

APG: Asia Pacific Group (secretariat based in Australia)

MENAFATF: Middle East & North Africa Financial Action Task Force (secretariat based in Bahrain)

GIABA: Inter-Governmental Action Group against Money Laundering in West Africa (secretariat based in Senegal)

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

ESAAMLG: Eastern and Southern Africa 'Anti-Money' Laundering Group (secretariat based in Tanzania)

EAG: Eurasian Group on combating money laundering and financing of terrorism (secretariat based in the Russian Federation)

The FATF has now moved onto the 4th round of MERs in response to the revised set of Recommendations and its proposed methodology for compliance assessment . It is interesting to note that the latter comprises a detailed 164 page document that sets out the approach to be adopted under the new system without showing how the proposed changes address any of the shortcomings identified with the 3rd round. To some extent this task is ably performed by Halliday, Levi and Reuter (2014) in a report that set about unpicking the new methodology and setting this in context of both the previously identified problems together with their recommendations of further adjustments that would still be needed.

**Table 3 Summary of Halliday, Levi and Reuter (2014)**

| **Area identified**  | **Issue** | **Observation** |
| --- | --- | --- |
| Objectives | Lack of clarity over objectives of AML/CFT regime (para 20 p 13) |  |
|  | No evidence to suggest inverse linear correlation between better compliance scores and amount of money laundering nor that this improved as a result or that it was better that countries with lower compliance ratings (para 23 p 14) | Extensive ***effort*** with no demonstrable impact (para 26, p 15)The revised approach that separates technical compliance with recommendations from the new approach to effectiveness is welcomed (para 30 p 16) |
|  | There is limited evidence to support the claim that AML/CFT countermeasures make a positive contribution to macro-economic performance or protection of integrity of the financial system and that which has been produced is based on analysis of micro-states (para 36, p 18) | The emphasis on different levels of objectives and their inter-relationships will still be based on interpretative judgement (para 32 p 17) |
| Assessment methodologies and practices  | Problems exist with assessment of proceeds of crime (whether absolute or as % GDP) – remain largely as estimates; different countries adopt different approaches to threshold setting for reporting of STRs and there is no analysis that suggests that there is any comparability from one country to another (para 40 p 19-20) | The 2013 methodology allows greater flexibility in data selection for demonstration of effectiveness (para 41 p 20-21) |
| Risk-based approach | Endorse the adoption of the risk based approach as being consistent with broader approaches to financial regulation (para 42 p 22) as offers a way around the ‘one size fits all’ (para 45 p 22) | Notes the challenge that risk assessment is as art not a science – estimations of risk will depend on the assessors’ judgement and estimation (para 46 p 22) |
| data | Continued lack of consistent methodology for systematic analysis of data (para 51 p 24) | Problems that could undermine the 4th round: pressure to improve data collection diverts attention to collection of meaningless numbers; emphasis on quants can imply spurious accuracy; no definition of how qualitative data is systematically collected; no detail on how fundamental attributes of different economics can be characterized (para 55 p 25 |
| Assessment process | 3rd round comprises: Desk analysis of legal and financial system; assessment questionnaire; site visit by team (up to 2 ½ weeks); meeting with officials as conclusion of visit; drafting and opportunity for response; discussion at FATF plenary; publication of report (para 59 p 27) | 4th round comprises: Incorporation of self assessment;desk review of technical compliance and visit to assess outcome effectiveness (para 62 p 28) |
| Assessor and assessment teams | Heavy reliance on quality of team leading to tension between peer review and assessor competency arising from relative inexperience and a majority of assessors only doing one review (para 65 p 30) |  |
| Global standards | variability in different legal systems and other standards of governance has meant that some standards are irrelevant or counterproductive and there was little ability to modify to particular country circumstances (para 79 p 36-37) with all recommendations equally weighted in all circumstances (para 87 p 39) | Criticised for the high cost of approach (para 89 p 40)Alternative approach to cluster countries according to core characteristics ‘country constellations’ (para 93 p 41) |
| Assessment reports | Reports frequently too long, negative in tone, unmindful of level of risk and unhelpful in priority setting and divergent views on value of compliance ratings(para 101 p 44) Indicated the cost of each assessment being in excess of $300,000. (para 112 p 49) | Welcomed proposals that reports be succinct, balanced, focus on targeted issues and prioritise recommendations (para 102 p 45) costs (of compliance) are **substantial** (para 107 p 48) unless this is addressed the system risks remaining ineffective as compliance will be superficial only |

The FATF is an organisation that acts on consensus and consultation so is extremely slow to change direction if indeed that is what it would want to do, remember that the list of ‘reviewers’ is limited and those that undertook the 3rd round reviews as most likely to be ask to undertake the 4th round ‘for purposes of consistency’ and hence creation of apparent objectivity.

Of concern is that the recommendations which were previously “soft law” and yet which required so much effort now become coercive policy, seemingly state sovereignty has been handed in, or exchanged for, a coveted position in the FATF. While initial review of the first handful of 4th round evaluations appears strong, on closer inspection cracks become visible particularly surrounding the concept of ‘risk’, the new mantra word of the FATF prayer wheel. We observe that Norway and Ethiopia received a low ranking: Norway (probably) because it considers the whole issue as of less importance given its general low level of crime and Ethiopia because all goes slow there anyhow.

Spain displays a highly valued risk-based approach. But looking closer I think they collected all sorts of information from general open sources or what was known already and smartly lined that information up as a risk picture gallery underlying their policy. It may be of interest to inspect these MERs on the lemma of ‘low risk’: I notice that when a phenomenon is rated as ‘high risk’ it is accepted blindly, but ‘low risk’ qualification seems evoke some dispute. I am not yet ready with this. Be assured one thing: the evaluation teams are larger than before (7-10) and spend more days (plm. 2 weeks), implying more expenses.

1. Available at: <http://ec.europa.eu/internal_market/company/docs/financial-crime/20110124_study_amld_en.pdf> (date of access 6/8/15) [↑](#footnote-ref-1)