Money Laundering and International Efforts to Fight It

Although money laundering is impossible to measure with precision, it is estimated that US$300 billion to US$500 billion in proceeds from serious crime (not tax evasion) is laundered each year. Measures in major financial markets to detect and prosecute laundering are driving it toward less developed markets linked to the global financial system. If left unchecked, money laundering could criminalize the financial system and undermine development efforts in emerging markets. This Note surveys efforts by international bodies to combat money laundering. It looks in particular at the Financial Action Task Force based at the OECD, which has made the most continuous effort.

How money is laundered

In money laundering, the proceeds of crime are run through the financial system to disguise their illegal origins and make them appear to be legitimate funds. Most often associated with organized crime, money laundering can be linked to any crime that generates significant proceeds, such as extortion, drug trafficking, arms smuggling, and white-collar crime. Although money laundering often involves a complex series of transactions, it generally includes three basic steps.

The first step is the physical disposal of cash. This placement might be accomplished by depositing the cash in domestic banks or, increasingly, in other types of formal or informal financial institutions. Or the cash might be shipped across borders for deposit in foreign financial institutions, or used to buy high-value goods, such as artwork, airplanes, and precious metals and stones, that can then be resold for payment by check or bank transfer.

The second step in money laundering is known as layering, carrying out complex layers of financial transactions to separate the illicit proceeds from their source and disguise the audit trail. This phase can involve such transactions as the wire transfer of deposited cash, the conversion of deposited cash into monetary instruments (bonds, stocks, traveler’s checks), the resale of high-value goods and monetary instruments, and investment in real estate and legitimate businesses, particularly in the leisure and tourism industries. Shell companies, typically registered in offshore havens, are a common tool in the layering phase. These companies, whose directors often are local attorneys acting as nominees, obscure the beneficial owners through restrictive bank secrecy laws and attorney-client privilege.

The last step is to make the wealth derived from the illicit proceeds appear legitimate. This integration might involve any number of techniques, such as using front companies to “lend” the proceeds back to the owner or using funds on deposit in foreign financial institutions as security for domestic loans. Another common technique is over invoicing or producing false invoices for goods sold—or supposedly sold—across borders.

Exposed emerging markets

Money laundering is a problem not only in the world’s major financial markets and offshore...
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centers. Any country integrated into the international financial system is at risk. As emerging markets open their economies and financial sectors, they become increasingly viable targets for money laundering activity. Increased efforts by authorities in the major financial markets and in many offshore financial centers to combat this activity provide further incentive for launderers to shift activities to emerging markets. There is evidence, for example, of increasing cross-border cash shipments to markets with loose arrangements for detecting and recording the placement of cash in the financial system and of growing investment by organized crime groups in real estate and businesses in emerging markets.

International accords

Concerted efforts by governments to fight money laundering have been going on for the past fifteen years. The main international agreements addressing money laundering are the United Nations Vienna Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (the Vienna Convention) and the 1990 Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds of Crime. And the role of financial institutions in preventing and detecting money laundering has been the subject of pronouncements by the Basle Committee on Banking Supervision, the European Union, and the International Organization of Securities Commissions.

The Vienna Convention

The Vienna Convention, adopted in December 1988, lays the groundwork for efforts to combat money laundering by creating an obligation for signatory states to criminalize the laundering of money from drug trafficking. It promotes international cooperation in investigations and makes extradition between signatory states applicable to money laundering. And it establishes the principle that domestic bank secrecy provisions should not interfere with international criminal investigations.

The 1990 Council of Europe Convention

Adopted in November 1990, the Council of Europe Convention establishes a common criminal policy on money laundering. It sets out a common definition of money laundering and common measures for dealing with it. The convention lays down the principles for international cooperation among the contracting parties, which may include states outside the Council of Europe. Its scope is not limited to money from drug trafficking.

Basle Committee statement of principles

In December 1988, the G-10’s Basle Committee on Banking Supervision issued a “statement of principles” with which the international banks of member states are expected to comply. These principles cover identifying customers, avoiding suspicious transactions, and cooperating with law enforcement agencies. In issuing these principles, the committee noted the risk to public confidence in banks, and thus to their stability, that can arise if they inadvertently become associated with money laundering.

European Union directive

In June 1991, the Council of the European Communities adopted a directive on the “Prevention of the Use of the Financial System for the Purpose of Money Laundering.” This directive was issued in response to the new opportunities for money laundering opened up by the liberalization of capital movements and cross-border financial services in the European Union. The directive obligates member states to outlaw money laundering. They must require financial institutions to establish and maintain internal systems to prevent laundering, to obtain the identification of customers with whom they enter into transactions of more than ECU 15,000, and to keep proper records for at least five years. Member states must also require financial institutions to report suspicious transactions and must ensure that such reporting does not result in liability for the institution or its employees.
Resolution of the International Organization of Securities Commissions

The International Organization of Securities Commissions (IOSCO) adopted, in October 1992, a report and resolution encouraging its members to take necessary steps to combat money laundering in securities and futures markets. A working group of IOSCO’s Consultative Committee has been set up to collect information from IOSCO members’ self-regulatory organizations and exchanges on their efforts to encourage their own members to fight money laundering.

The Financial Action Task Force

The main international body engaged in continuous, comprehensive efforts both to define policy and to promote the adoption of countermeasures against money laundering is the Financial Action Task Force (FATF). The FATF, set up by the governments of the G-7 countries at their 1989 Economic Summit, has representatives from twenty-four OECD countries, Hong Kong, Singapore, the Gulf Cooperation Council, and the European Commission. Participants include representatives from members’ financial regulatory authorities, law enforcement agencies, and ministries of finance, justice, and external affairs. Representatives of international and regional organizations concerned with combating money laundering also attend FATF meetings as observers.

The FATF has pursued three main tasks:

- Monitoring members’ progress in applying measures to counter money laundering.
- Reviewing money laundering techniques and countermeasures.
- Promoting the adoption and implementation of appropriate measures by nonmember countries.

A cornerstone of the FATF’s efforts is its detailed definition of appropriate countermeasures for countries to use. These measures are set out in the “Forty Recommendations” formulated and adopted by the group in 1990.

The Forty Recommendations

The Forty Recommendations address four general themes:

- The overall context, in which the recommendations urge member countries to ratify the Vienna Convention, to ensure that financial institution secrecy laws do not inhibit implementation of the recommendations, and to promote multilateral cooperation and mutual assistance in investigations, prosecutions, and extraditions.
- The legal framework, in which the recommendations require the criminalization of laundering the proceeds of drug-related crimes, encourage the coverage of all serious crimes or all crimes that generate large proceeds, and promote provisions allowing the freezing, seizing, and confiscation of property related to laundered funds.
- The role of the financial system, in which the recommendations define roles for banks, life insurance companies, and other nonbank financial institutions, as well as financial regulatory authorities. The role envisioned for financial institutions is identifying their customers, maintaining records sufficient to allow the reconstruction of transactions, and making these records available to the right authorities for criminal investigations and prosecutions. The recommendations thus imply that financial institutions should not keep anonymous accounts. The recommendations encourage institutions to make a serious effort to identify and report suspicious activities and to adopt good internal policies, procedures, and controls. And they encourage states to adopt legal provisions protecting institutions and their employees from legal liability for reporting suspicious activity in good faith. The authorities are supposed to ensure that financial institutions have put in place adequate internal safeguards against money laundering. And states are to take legal or regulatory measures to prevent criminals from getting control of financial institutions.
- The strengthening of international cooperation, in which the recommendations encour-
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age authorities to exchange information on currency flows and money laundering techniques and on suspicious transactions or operations. International cooperation should be supported by bilateral and multilateral agreements based on generally shared legal concepts. Cooperation and mutual assistance should include the production of records by financial institutions, the identification, freezing, seizure, and confiscation of criminal proceeds, and extraditions and prosecutions.

The discipline of self-assessment and peer review

The FATF has two mechanisms for promoting effective action by member states. The first is a self-assessment by authorities in each state to evaluate the state’s progress in implementing the Forty Recommendations. The second is a peer review. Both have proved highly effective in highlighting weaknesses in states’ legal frameworks and procedures and in generating support for needed improvements.

Self-assessment. The self-assessment is based on a detailed questionnaire developed by the FATF in 1991 and periodically revised to take account of developments in laundering techniques. The questionnaire is designed to elicit objective indicators of whether recommendations have been implemented and how they have been implemented. Each member completes the questionnaire once a year.

Peer evaluation. In the peer evaluation, a team of representatives from at least three member governments reviews the performance of another member government. The evaluation team, reviews information submitted by the government and verifies and supplements that information through on-site visits and interviews. Under the guidance of the evaluation team, the FATF secretariat writes a draft confidential report, which is discussed with the member in meetings with other FATF members. The final report gives a confidential assessment of how well the member is adhering to the recommendations and identifies areas needing further work.

Training and support network

The goals of the FATF are, first, to persuade all countries with important financial centers to endorse and implement its recommendations and, second, to support those countries’ efforts. The FATF runs international seminars on combating money laundering and sends missions to countries to encourage the adoption of its recommendations. The FATF also acts as a clearinghouse for requests from nonmember countries for training and technical assistance. With the help of the FATF, a separate task force has been established for governments of the Caribbean and the Caribbean rim. The FATF has also recently set up an Asian secretariat to work with governments in that region.

World Bank operations

Emerging markets are increasingly becoming the venue for large-scale money laundering operations. If left unchecked, this activity eventually will undermine the credibility of the formal financial sector. In its financial sector operations, the World Bank can promote measures to counter the flow of illicit funds into the financial systems of countries and arrange for external assistance. In doing so, the Bank needs to recognize that measures to prevent and detect money laundering activities cannot focus only on banks. Effective measures must also address the formal securities, insurance, and money changing sectors.

Illustration by Ruth Sofair Ketler.

The following documentation is available from the Financial Sector Development Department:

▪ Annual reports of the FATF providing detailed information on steps by member states to combat money laundering, trends in money laundering techniques, and the activities of the FATF in emerging markets.

▪ A synopsis of the Forty Recommendations.

▪ The United Nations Vienna Convention.

▪ The Council of Europe Convention.

▪ The Basle Committee statement of principles.

▪ The European Union directive on money laundering.

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