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Offshore finance and money laundering: The politics of combating parasitic strategies

by

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Offshore finance and money laundering: The politics of combating parasitic strategies

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Preface

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Abstract

In recent years the number of states and territories that try to attract financial flows through offering a combination of lax regulation and strict secrecy laws has shot up. These types of state-strategies can be described as parasitic when they entail seeking to attract business in ways that are detrimental to global welfare and the rule of law. They can also represent misuse of sovereignty in so far as sovereign states have offered tools explicitly designed to defeat the laws of other countries. Since the late 1990s a series of international initiatives have been launched through the G7's Financial Action Task Force on Money Laundering (FATF) and Financial Stability Forum (FSF) and the OECD in an effort to combat global financial abuses, and in some respects impressive headway has been made.

This report discusses four questions relating to the problems caused by financial havens in general, and those raised by offshore financial centres in particular. The first two issues relate to the role and significance of financial havens respectively. Against this backdrop a short review of current regulatory initiatives against money laundering, ("harmful") tax competition and rogue banking is given. Then a case study of the relatively successful FATF process to combat money laundering is undertaken. It is argued that the FATF may well be close to optimal as regards size and composition for a standard setting body. The report concludes with an assessment of policy options in the area of offshore finance with special emphasis on money laundering. The main thrust of the advice given is to continue to prioritise and broaden the processes already under way.

List of abbreviations

BIS	Bank for International Settlements
FATF	Financial Action Task Force (of the G7)
FIU	Financial Intelligence Unit
FSF	Financial Stability Forum
NCCT	Noncooperative Countries and Territories
OFC	Offshore Financial Centre
OECD	Organisation for Economic Co-operation and Development
UN	United Nations
UNODCCP	United Nations Office for Drug Control and Crime Prevention

1. Introduction

The problem of financial abuses is as old as money itself, but in recent years the number of states and territories that try to attract financial flows through offering a combination of lax regulation and strict secrecy laws has shot up. Small, once remote islands and territories, but also bigger more “fully fledged” states have found a new way of profiting from the globalised economy. A market once dominated by a few advanced or fairly advanced states like Switzerland, the Cayman Islands and Liechtenstein has increased greatly. New information processing and telecom technology, liberalisation and “decompartmentalisation” of finance, the end of the cold war and the globalisation and partial “dollarisation” of business and organised crime have lowered the threshold for entry into the market for financial havens.[1]

This “new” environment for financial abuses is one where physical proximity to major financial centres is of diminishing importance, and where “banks” are often not more than an internetserver somewhere. This has turned problems of money laundering, tax evasion and rogue banking into major issues on the global governance agenda. There is also an internal dynamism to this development. As traditional havens like Switzerland and the Cayman Islands have moved “up-market” through yielding to international pressure and signing international treaties, smaller havens have moved in on the more shady part of their business.

Since the late 1990s a series of international initiatives have been launched through the G7’s Financial Action Task Force (FATF) on Money Laundering and Financial Stability Forum (FSF) and the OECD in an effort to combat global financial abuses, and in some respects impressive headway has been made.

The remainder of this report discusses four questions relating to the problems caused by financial havens in general, and those raised by offshore financial centres in

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[1] *Decompartmentalisation* denotes the trend towards “financial supermarkets” that is a breakdown of barriers between traditionally different functions in finance e.g. between brokering, insurance and banking. This trend is of relevance for the fight against money laundering because it reduces the number of entry and exit points for a given flow of funds in the financial system and thus

particular. The two sections that follow provide an overview of the role and significance of financial havens. Against this backdrop a short review of current regulatory initiatives against money laundering, tax competition and rogue banking is given. Then a case study of the relatively successful FATF-process to combat money laundering is undertaken. The reviews of measures against tax competition and rogue banking are short, incomplete, based on secondary material and are included mainly for purposes of comparison and contrast. The analysis of anti money laundering measures is based on more thorough research, but it still represents a first stab at a complex topic. The aim is to draw issue-area specific - and general - lessons about how to best promote the implementation of improved regulatory standards. Finally, the report concludes with an assessment of policy options in the area of offshore finance with special emphasis on money laundering.

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makes tracing harder. Dollarisation denotes a trend towards using dollars in black (and legitimate) markets across the globe, this trend facilitates linkage between illegal markets.

2. Parasitic strategies and the misuse of sovereignty

It is a fundamental and elementary principle of liberal democracy that political and juridical systems seek to achieve a balance between the rights and obligations placed on individual citizens, private corporations and other legal entities. How these values are best balanced and how an agreed "equilibrium" can best be realised through institutional design are contested and dynamic issues. The quest for balance between rights and obligations is thus a source of legitimate variation and strife over time and across democratic polities. Most financial havens, however, do not seek such a balance in the financial sphere. Instead rules are wittingly designed granting rights but not obligations for foreign citizens in order to attract their funds.

The provision of offshore financial services is often part of a *parasitic* strategy. A strategy can be termed parasitic when a state deliberately designs its policies to try to attract business and achieve self-enrichment in ways that are detrimental to global welfare and the rule of law. In the context of financial havens these policies typically combine under-regulation with strict secrecy rules.

Such a strategy may also be said to represent a *misuse of sovereignty*. World order rests on a system of sovereign states. A sovereign state – as agreed to by the members of the United Nations - has the right to control its territory, its citizens and its residents. One obvious external corollary to this is the obligation of non-intervention and the right of immunity: No other authority can legislate and execute power on another state's territory, unless this right is granted in a treaty entered into voluntarily (Føllesdal 1999). A second less frequently stated corollary is that no state should assist citizens or residents of another state in the violation of the laws of their home countries. One state's sovereignty must be reigned in, in order to protect the sovereignty of other states. The importance of balancing rights and obligations re-emerges at the state-to-state level.

Thus, when states seek to use their sovereignty to undermine the capacity of other states to enforce their own laws, in order to gain financially, a dilemma and the need for balancing emerge. In a report to the United Nations Office for Drug Control

and Crime Prevention (UNODCCP) four prominent experts stated the issue of misuse of sovereignty by financial havens like this:

> These sovereign states have offered tools explicitly designed to defeat the laws of other countries. Many of these tools are made available only to non-residents and can only be used offshore. The sale or rental of sovereign status degrades national legal institutions. Further it blocks the development of an international rule of law that is an essential concomitant of a globalized economy.[2]

There are circumstances in which international law recognises the right of one state to shelter the citizens of another, for example the granting of asylum to persons fleeing political persecution and protection against crimes against humanity. These exceptions, the UN-commissioned report says, must be considered when privacy and secrecy are debated. But as the report goes on to say:

> …the fact is that almost everything that is hidden by bank secrecy and financial privacy laws is being hidden to protect the owner from taxation, criminal prosecution and civil court judgements.[3]

In a more direct language the secrecy laws of financial havens facilitate the activities of drug cartels, traffickers in human beings and sexual services, arms traffickers, terrorists, corrupt governments and private officials, tax evaders and rogue speculators whose activities threaten to destabilise the world financial system.

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[2] Blum et al (1998:59).

[3] Ibid

3. Money laundering, tax evasion and rogue banking

For analytic and regulatory purposes we can distinguish between three clusters of problems related to financial havens: Money laundering, tax evasion (and avoidance) and rogue banking.

Money laundering is the process whereby illicit funds are made to appear legal. There are two main reasons why criminals want to launder their money (Blum et al 1998:4). Firstly because the money-trail in itself can become evidence and secondly because money per se can become the target of investigation and action.

There are rival definitions of money laundering, but most of them distinguish analytically between three stages or functions. Firstly the money has to be de-associated from the crime in question. Secondly the trail must be covered in order to foil pursuit and thirdly a perception of legitimacy must be created for the money to be made available to the criminal again.

Simple forms of money laundering combine all three stages in one operation like when criminals buy up winning betting slips at a racecourse. This way a "legitimate" receipt is produced and the origin of the funds is concealed in one move. To handle ongoing flows of money criminals need more permanent set-ups like cash based retail services where illegal money is mixed the with legal and the total sum is reported as legal earnings.

International money laundering involves moving money out of their country of origin either through smuggling or through a front business that appears to have legitimate reasons for sending money abroad. Once abroad, the money can be filtered through financial centres with strict secrecy laws in order to make it virtually untraceable. Finally, the money needs to be made available again. For this many techniques are available. These range from making withdrawals on secure credit cards issued by banks in financial havens to creating bogus capital gains, to setting up front companies that do successful trades with the outside world. The last two types of transactions are made to appear as the result of good business sense but are actually transactions where the launderer is dealing with himself and where his or her foreign

company is taking a loss while the domestic company or persona is reaping the rewards.

Money laundering may seem like a technical and remote problem but it is enormous in scope and the underlying crimes are often violent and bloody. Successful money laundering makes the work of law enforcement officials extremely difficult and is thus a threat to the rule of law. It is also a huge problem in sheer volume: An estimate by the then IMF director general Michel Camdessus was that money laundering represented two to five percent of world GDP in 1998, that is between $800 million and $2 trillion per year.

As Blum et al (1998:5) point out, although money laundering and tax evasion share many techniques and can be run in tandem, the underlying purposes are distinct. In general tax evasion entails taking legally earned income and making it illegal through hiding its origins (transferring it into a less taxable or non-taxable type of income) or hiding it altogether, while money laundering is the reverse process. It takes illegal income and makes it appear legal. Whereas tax evaders under-report their legal earnings thereby paying less tax than they legally should, money launderers often over-report the earnings they make through their legal enterprises thus becoming liable for more tax than they would otherwise be. Tax avoidance, as opposed to tax evasion, is legal, but the policies that invite it may still be classified as “harmful” by the OECD (see below).

According to the OECD, what it terms harmful tax practices distort trade and investment, erode national tax bases and weaken the legitimacy and structure of national tax systems. Oxfam, the British based international anti-poverty organisation, has estimated that developing nations alone lose $50 billion a year due to tax evasion through financial havens.

A bank or other financial institution is engaging in rouge behaviour when it seeks to avoid national and international supervisory, risk-regulating and behavioural standards. The motive for engaging in such behaviour can be to be able to assume the degree of risk these standards seek to prohibit or to achieve freedom of action to engage in illicit activities and market abuse. Under-regulated financial centres increase

the potential for regulatory arbitrage. Rogue market actors seek out financial centres with weak supervisory practices, negligible willingness to co-operate and lack of transparency.

4. Recent regulatory initiatives

Money laundering, tax evasion and rogue banking thrive in similar environments. The common denominators for financial havens that stimulate these problems are secrecy/lack of transparency, lax demands placed on customers (from capital adequacy requirements to tax rates) and a lack of willingness on the part of local authorities to enter into international co-operation and information exchange.

The late 1990s witnessed a co-ordinated international effort against these problems run through three different multilateral fora. The Financial Action Task Force (FATF), which was set up by the G7 in 1989, is administratively located within the OECD. Its contribution to the co-ordinated effort was to focus on identifying "non-cooperative jurisdictions" as regards money laundering. The OECD ran a process seeking to identify "tax havens" and the Financial Stability Forum (FSF), which was set up by the G7 in 1999 and is located together with the BIS in Basel, did the same with regards to underregulated financial centres.

The methods employed were broadly similar and the three processes ran on co-ordinated timetables. The first reports were expected by June 2000 so that the G7 meeting that summer could receive them. As is evident from the table below the three organisations involved have overlapping, but different memberships. They also have different mandates and unequal amounts of resources at their disposal. Membership variation follows a pattern. The FSF is most exclusive and most technical in its set-up. It consists of the G7 countries, plus four more countries with advanced financial systems and representatives of the IMF, the World Bank and international standard setting bodies within the financial sphere. The FATF and OECD are more similar, with the exception that FATF has invited selected developing countries into the fold to function as bridgeheads through a system of regional "FATF-style" bodies. The OECD, mirroring its origins, remains predominantly European, which is also reflected in its recent willingness to accept European economies in transition as members.

Despite these differences there is a fundamental similarity between the strategies pursued. It has been three "top down" standard setting exercises based on

consensual decision making within the organisations.[4] Through a combination of sticks, carrots and assistance the aim has been to instigate what in political science is often referred to as “a race to the top”.[5] These similarities further indicate that the G7 has been instrumental, with the US playing a leading role.

Table 1. Hierarchy and participation: Membership in organisations engaged in fighting financial abuses. G7 members listed first. States that are members of the FATF but not the OECD underlined, OECD-members outside of FATF in italics. International organisations part of FSF in bold.

FATF	**OECD**	**FSF**
Canada	Canada	Canada
France	France	France
Germany	Germany	Germany
Italy	Italy	Italy
Japan	Japan	Japan
UK	UK	UK
US	US	US
Australia	Australia	Australia
Hong Kong	*Korea*	Hong Kong
Netherlands	Netherlands	Netherlands
Singapore	*Poland*	Singapore
Argentina	*Slovak Rep.*	**IMF**
Austria	Austria	**World Bank**
Belgium	Belgium	**Basle committees[1]**
Brazil	*Czech Rep.*	**BIS**
Denmark	Denmark	**IOSCO[2]**
Finland	Finland	**IAIS[3]**
Greece	Greece	1) bank supervision, payments and glob. financial system
The European Commission	*Hungary*	2) Securities commissions
Iceland	Iceland	3) Insurance supervisors
Ireland	Ireland	
Luxembourg	Luxembourg	
Mexico	Mexico	
New Zealand	New Zealand	
Norway	Norway	
Portugal	Portugal	
Spain	Spain	
Sweden	Sweden	
Switzerland	Switzerland	
Turkey	Turkey	

The main technique employed has been one of “naming and shaming” jurisdictions that do not live up to international standards as defined by the three bodies in question.

[4] The OECD process has not succeeded in being fully consensual as some member states have refused to support the tax-haven criteria agreed upon by the majority of the other states (see below).

[5] The mechanisms that work in this type of competitive environment will be discussed in the next section.

The FATF had since the early 1990s built its activity around a normative core consisting of 40 recommendations for states that want to fight money laundering. Based on these recommendations the FATF at the end of 1998 started developing 25 criteria for identifying non-cooperative countries or territories (NCCT). The criteria were developed in a consensual process. The criteria included quality of supervision, customer identification rules, excessive secrecy provisions, reporting requirements, requirements for identification of beneficial owners of legal entities, failure to criminalise money laundering and issues of resource sufficiency. The laws and practices of 29 jurisdictions were reviewed. These jurisdictions were invited to provide their own input – i.e. state their own cases – before the FATF produced its first official list of NCCTs in June 2000. This list named 15 jurisdictions as NCCTs while the further 14 under review were (merely) judged to have "deficiencies". The NCCT process is not over. The list is updated continuously, and "new" jurisdictions are taken under review, see next section and table 2 below.

The OECD has been running a similar process on harmful tax practices from 1998. Reflecting the general proposition that to protect one state's sovereignty other states' sovereignty has to be exercised within limitations, the general definition of harmful tax practices is given by the OECD (2001:4) as "when governments introduce practices designed to encourage non-compliance with the tax laws of other countries". The list of criteria developed by the OECD is less complex than what is the case with the FATF-NCCT list. Still, the criteria definition process was not entirely consensual. Luxembourg and Switzerland abstained. Four criteria stand out. 1) No or nominal taxes in the case of tax havens, nor low effective tax rates on the relevant income in the case of preferential regimes. 2) Lack of effective exchange of information 3) Lack of transparency and 4) No substantial activities required by tax domiciles, or in the case of preferential regimes, ring fencing rules, i.e. rules that insulate a country's core tax base from low or no tax demands. Most commonly ring fencing entails that a country which offers a preferential regime denies that regime to domestic taxpayers and domestic activities.

The OECD stressed that no or nominal taxes are not a sufficient criterion in itself. Rather it is a "gateway" criterion that merits the review according to the other criteria on the list. It is only when low or no taxes are combined with harmful tax practices that it becomes problematic for the OECD. In a review of the criteria the OECD has later decided to stop using criterion number 4 about substantial activities, the official reason given is difficulties in determining exactly what constitutes substantial local activities (OECD 2001:10).

Like the FATF the OECD allowed the jurisdictions under review to defend their own cases. During this process six jurisdictions, Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino committed to complying with the OECD's principles by 2005 and they were therefore not listed. Six more jurisdictions out of the original 47 under review did not qualify as tax havens, leaving 35 jurisdictions to be named and shamed in June 2000. The process of securing further commitments originally had a deadline for end of February 2002. It was still on-going at the time of writing and by mid-March, 19 more jurisdictions had committed to eliminate harmful practices, while one jurisdiction (Tonga) had actually already made the required legislative and administrative changes.

The FSF process was, by comparison with the two reviewed above, less dynamic, precise and interactive. The key concept of the FSF process is Offshore Financial Centres (OFCs). That is jurisdictions where the volume of non-resident business greatly exceeds the volume of domestic business, a state of affairs most likely brought about by the presence of at least some of the following characteristics. Low or no taxes, easy licensing, light supervision, flexible use of trusts and other corporate vehicles, no physical presence requirements, impenetrable secrecy laws and unavailability of similar incentives to residents. The FSF established a committee with the aim of compiling a list of underregulated (OFCs) and assessing their potential to contribute to financial instability.

The main method employed to this end was the construction of a survey that asked onshore supervisors about their judgement of the quality of regulation and supervision in offshore jurisdictions with which they had experience and knowledge.

Simultaneously offshore supervisors were asked about their interaction with the home supervisors of financial service providers operating in, or from, their offshore jurisdictions. The FSF looked at many aspects of regulatory and supervisory policy, but the three key issues were quality of supervision, degree of co-operation and degree of transparency and information sharing. On the basis of this the FSF grouped OFCs into three categories, from high to low quality. The list it published did, not surprisingly, show a large degree of overlap with the efforts of the FATF and the OECD.

Unlike the two latter however, the FSF did not create an ongoing process whereby jurisdictions were given incentives to get off the list of "named and shamed". Instead the FSF more or less passed the buck to the IMF, asking this organisation to take over the role of assessing implementation of standards.

In conclusion the FSF said:

> the FSF took note of the positive actions that had been taken by some OFCs to enhance their supervisory, regulatory, cooperation and information practices. It emphasised that continuing efforts were needed to translate legislative changes into practices. OFCs that have not already done so were encouraged to take the necessary steps to enhance their implementation of relevant international standards, and to enlist the assistance of the IMF and the World Bank and participate in assessment programs, as appropriate. Disclosure of action plans and assessment findings were seen as a useful means for OFCs to help demonstrate their progress towards meeting such standards.

5. FATF and the case of money laundering

The FATF is arguably the most successful of the three multilateral efforts reviewed above. Without diluting the standards originally developed the organisation has led a dynamic existence with ongoing work vis-à-vis NCCTs and the evolving character of the problem of money laundering.

The normative and intellectual core of the FATF effort is a set of 40 recommendations. These were originally drafted in 1990, one year after the organisation's inception in 1989. They were revised in 1996 and a new revision is currently under way. The recommendations are now established as the international standard for anti-money laundering programs. All of FATF's 29 members have committed to them, and outside of the FATF they represent a commonly accepted point of reference for anti-money laundering efforts. These recommendations can be grouped into five different clusters.

- *Criminalisation of the act of money laundering:* The criminalisation of the laundering of the proceeds of serious crime and the enactment of laws to seize and confiscate the proceeds of crime.
- *Customer identification:* Obligations on financial institutions to identify all clients, including any beneficial owners of property, and to keep records.
- *Reporting requirements:* A requirement for financial institutions to report suspicious transactions to the competent national authorities and to implement a comprehensive range of internal control measures.
- *Control and supervision:* Adequate systems for control and supervision of financial institutions.
- *International co-operation.* The need to enter into international treaties or agreements and to pass national legislation which will allow countries to provide prompt and effective international co-operation at all levels.

The 40 recommendations are formulated trying to strike a balance between the general and the specific: General enough to be valid across legal systems and specific enough to avoid new loopholes emerging. One mechanism that aids in the process of "translation" from general principle to national legislation is the group of regional style FATF bodies that have been set up around the world. These bodies also seek to reproduce the kind of peer pressure and alertness FATF proper seeks to generate through other techniques, such as mutual evaluations, and self-assessment exercises. Both the FATF proper and the regional bodies also seek to facilitate collective learning and technical assistance.

There are now such bodies in the Caribbean, in the Asia/Pacific region, as well as in Europe, where the Council of Europe has one that is particularly active working with transition economies in Central and Eastern Europe. Furthermore there is one for Eastern and Southern Africa, one for Latin America and there are also initiatives for Western and Central Africa. Finally, there is also a body for offshore banking supervisors that do FATF style work.

An important part of the global effort against money laundering is facilitating technical assistance. Getting legislation in place, setting up Financial Intelligence Units (FIUs) that can receive and analyse the data generated by reporting requirements, and training/recruiting qualified personnel can be demanding tasks even for richer and more developed states.

History has demonstrated that money laundering is a dynamic field. Money launderers keep coming up with new techniques in response to changes in the economic, technological and law enforcement environment that they function within. This is the rationale behind the FATF (and FATF-style bodies) doing "typologies" work. It is organised in working groups that meet at the margins of FATF meetings. Its purpose is to facilitate collective learning on money laundering trends and countermeasures through exchange of knowledge gained by regulators and law enforcement officers that are involved in combating money laundering in the field.

All this has yielded what appears to be impressive results. From the original "naming and shaming" list published in 2000, four jurisdictions were off one year later because they had enacted legal reforms and were found to be under way to implementing them. Eight more jurisdictions were found to have made progress, but not enough to get off the list by the summer of 2001. At the same time 13 "new" jurisdictions were reviewed, which resulted in six newcomers to the NCCT list.

Table 2. Bold progress: The ”naming and shaming” lists of the FATF, OECD and FSF.

Jurisdictions in bold have made legislative amendments or commitments that have qualified for being taken off the lists of the FATF and OECD respectively.

Underlined and bold in the FATF-list are jurisdictions that were reviewed before publication of the original list in 2000 or included for the first time in the review for 2001, where there were found deficiencies but not significant enough to merit inclusion on the list.

Underlined and bold in the OECD-list are jurisdictions that prior to the release of the 2000 Progress Report in June 2000 made commitments to co-operate with the OECD in addressing harmful tax practices and where therefore never put on the original list.

Jurisdictions in italics on the FATT- list are those that are judged to have made progress by the 2001 review, but not enough to merit coming off the list so far.

FATF NCCT-list	OECD-tax haven-list	FSF-list of "low quality"
	Andorra	
	Anguilla	Anguilla
Antigua and Barbuda	**Antigua and Barbuda**	Antigua and Barbuda
	Aruba	Aruba
Bahamas	**Bahamas**	Bahamas
	Bahrain	
	Barbados	
Belize	Belize	Belize
Bermuda	**Bermuda**	
British Virgin Islands	British Virgin Islands	British Virgin Islands
Cayman Islands	**Cayman Islands**	Cayman Islands
Cook Islands	Cook Islands	Cook Islands
		Costa Rica
Cyprus	**Cyprus**	Cyprus
Czech Rep.		
Dominica	**Dominica**	
Egypt		
Gibraltar	**Gibraltar**	
Grenada	**Grenada**	
Guatemala		
Guernsey	**Guernsey/Sark/Alderney**	
Hungary		
Indonesia		
Isle of Man	**Isle of Man**	
Israel		
Jersey	**Jersey**	
Lebanon		Lebanon
	Liberia	
Liechtenstein	Liechtenstein	Liechtenstein
	Maldives	
Malta	**Malta**	
Marshall Islands	Marshall Islands	Marshall Islands
Mauritius	**Mauritius**	Mauritius
Monaco	Monaco	
	Montserrat	
Myanmar		
Nauru	Nauru	Nauru

	Netherlands Antilles	Netherlands Antilles
Nigeria		
Niue	Niue	Niue
Panama	Panama	Panama
Philippines		
Poland		
Russia		
Samoa	Samoa	Samoa
	San Marino	
Seychelles	**Seychelles**	Seychelles
Slovak rep.		
St. Lucia	**St. Lucia**	St. Lucia
St. Kitts and Nevis	**St. Kitts & Nevis**	St. Kitts & Nevis
St. Vincent and the Grenadines	**St. Vincent and the Grenadines**	St. Vincent and the Grenadines
	Tonga	
Turks & Caicos	**Turks & Caicos**	Turks & Caicos
Ukraine		
Uruguay		
	US Virgin Islands	
Vanuatu	Vanuatu	Vanuatu

The FSF-list of under-regulated jurisdictions has not been updated since the summer of 2000.

5.1. What can explain the relative success of FATF?

FATF's goal is to make states conform to the anti-money laundering principles laid out in the 40 recommendations and the 25 criteria used to judge possible NCCTs. The last three to four years have seen continuous progress on this front. A group of sovereign states has managed to cajole other sovereign states and jurisdictions into changing their policies. All experience of (and theory concerned with) international relations tells us that this is not commonplace. How can it be explained?

The FATF process is on a general level driven by peer-pressure. It is a race to the top. We can identify several mechanisms that animate this principle.

i) The harnessing of market power is one. Naming and shaming can be a powerful technique as it directs the attention and changes the perceptions of market actors. Rating agencies and individual financial institutions may start to ask questions about listed countries and territories. They are singled out, and suffer reputational costs. This translates into measurable costs in the shape of more cumbersome business practices, the risk of downgrading by rating agencies and even lost business opportunities.

ii) The sanctions, or just the threat of sanctions, are a closely related mechanism that reinforces the market power mechanism. Sanctions are applied to countries that do not respond adequately to being listed. They range from countries advising their financial institutions to show caution to actually prohibiting business with them. The FATF's lowest level of sanction, which comes with listing is specified in recommendation 21:

> Financial institutions should give special attention to business relations and transactions with persons, including companies and financial institutions, from countries which do not or insufficiently apply these Recommendations. Whenever these transactions have no apparent economic or visible lawful purpose, their background and purpose should, as far as possible, be examined, the findings established in writing, and be available to help supervisors, auditors and law enforcement agencies.

iii) On a more positive note, dialogue, learning and associated transfer of resources constitute a third active mechanism. Countries with weaker traditions for regulation and supervision are made aware of deficiencies and methods for how to deal with them. Technical assistance is offered through individual countries and multilateral bodies such as the UN and the Council of Europe.

iv) A fourth mechanism that may work in the FATF's favour is that several states, in particular transition states, have a desire to become fully accepted members of the international society. For example, prospective EU-members are eager to conform to the standards set for them. Membership of organisations like the EU is deemed to bring both tangible and intangible rewards. Tangible rewards may include market access or even political stability. Among the less tangible rewards are factors such as national self-esteem and a general feeling of being accepted as a (more) equal partner.

One might argue that for these mechanisms to work it has been imperative that the FATF has functioned within a hierarchical system. The most advanced, richest countries have set standards that other countries have to conform to. These standard setting countries possess the biggest financial markets – the markets everybody wants access to. This is a pattern that is well known from the standard setting efforts of the

Basle committee on banking supervision (Kapstein 1994, Helleiner 2002). It follows from this argument that the FATF should not become too big, as its consensual decision making procedure would be bogged down and its standards would risk dilution in the name of compromise. In short, it has to retain an element of elitism to be able to assert productive peer pressure.

Countries have tried to ask for special favours for “client-states” of theirs. That is, some FATF members have on occasion been willing to depart from the standards of the organisation if it could benefit a “listed state” with which it enjoys special relations. But according to the FATF secretariat this has never gone through. Such attempts have been stopped by other member states. Thus according to the available evidence there has been no “contamination” of the NCCT-process so far. It has been consistent in its application of standards. The ability to maintain this level of consistency could be jeopardised by a large increase in the organisation’s membership.

It should also be noted that there are problematic aspects to the hierarchical top-down model of standard setting. There is a danger that this method will lead to too much focus on the least attractive aspects of poor country regulation while similar features in the standard setting countries are less likely to be given the same amount of attention. One counter argument here is that the FATF members do review themselves and each other according to the 40 recommendations. Still, to defend the FATF model we have to make the assumption that there are greater weaknesses in the targeted jurisdictions than in the FATF member states that wield the power to list and de-list. This is not an unreasonable assumption given that NCCT jurisdictions typically have both a stronger motive to try to attract shady capital while they have less resources available for supervision, regulation and law enforcement.

Even if this reservation about the unfortunate aspects of asymmetry is disregarded, the size argument should not in any case be made out to be a linear one (“i.e. the smaller the better”), or otherwise be taken too far. The FSF is the most exclusive organisation of the three discussed here, but it has achieved less impressive results in its field than the two others have in theirs. This could mean that there is such a thing as an optimal size for standard setting exercises, where considerations of power

and the costs of consensual decision making in large fora must be weighed against considerations of legitimacy, “ownership” and collective learning.

The complexity of the size-argument should also direct our attention towards characteristics of the issue area. The main point here is that money laundering has a much clearer normative status – its status as something undesirable is uncontested. This is not so much so the case with tax evasion and underregulation. Tax evasion is related to tax levels. The principle that sovereign states are free to set their own tax levels, has not been challenged by the OECD. According to dominant neo-liberal ideology tax competition is fundamentally healthy, it can stimulate efficiency in government spending. This means that the intellectual and normative starting point for combating harmful tax competition is ambiguous. As the OECD says in its 2001 report on harmful tax practices:

> The more open and competitive environment of the last decades has had many positive effects on tax systems, including the reduction of tax rates and broadening of tax bases which have characterized tax reforms over the last 15 years. In part these developments can be seen as a result of competitive forces which have encouraged countries to make their tax systems more attractive to investors. In addition to lowering overall tax rates, a competitive environment can promote greater efficiency in government expenditure programs.

Similarly, weak regulation cannot easily be linked to harmful intent. It is also a concept more difficult to define than money laundering. Furthermore, the fear of financial instability and the problem of weak regulation which is associated with it are probably more vulnerable to changes in the “business cycle” than the other two problems. Fears for the stability of the international financial system reached something of a historical peak during the Asian crisis, but interest seems to have weakened somewhat as time has passed. On the other hand, the success of the FATF process and the similarity of the demands stemming from the three processes may mean that the FSF- process has to a certain degree been usurped by the FATF and OECD processes.

The different normative status of the three projects is also reflected in the willingness to use sanctions in the three processes. FATF has the widest range of negative incentives available and is willing to use some of them. Recommendation 21 is only a first possibility on the FATF menu. Jurisdictions that fail to respond to this

level of sanction risk the next step. A typical FATF (2001:4) formulation on jurisdictions that have been on the list for a while reads like this (the following excerpt is taken from a FATF statement on "the inadequate progress has been made by Nauru, the Philippines and Russia in addressing the serious deficiencies identified in June 2000"):

> In addition to the application of Recommendation 21, it recommends the application of further counter-measures which should be gradual, proportionate and flexible regarding their means and taken in concerted action towards a common objective. It believes that enhanced surveillance and reporting of financial transactions and other relevant actions involving these jurisdictions is now required, including the possibility of: Stringent requirements for identifying clients and enhancement of advisories, including jurisdiction-specific financial advisories, to financial institutions for identification of the beneficial owners before business relationships are established with individuals or companies from these countries;

In contrast, the OECD (2001:14) never wanted to impose sanctions (or "coordinated defensive measures") after publishing the first list in 2000. Rather, it wanted to return to the question a year later, but as it turned out, in 2001 it was still hoping to avoid it:

> Although the Committee believes that a framework of co-ordinated defensive measures can help mitigate the impact of the erosive effects of harmful tax practices and ensure against their spread, it strongly prefers an approach that promotes change through dialogue and consensus.

To this, a pure speculation on the part of the author may be added. If we accept that the normative case against money laundering is much more clear-cut than the other two, this would also make lobbying by financial community interests harder in this case than in the other two. Simply put, rich country business interests hurt by the money laundering initiative have a much harder time arguing their case than corresponding interests in the two other cases. To attain data on this point would require a much more time consuming and ambitious project than the one from which this report springs.

A final factor that counts in the FATF's favour is the mandate the organisation has been given to co-ordinate international efforts against terrorist financing after the attacks of September 11th. The political energy and co-ordinated strengthening of legislation and increased flow of resources for surveillance that have followed, and will continue to follow, from this is of course a recent phenomenon and we cannot measure its impact yet. It seems reasonable though, to expect that the anti-terrorist

agenda will have an impact on the fight against money laundering over the next two or three years. This point will be briefly touched upon below.

6. Conclusions and policy recommendations

Conclusions

Secrecy rules and lack of transparency, underregulation and lack of co-operation stimulate money laundering, tax evasion and rogue banking. In turn, these undesirable activities can be related to a large number of very serious problems. Organised crime is facilitated by the availability of channels for money laundering and tax evasion. So is corruption in the public and private sectors. Terrorism depends on the ability to transfer funds, hiding their purpose and often their source. National tax bases are eroded by tax evasion reducing the fiscal powers of the state and placing a disproportionate size of the burden on law-abiding citizens. The integrity and stability of financial markets are threatened by rogue behaviour. In sum key values such as human safety, law and order, fairness and economic stability are undermined by financial abuses and the states that encourage them.

The evidence reviewed here demonstrates that in spite of the expectations most theories of International Relations generate, important progress has been made in terms of achieving better global governance of these issues, particularly the work which has centred on combating moneylaundering. However, it is difficult to draw clear conclusions as to why the money laundering process has been the most successful. It is probably related to the size and composition of the forum, the normative status of the issue of money laundering, and the evolution of an efficient modus operandi by the FATF. But it is important that this progress is maintained. At least seven policy recommendations can be linked to the analysis above:

Recommendations

a) Governments must work to broaden the legal base for when money can be the target of investigation and seizure.

Money laundering is a derivative crime. Its status as a crime depends on how the funds involved were earned (Blum et al 1998:66). From a law enforcement point of view it is important to be able to go after all kinds of misuse of the financial system, without worrying about what is the underlying predicate offence. The Vienna convention of 1988 paved the way for making the laundering of drugs money a crime in the signatory states.[6] This was an important break-through because it cleared the way for attacking criminals via their funds. Over time the international community has expanded the range of underlying offences and thus the definition of money laundering. There is variation between jurisdictions today, but there are generally still clear limits to what kind of criminal money can be pursued. Blum et al (1988:66) are almost entirely clear on this point:

> The time may have come to end the artificial divisions of criminal money into categories depending on the nature of the crime. As long as some criminal money can be laundered legally, the financial system will argue that its financial centre arrangements to hide funds have a legitimate purpose. Bankers and brokers who are asked to launder money will argue that they thought the money came from a non-predicate crime.

b) Corporate secrecy must be afforded the same amount of attention banking secrecy has been receiving.

Money laundering often involves several levels of secrecy. International efforts so far have been focused on banking secrecy. The type of corporate vehicles available will vary between jurisdictions of even within nation-states e.g. the problems raised by the special corporate laws enacted in Delaware, USA. Some places, particularly in common law countries, the main problem is with trusts. Some countries allow bearer shares. In offshore jurisdictions the problem is often International Business

[6] The United Nations Convention Against Illicit Traffic in Narcotics and Psychotropic Substances.

Corporations (IBCs) or “Shell companies”, i.e. companies that are not required to do anything except refrain from doing business in their port of registration. Such a company may hide its ownership, it need not pay taxes, does not have to keep books or prove any substantial type of activity. Normal limited companies have all kinds of demands placed on them in return for the privilege of risking a limited amount of capital. With IBCs there is no such trade-off and this makes them ideal for money-laundering purposes.

Corporate secrecy (unlike banking secrecy) is not properly reflected in the 40 FATF recommendations, and it is not included in the mutual evaluations. It is included in the 25 criteria though, so jurisdictions that want to come off the NCCT list have to make some improvements as regards corporate transparency. The main reason why corporate secrecy has been problematic for the FATF is disagreement among members on how to handle it. The US, for instance, says that secrecy provisions in Delaware corporate law are not a problem. The argument is that US law enforcement agencies have no problem getting what they want if they have a subpoena. This may not hold true for investigating bodies in other states though (see point d) below). In the ongoing revision of the FATF recommendations the issue of corporate secrecy is addressed; how clear-cut the outcome will be after the negotiations are over, however, remains to be seen. This topic is of the utmost importance and needs to be followed up at all levels where governments meet to tackle financial abuses. Any victory gained in the fight against banking secrecy will be somewhat hollow if corporate transparency is not improved correspondingly.

c) Broaden the base of reporting requirements

Traditionally, requirements for reporting suspicious transactions are only made on banks or financial institutions more generally. As money laundering techniques change it has become evident that this is not enough. Value can be stored and transferred in a multitude of objects that lend themselves to money-laundering. This means that different professions are the potential recipients of information of relevance for money-laundering investigations. It is difficult to know where to draw the line.

Lawyer-client privileges may have to be challenged on some points, and this is a sensitive issue in many jurisdictions. Stockbrokers, auditors, insurance companies, auction houses, realestate agents, jewellers, art dealers, there are many professions to which there are good reasons to extend reporting requirements. The issue of linking penalties to third parties also needs be addressed in many jurisdictions.

d) Further work is needed to facilitate international co-operation

Money laundering is an international problem and demands a multilateral approach. The first level of the problem is to get states to sign on to treaties that oblige them to participate in mutual legal assistance. Once this hurdle has been cleared, however, there are still several administrative ones left. One of the many challenges arising in international co-operation within the field is problems that stem from the fact that states have differing administrative systems. For instance in some states the FIU may be an administrative unit without powers of prosecution or law enforcement. In other states it may mean that the FIU cannot request information from a law enforcement agency in a different country. It has to go through its own law enforcement agency first. Time is often essential in money-laundering investigations. A slower process provides the criminals in question with more time to move their money. If legislation is harmonised to avoid such time and energy consuming procedures, some of the real-life problems facing those combating financial abuses in the field may be reduced.

e) Keep the FATF

The FATF is prolonged for five-year periods at the time. The current period is up in 2004 and a decision will probably be made in 2003. There is a school of thought that says that this is enough and that the FATF should be closed down two years from now. Too much pain and noise could be one (real) reason. The argument/excuse used could be that now that we have regional FATF-style bodies coming into existence all over the world, these could take over the responsibilities of the FATF. This argument, however, is faulty on at least two grounds.

Firstly, it assumes that the 40 recommendations can be finalised once and for all. This disregards the fact that money laundering is a dynamic phenomenon. Methods change in response to the evolution of regulation, legislation, business practices and technology. This means that the 40 recommendations have to evolve as well. The global effort against money laundering needs a global co-ordination centre, a standard setter that provides the baseline for the others. This brings us back to the more general point of the advantages of hierarchy that was argued above.

f) Increase the flow of resources to the FATF

The FATF has achieved impressive results particularly if measured against the resources spent on driving the organisation. It has worked with i) Typologies (because money-laundering practices change, legislation and recommendations have to evolve too); ii) The NCCT process; iii) Mutual evaluations; iv) Reviewing of the 40 recommendations; v) Meetings at the FATF and institutionalised meetings with other organisations and institutions; vi) PR-related work – speeches at other fora; and vii) The fight against terrorist financing has just been added to the mission. All this has been done with a secretariat consisting of three professionals. There are now plans to add two more to this, and perhaps another two after that. The current model – despite the impressive output currently generated – is not sustainable given current and future tasks. The model is also vulnerable. The history and tacit knowledge required to run the FATF effectively is to a large degree stored in the heads of three individuals. This makes the set-up vulnerable.

g) Increase public and political awareness of the problem of financial abuses

Financial abuses can often seem remote, technical and abstract, even if the underlying realities are clearly not. Political systems, however, often operate according to incentive structures that are not favourable to the fight against global financial abuses. Political (and financial) payoff in the form of spectacular arrests of people and money is not immediately forthcoming. Seeking to trace and seize funds hidden away in offshore havens is normally a cumbersome and expensive process. If short-term and

narrow cost-benefit criteria are used to evaluate single investigations, they can be vulnerable to political criticism and even lobbying by interests that stand to gain from cutting off the flow of resources to a given investigation.

The building blocks of the global fight against financial abuses are national legislation, supervision, and, in the last instance, personnel. Each nation committed to fighting financial abuses needs to maintain a keen focus on the issue and back this up with resources. Expertise financed and developed at the national level is crucial for international efforts like the FATF with its many evaluations, technical assistance programs and working groups. The existence of domestic expertise also increases the likelihood of influencing the work of bodies like the FATF.

A note of caution

Despite singing the praises of the FATF effort and to a lesser degree congratulating the OECD on the tax haven process, this report should, however, end on a cautious note. What we know has been achieved, is on the regulatory front widely defined. Better rules and executive capacity are in place in many locations and the work to further improve on this level is ongoing. This is documented - knowledge about these processes is available and the evidence is fairly unequivocal. What we have far less knowledge about, however, is to what degree regulatory change has resulted in behavioural change in the market place and in jurisdictions that are prime sites for these activities. We need to know more about two aspects: Both to what degree regulators and supervisors in underregulated OFCs and other problem sites actually follow up on their new formal commitments, and to what degree criminal, fraudulent and destabilising behaviour is actually curbed.[7]

During my study of these topics I have come across very little evidence on behavioural change. Measuring phenomena like money laundering, tax evasion and rogue financial practices with any degree of accuracy is - because of the very nature of

[7] There are many ways a jurisdiction which is formally obliged to play by new rules can sabotage the work of foreign law enforcement officers. They can make it costly, they can make them time-consuming, they can provide low quality assistance and they can deliberately “misunderstand” when a request for help is given.

these activities – well neigh impossible. Still, one could imagine indirect measurement through indicators such as sums seized, cases brought to court, number of bank-failures or financial melt-downs that reveal rouge practices ex-post or even fiscal revenues in the case of tax evasion. Similarly, a better impression of to what degree regulatory and supervisory behaviour has improved in problem sites could be achieved through extensive interviewing of law enforcement officials that work with money laundering and tax evasion cases on a daily basis. Since the regulatory processes dealt with in this report are all recent, one should not expect, even if intelligence and statistics were available, immediate and dramatic improvement. This is, however, a field of inquiry that needs to be followed up closely in the future by those concerned with global governance, if one is serious about combating money laundering, tax evasion and rogue banking.

7. Literature

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