ASSESSING THE TRUE EFFECTIVENESS OF AML/CFT CONTROLS IN DEVELOPING COUNTRIES

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ABSTRACT

The Financial Action Task Force (FATF) has enjoyed a remarkable amount of success in raising awareness about money laundering and terrorist financing and inducing states around the world to commit to countering these serious threats to international security. The steps that developing countries have taken to comply with FATF recommendations, which have involved legal and bureaucratic measures necessary but not sufficient to create an effective AML/CFT regime, have led many to believe that these countries are doing a better job protecting against money laundering and terrorist financing than they are in reality. A closer examination of what has actually been done by developing countries to prevent these crimes, as demonstrated in this paper using case studies of eight countries, reveals that many states lack the effective oversight and supervisory systems necessary to ensure that their domestic institutions have robust controls in place. Without sufficient oversight and enforcement efforts on the part of developing countries, money laundering and terrorist financing will remain pervasive across these jurisdictions. This misunderstanding may be causing many involved in the international financial system to let their guard down with respect to the threat of illicit financial crime, increasing the potential for abuse by money launderers and terrorist financiers across the globe. These circumstances highlight a number of actions that policy makers can take to address the problems faced by developing countries.
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INTRODUCTION

Many Americans would be shocked and disturbed to discover that the institutions with which they trust their wealth are unwittingly doing business with banks involved in money laundering or the financing of terrorism, or even caught up in such activities themselves. Over the past several decades there has been a concerted effort, led by the United States and Western European countries, to limit the prevalence of money laundering (ML) and terrorist financing (TF) by exhorting states around the world to adopt robust controls to counter such activities. And while it is clear that there is a long way to go before anti-money laundering and counter-terrorist financing regimes in developing countries are caught up with those of the most developed countries, the widespread belief is that great progress has been achieved through the efforts of the Financial Action Task Force (FATF) and other international bodies. This paper seeks to provide an assessment as to whether that belief is accurate.

The objective of this paper is to reveal the extent to which the international effort to promote anti-money laundering (AML) and counter-terrorist financing (CFT) in developing countries\(^1\) around the world has brought about effective controls. I hypothesize that the FATF’s efforts have prompted developing countries to take steps that make them appear to be better at protecting against ML and TF than they actually are, and that in reality these countries lack the necessary effectiveness in their oversight and supervisory systems to bring about real change in the behavior of domestic entities, where ML and TF can best be prevented. To test this hypothesis, a case study

\(^1\) For the purposes of this paper, a “developing country” is any country whose name appears on the International Monetary Fund’s ‘Emerging and Developing Countries’ list. This list is extensive, and includes most countries outside of Western Europe, Japan, Australia, New Zealand, the U.S. and Canada. See http://www.imf.org/external/pubs/ft/weo/2010/01/pdf/text.pdf
methodology with eight developing countries—Brazil, China, Egypt, Indonesia, Mexico, Saudi Arabia, South Africa and the United Arab Emirates—is employed. Detailed reports produced by the FATF and affiliated organizations which assess each country’s compliance with key AML and CFT recommendations will be examined, to determine whether the overall indicators of compliance accurately reflect the effectiveness of the AML/CFT systems in practice.

The results of the case study largely support the idea that developing countries are not doing as well in protecting against ML and TF as it would appear on the surface, and that the oversight and supervision of financial institutions within these territories is generally not done well enough to ensure that effective AML/CFT measures are being implemented. The implications of this finding are significant, as a widespread belief that the international financial system is better prepared to fight money laundering and terrorist financing than it actually is constitutes a dangerous environment of misperception, providing a false sense of security to the global financial community and those that use it. The results indicate that action needs to be taken by policy makers on several fronts, both to eliminate any misperception or confusion regarding the state of AML/CFT controls in the developing world, and to induce developing countries to address key failures in their systems immediately. So long as there exists enormous disparity between the ability to stem illicit financial activity in developed and in developing countries’ financial systems, every part of the international financial system will remain be highly vulnerable to abuse.

While this study aims to contribute to the overall understanding of how to improve international AML/CFT efforts, there are certain important issues that fall
outside of its purview. The broad question of whether countering ML and TF is a worthwhile pursuit, for example, will not be comprehensively examined—although the primary reasons for undertaking AML and CFT will be touched on in the next section. The paper will not seek to answer the question of why developing countries have largely failed to implement effective AML/CFT regimes; while this is undoubtedly an important and worthwhile question to consider, the present work is confined to assessing whether or not developing countries have done so in response to international efforts.

The following section will provide a brief description of the money laundering and terrorist financing problems and some of the most germane issues surrounding them, as well as a description of the FATF and its main functions and components. The section entitled “The Potential Problem” will lay out the circumstances underlying my hypothesis, including an examination of the different types of FATF Recommendations and what goes into building an effective AML/CFT regime. Next, the results of the case study are presented, followed by a discussion and analysis of the research. Finally, policy implications will be discussed and several recommendations for action will be proposed.

**Money Laundering, Terrorist Financing, and the FATF**

*Money Laundering*

Despite the often complex schemes in which it manifests itself, money laundering is, at its core, a simple phenomenon: it is the conversion of assets generated from criminal activity into assets that cannot be traced back to the underlying crime. Money laundering is done so that criminals can use their illicit profits in the open economy. After all, most car dealerships and real estate agents would be suspicious if they were handed a
duffle bag full of cash in small bills, and avoiding unwanted scrutiny that could lead to incarceration is of primary concern to criminals. Money laundering is traditionally separated into three stages: the placement of funds derived from crime, the layering of those funds by passing them through multiple institutions and/or jurisdictions, and finally, their integration into an economy where they appear legitimate. Needless to say, the ways of going about these three stages are many and in constant evolution\(^2\), and the growth in their complexity and sophistication has mirrored that of the international financial system as a whole. The technological innovation that has made once-exclusive devices such as personal computers and mobile telephones prevalent across much of the globe has inevitably led to their exploitation by criminals wishing to launder funds, allowing for the anonymous transfer of assets across the world in seconds. This rapid technological advancement has further facilitated ML and has presented huge challenges for the authorities. Today, the amount of money laundered globally each year is estimated to be in the hundreds of billions of dollars, if not more.\(^3\)

Despite its longstanding proliferation, money laundering has only recently been recognized as a major problem and a threat to both domestic and international security. The United States, generally ahead of the curve in law enforcement and financial regulation since the early 20\(^{th}\) century, did not criminalize money laundering until 1986—and was among the first countries to do so. Instead of focusing on ML itself, the approach commonly taken by states—still prevalent today—has been to target the predicate crime that generated the funds in need of washing; in other words, to go after the drug running,

\(^2\) For a look at common ML and TF methods and typologies, see the FATF’s most recent “Global Money Laundering & Terrorist Financing Threat Assessment,” (July 2010), available at http://www.fatf-gafi.org/document/51/0,3746,en_32250379_32237202_45724403_1_1_1_1,00.html

bank robbing, and corruption giving rise to “dirty” money. While these crimes clearly need to be investigated and the perpetrators punished, there are substantial advantages to incorporating money laundering into the investigation and enforcement effort. Strong action on both the law enforcement and regulatory side can help curb the harmful crimes underlying ML, by making it more difficult for criminals to benefit from unlawful activity and potentially leading to their capture by using a “follow the money” approach—both of which can discourage people from committing the predicate crime in the first place. Focusing on ML also upholds the integrity of the financial system, allowing people to feel confident that they are not unwittingly complicit in supporting crime as patrons of banks, and promotes the stability of the financial sector itself.\(^4\) Finally, anti-money laundering efforts have been identified as playing an important role in controlling three types of global “bads”: corruption, failed states, and terrorism.\(^5\)

**Terrorist Financing**

If states were late in confronting the problem of money laundering, they were even more belated in addressing the challenges and risks posed by terrorist financing. TF involves the provision or collection of funds, directly or indirectly, with the intention or knowledge that they are to be used to facilitate terrorist activity.\(^6\) While sporadic action was taken in a few countries in the late 20th century to address terrorist financing—for example, the Clinton administration criminalized TF and used sanctions on two occasions


\(^5\) Reuter and Truman, p.2.

\(^6\) This is a modified definition derived from Article 2 of the 1999 United Nations International Convention for the Suppression of the Financing of Terrorism.
to freeze terrorist assets\textsuperscript{7}—it was not widely considered a serious threat in the international arena. The United Nations adopted the ‘Convention for the Suppression of Terrorism Financing’ in late 1999, but only four states had ratified it by September 2001.\textsuperscript{8} Predictably, it was not until after the 9/11 attacks that TF became a visible policy issue for governments and an internationally recognized threat; even so, it has yet to be criminalized in some countries. Since 9/11, a number of international measures have sought to disrupt terrorist financing, such as U.N. Security Council Resolution (UNSCR) 1373 (2001), which requires states to, \textit{inter alia}, freeze the assets of any individuals or organizations that commit or attempt to commit terrorist acts, or who participate in or facilitate such acts.\textsuperscript{9} However, it is up to the states themselves to identify and designate persons that fit this description, and in practice many states have not done so. The result is that UNSCR 1373 is much less valuable than it could and should be.

There is also a common misunderstanding regarding what terrorist financing usually looks like in practice, one that the media and academics have done little to dispel. When the average person is asked to give an example of terrorist financing, a typical response would involve the transfer of funds to a terrorist’s bank account, which are then used to carry out an attack. While discrete acts of terrorism are certainly among the activities made possible by terrorist financing, such acts are relatively infrequent and inexpensive to sponsor—although they do, unfortunately, inflict grievous harm on innocent people and property. In addition to terrorist acts alone, however, the

organizations behind such acts must have funds available for their day-to-day activities. Overhead costs for items such as food and training material, as well as transportation, training and even rent, make up a significantly larger portion of terrorist organizations’ operating costs than do discrete acts of terrorism. Without the resources to cover its daily operating expenses, a terrorist group’s continued existence—not to mention its ability to carry out attacks—would be put in jeopardy. Thus, the large majority of funds raised and sent to terrorists are used for non-violent purposes that nonetheless support the overall goals and activities of a terrorist organization, even if these goals are seemingly harmless or positive—like providing assistance to the poor. Thus, giving money to a terrorist organization like Hamas or Hezbollah that is ultimately used for charitable purposes—which promotes the image and thus the influence and power of these organizations—can be considered terrorist financing just as much as paying for Osama Bin Laden’s AK-47. Clearly, this complicates the task of detecting and potentially interdicting the flow of funds to terrorist groups, and represents just one of the many challenges of combating terrorist financing.

Another significant and recurring issue surrounding CFT is the question of whether it is possible to stymie the flow of funds to terrorist organizations enough to have a substantial impact on their ability to operate. While this question is nearly impossible to answer definitively, and largely outside the scope of this paper, it is worth considering briefly. Some scholars point out that thus far CFT measures “have had little externally discernable impact on reducing levels of terrorism or on criminal convictions.”\(^{10}\) Others have highlighted both the resources necessary to carry out CFT by private and public sector institutions, and the negative externalities of implementing CFT controls. For

\(^{10}\) Levi, p.650.
example, the increased customer due diligence requirements at the core of CFT (and AML) programs, in addition to being expensive for the institution implementing them, can reduce access to the financial system for poorer segments of society, in part because meeting the strict identification requirements (holding a government issued ID, proof of address, etc) is often hard for such people.\textsuperscript{11} Despite the downside, CFT is undoubtedly useful in the broader struggle against terrorism, even if its effects are in part intangible and cannot be easily measured or quantified. The financial intelligence generated from monitoring for TF has led to significant successes in the law enforcement or military side of counter-terrorism. For instance, the Council on Foreign Relations describes, in an updated 2004 report on the campaign against TF, how the efforts of a U.S.-Saudi ‘Joint Terrorist Financing Task Force’ led to the designation and subsequent dissolution of Al Haramain, a charity found to be involved in terrorist financing. The report notes,

“As a result of the forgoing activities, al-Qaeda’s current and prospective ability to raise and move funds with impunity has been significantly diminished. These efforts have likely made a real impact on al-Qaeda’s financial picture, and it is undoubtedly a weaker organization as a result. Much of the impact has been through deterrence—i.e., past or prospective donors are now less willing to support organizations that might be complicit in terrorism.”\textsuperscript{12}

This last point is significant. Deterrence cannot be reliably tested or measured but is nonetheless crucial to the overall counterterrorism campaign. Even a slim chance of getting caught is sufficient in many cases to deter people, especially affluent donors who have the most to lose in both wealth and reputation, from contributing to an entity that they have reason to believe has ties to terrorists.


In the end, few would argue that governments should do nothing on the CFT front, allowing funds to flow freely to those wishing to use violence against innocent people. The real argument lays in how much should be done, with some arguing for strict enforcement of comprehensive measures for every entity that could be involved in TF, while others draw a much closer line beyond which the costs of CFT outweigh the benefits. The overall value of CFT—and of AML, for that matter—ultimately depends on how thoroughly it can be implemented on a global scale, not just in a handful of countries that have the capacity and political will to do so. The reason for this is that criminals and international terrorist groups naturally gravitate towards jurisdictions that have fewer controls and less government scrutiny to handle their financial needs, since the risks of doing illegal business are fewer in such areas. This leaves the rest of the international system vulnerable, since money that has been successfully laundered in a country with few controls can be transferred to other jurisdictions, even those with robust AML/CFT regimes, with little chance of detection or interdiction. Thus, states that do not have the capacity or the will to implement tight AML/CFT regimes expose the entire system to a higher degree of risk, creating a collective action problem. Anne Clunan, an expert on terrorist financing issues, argues that global CFT effectiveness can only be achieved by redefining states’ interests and making them understand the “collective responses necessary to manage nonstate transnational actors.”\(^\text{13}\) This sort of redefinition of interests is one of the primary goals of the FATF.

The Financial Action Task Force

The FATF has emerged as the preeminent international body for developing and promoting AML and CFT controls, a self-described “policy-making body” that works to generate the political will necessary to bring about legislative and regulatory reforms. The task force was established in 1989 by a G-7 summit in Paris convened to address mounting concerns about money laundering, and was given the responsibility of examining ML trends and setting out actions that needed to be taken to combat it. The FATF’s “primary role is to set global AML/CFT standards and ensure the effective implementation of these standards in all jurisdictions,” and to this end the “task force”—nomenclature that suggests a temporary body, but that in reality is a standing inter-governmental collaboration—issued 40 Recommendations in 1990 to serve as a comprehensive plan for states to combat ML. In 2003 the FATF, whose membership has expanded from the original 16 to 36 states, revised the 40 Recommendations substantially. The AML recommendations can be informally grouped into several broad categories, dealing with: the legal system; preventative measures for financial institutions and designated non-financial businesses and professions; institutional and other systemic measures; and national and international cooperation. After the September 11 attacks the FATF’s purview expanded to include terrorist financing, and in October 2001 a new set

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14 FATF website, “About the FATF,” accessed online via http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236836_1_1_1_1_1,00.html
15 The FATF’s mandate is in fact not indefinite, but rather reviewed every five years and extended as necessary. In practice, it is highly unlikely that the FATF will view its mission as complete and disband anytime in the near future. Structurally, the FATF is run by a Secretariat with international staff from member countries, and maintains its head office in Paris. It is led by a President, designated for a one-year term, and advised by a seven member Steering Group. The FATF is accountable to the Ministers of its membership. More information on the structure and composition of the FATF can be found on its website, at: http://www.fatf-gafi.org/dataoecd/3/32/40433653.pdf
16 FATF membership is actually comprised of 34 individual jurisdictions and 2 regional organizations. See http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236869_1_1_1_1_1,00.html for a full list of members.
of eight “Special Recommendations” (SRs) on TF were created. Several years later a ninth SR was established, forming what is now collectively known as the FATF “40+9”.  

While the creation of this sort of international body seeking to combat important global issues is laudable, it is also of little value unless the institution is able to garner a substantial degree of legitimacy and credibility around the world. Sovereign nations are not apt to follow the recommendations of an outside organization, especially if those recommendations require difficult and costly measures to be imposed, without a firm belief that the organization has proven expertise and, more importantly, has the ability to enhance or harm the interests of the state in some way. Without the influence and power to actually induce change, an international organization can have the best of intentions and achieve little or nothing. The FATF’s value lies in the fact that it has had remarkable success in getting countries around the world to buy in to its core principles and treat the 40+9 seriously. This “supranational” approach to global governance, as it has been described in academia, has been made possible by two crucial tools employed by the FATF: the mutual evaluation process and the ability to “name and shame” uncooperative states.

The FATF conducts periodic reviews of member countries’ compliance with the 40+9 Recommendations, and compiles and publishes a detailed description of its findings in Mutual Evaluation Reports (MERs). This evaluation process is a central pillar in the

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17 See Appendix A for a short description of each of the 40+9 Recommendations.


19 Mutual evaluations are conducted approximately every 5 years.
FATF’s efforts to promote robust AML/CFT standards. In describing the role of the mutual evaluation process, the FATF states:

“The scope of these evaluations is to assess whether the necessary laws, regulations or other measures required under the new standards are in force and effect, that there has been a full and proper implementation of all necessary measures and that the system in place is effective.”

The reviews are conducted by a team of experts from the financial, legal and law enforcement sectors, and encompass comprehensive on-site visits to the jurisdiction including extensive meetings with government officials and private sector entities. The assessors use a common methodology for each review, and FATF’s affiliate organizations (called FATF-style regional bodies, or FSRBs) perform the same reviews for the states and territories under their supervision. In practice, the degree of professionalism and consistency across MERs completed by the FATF and the various FSRBs is such that it is nearly impossible to tell which body is responsible for a given report. In terms of content, MERs include an overview of the economy, system of governance and financial sector of the country being reviewed, and then a close examination of the country’s compliance with each of the 40+9 Recommendations in turn, including suggestions for improvement. The degree of compliance with each Recommendation is rated in one of four ways: “Compliant,” “Largely Compliant,”

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20 FATF website, “Mutual Evaluation Programme,” accessed online via http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236982_1_1_1_1_1,00.html
22 The FSRBs are similar in form and function to the FATF, and were developed due to the limited membership of the FATF in order to address ML and TF issues in jurisdictions across the world. There are currently 8 FSRBs, all of which now work closely with the FATF to ensure consistency in the mutual evaluation process. They include: the Asia/Pacific Group on Money Laundering (APG), the Caribbean Financial Action Task Force (CFATF), the Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL), Eurasian Group (EAG), Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG), Intergovernmental Action Group against Money-Laundering in Africa, Financial Action Task Force on Money Laundering in South America (GAFISUD), and Middle East and North Africa Financial Action Task Force (MENAFATF). Some countries, like China, are members of both the FATF and a FSRB.
“Partially Compliant,” and “Non-Compliant.” A typical MER will run to about 300 pages, which provides a sense of the detail and in-depth analysis that goes into each assessment. The FATF’s mutual evaluation process thus represents an excellent way for countries to identify the strengths and weaknesses of their domestic AML/CFT regimes and, more importantly, to target areas for improvement.

The second tool that has brought the FATF sway in the international arena goes hand-in-hand with its mutual evaluation process, and that is the ability to “name and shame” uncooperative states. The Non-Cooperative Countries and Territories process, renamed the International Cooperation Review Group (ICRG) in 2007, provides a mechanism for the FATF “to identify and to respond to jurisdictions with strategic deficiencies in their AML/CFT regimes that pose a risk to the international financial system.”

Countries with sufficiently serious deficiencies, as identified in the mutual evaluation process, are given the opportunity to improve their controls within a reasonable amount of time. If they fail to do so, the FATF can publicly identify the jurisdiction and recommend that states take countermeasures to “protect themselves” from the risks emanating from this jurisdiction. In practice, this means that the state is essentially blacklisted from doing business with a majority of important financial centers around the world—because the reputable “heavy-hitters” of banking and finance in the United States, Europe and elsewhere prohibit or severely limit financial transactions with institutions located in a country designated as uncooperative by the FATF. Jackie Johnson, an expert on FATF and AML/CFT issues, notes that “blacklisting questions the legitimacy of the country or jurisdiction identified and its right to conduct financial

23 FATF website, “High risk and non-cooperative jurisdictions,” accessed online via http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236992_1_1_1_1_1,00.html
business in the global environment.” The desire of practically every government, other than the rare pariah like North Korea, to be seen as a sufficiently friendly and safe place to do business has led to widespread willingness to conform to the standards set by the FATF. Of the 23 jurisdictions first identified as Non-Cooperative in 2000 and 2001, including countries such as Israel and Russia, all have since been removed from the list after the FATF determined that sufficient progress in the AML/CFT regimes had been made (others have since been named, such as Iran). Despite the genuine accomplishments of the FATF, including its establishment of international political credibility, it is important to ask how much has actually changed in the campaign against money laundering and terrorist financing, especially in developing countries where the danger of ML and TF is often the most acute.

**THE POTENTIAL PROBLEM**

The FATF’s emergence as a valuable advocate of strong global AML/CFT controls, and its success in raising awareness regarding the dangers of ML and TF and in convincing states to improve in these areas, is an outstanding achievement. Scholars have asserted that the FATF’s mutual evaluation process “appears to have an empirically

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25 As of February 2011, Iran and North Korea are the two countries with respect to which the FATF has called upon states to employ defensive counter-measures. However, there are a further 11 jurisdictions currently identified as having strategic AML/CFT deficiencies from which the FATF has not yet received the necessary high-level political commitment to improve their regimes. If these jurisdictions have not taken sufficient steps to address their issues by June 2011 (the next FATF Plenary date), the FATF will call upon states to take counter-measures against them. These 11 jurisdictions are: Angola, Bolivia, Ethiopia, Kenya, Myanmar, Nepal, Nigeria, Sri Lanka, Syria, Trinidad & Tobago, and Turkey. See http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236992_1_1_1,00.html
observable impact”\textsuperscript{26} with respect to improving banking systems and regulations, and it has been estimated that “about 130 jurisdictions representing 85 per cent of the world population, and about 90-95 per cent of global economic output, have made at least a political commitment to implementing FATF recommendations.”\textsuperscript{27} However, while nobody would argue that developing countries have especially robust overall controls or that there are not significant gaps that need to be addressed, there is nevertheless a danger that the level of compliance among these countries is overstated. To account for this, it is necessary to delve deeper into the different types of FATF Recommendations and exactly what goes into building a strong domestic AML/CFT regime.

As previously mentioned, the 40+9 can be grouped into four general categories—those involving the legal system, preventative measures for financial institutions and other entities, institutional and systemic measures, and national and international cooperation. Many of the recommendations are legal or bureaucratic in nature, setting the foundation upon which a robust AML/CFT regime is built. For instance, several recommendations deal with the criminalization of ML and TF; a few have to do with ensuring that various government agencies have the authority to confiscate proceeds of ML or to obtain information from domestic entities, or that countries delegate responsibility of investigating crimes to a specific body; and others involve recordkeeping requirements for domestic entities. While these standards are all necessary in laying the groundwork for the detection and prevention of money laundering and terrorist financing, they do not themselves ensure that controls are functioning effectively


where it matters—in the financial institutions on the front lines of criminal financial activity. Only these entities have the ability to monitor the millions of transactions that flow through their systems each day, and to perform due diligence on people and businesses opening accounts at their branches.

Unfortunately, absent interference from higher authorities, financial institutions are naturally motivated to look out for their own well-being and not necessarily for issues that may have negative externalities for society as a whole. Banks and other businesses perform certain compliance-like functions to manage their economic risk and help maximize profits—a simple example being the evaluation of a customer’s credit history before extending them a loan. However, more comprehensive measures to prevent money laundering and terrorist financing can be extremely costly to implement and are less likely to be undertaken without outside pressure. ML and TF do not have as much of a direct impact on the performance of banks as, say, a loan default, and can even be profitable; drug kingpins that maintain high cash balances and conduct large transactions on a frequent basis will contribute to a bank’s bottom line. This is not to say that most banks and other financial institutions want to be involved, even unwittingly, in criminal activity, but rather to point out that there is less incentive for them to spend significant amounts of money to protect against something that does not pose an obvious direct threat to their businesses. This motivation must therefore come from the outside.

A strong domestic oversight and supervisory system that effectively monitors banks and other financial entities is possibly the most necessary component for a country to have AML/CFT controls that work. Ensuring that financial firms have appropriate policies and procedures in place and that these processes are actually operating correctly
is key.\textsuperscript{28} This typically involves the active examination of private sector entities by well-trained professionals from (or representing) the government, who can provide useful feedback as to what is being done well and what needs improvement. It also entails having the ability and willingness to punish those institutions that violate the law or have sufficiently poor AML/CFT controls, in order to induce widespread adherence to laws and regulations and to create a culture of robust compliance. This type of effective government supervision and oversight, not surprisingly, is one of the hardest things to get right. It requires a certain minimum level of bureaucratic and authoritative capacity and political will. It seems plausible, then, that many developing countries have made the changes necessary to comply with FATF Recommendations that require action on paper—the passing of rules and regulations, the delegation of authorities, and so on—but are not carrying out robust oversight and supervision to ensure that effective AML/CFT is being done in practice. Such a scenario would indicate that developing countries have done more to comply with certain types of FATF Recommendations than others—the “others” being oversight and supervision-related measures. And while it is not necessarily accurate to say that one type of compliance (or FATF Recommendation) is more important than another—since these measures are highly interdependent, with areas like supervision and enforcement of domestic entities predicated upon the legal system and regulatory structure in place—what is true is that compliance with only some areas, such as those laying the foundation for effective AML/CFT to take place, without following through in other key areas is highly problematic. Thus the danger—and what I

\footnote{Just because an institution has a written AML and/or CFT policy and written procedures to implement that policy does not mean that the relevant employees are fully aware of them, or are carrying out the necessary activities (which can be burdensome and time-consuming) to effectively implement written guidelines. Even the most well thought-out compliance programs can be undermined by common issues such as staff turnover and time and performance pressures.}
hypothesize—is that the steps that many developing countries have taken to comply with some of the FATF Recommendations have led to an undeservedly optimistic view about the vulnerability of financial systems in such states, since these steps have not translated to effective money laundering and terrorist financing controls in practice.

As described in more detail below, the primary indicator used in this paper for the perception of developing countries’ AML/CFT regimes is their overall degree of compliance with the FATF Recommendations. However, examining the statements of public officials concerning the progress of AML/CFT efforts in developing countries can also yield some insight as to the common perception of this progress. While instances of high public praise are relatively rare—since it is widely agreed that much more work needs to be done in developed and developing countries alike, and officials do not want to send signals that would suggest otherwise—it is possible to detect an undercurrent of optimism that may not be deserved. For instance, James H. Freis Jr., Director of the Financial Crimes Enforcement Network (FinCEN) of the U.S. Treasury Department, praises the AML/CFT efforts of financial institutions in Colombia and Mexico in speeches in 2007 and 2009—applauding the “vital role” these efforts have played—despite the pervasive and ongoing concerns about narcotics-related money laundering in these countries. These remarks could be interpreted as an overstatement of the ability of banks and other entities in such countries to detect and prevent illicit activity.

Additionally, in a June 2007 speech at the Council on Foreign Relations, then-Treasury

Secretary Henry Paulson, commenting on the preferences and motivations of financial institutions around the world to avoid doing business with bad actors, states that “They [financial institutions] genuinely want to be good corporate citizens and want nothing to do with illegal behavior. Additionally, a lack of vigilance on their part is not worth the risk of regulatory action.”31 The latter part of this statement is telling, in that it reflects Secretary Paulson’s implicit belief that a lack of vigilance on the part of financial institutions around the world would likely lead to regulatory action being taken against such institutions—i.e., that the countries where these institutions are based are effectively overseeing the actions of domestic entities and enforcing non-compliance. As the next section will make clear, this is often not the case. Finally, the perception of states themselves regarding their own progress and compliance with the FATF Recommendations has been shown to be wildly inaccurate in many cases. The FATF’s now-defunct program for countries to rate themselves regarding compliance with the 40+9 (apart from their mutual evaluations), in what was called a “self-assessment,” resulted in states consistently overestimating their level of compliance as compared to the results of their mutual evaluations.32 While it is possible that such inflated self-assessments represent intentional misrepresentation for political purposes, it is also reasonable to believe that they reflect, at least in part, an honest belief that the controls the states put in place were effective in preventing money laundering and terrorist


financing. As shall be shown in the following section, key aspects of AML/CFT regimes in many developing countries are, in reality, deeply flawed.

CASE STUDIES

Methodology

To test whether the perception of developing countries’ AML/CFT regimes are in line with reality, the most recent\textsuperscript{33} mutual evaluation reports completed by FATF and the FSRBs will be examined for eight countries. The selection of cases was based on several factors: the degree to which ML and/or TF is a concern in the country, with higher levels being more desirable to make the case study as relevant as possible; geographic location, to ensure representation from different parts of the world and thus enhance the study’s usefulness; and stature in the international arena, in terms of demography and economic/financial importance, with higher stature being more desirable again in order to increase the relevance and significance of the case study. The overall state of each country’s compliance with the FATF Recommendations will be compared to the effectiveness of their oversight and regulatory systems. To translate overall compliance to a precise figure, I borrow from Jackie Johnson's method\textsuperscript{34} of converting the FATF's ratings (Fully Compliant, Largely Compliant, Partially Compliant, Non-Compliant) into numerical values (1, .67, .33, and 0, respectively) for each recommendation. The average of these numerical values over the entire FATF 40+9 is used to provide a quantitative

\textsuperscript{33} Two MERs were completed in 2010 (Brazil, Saudi Arabia), two in 2009 (Egypt, South Africa), three in 2008 (Indonesia, Mexico and the UAE) and one in 2007 (China). Where significant changes in laws, regulations or procedures are planned and noted in the MERs that would substantively affect my analysis, such upcoming changes will be duly noted.

\textsuperscript{34} Johnson employs this method in a number of her articles; see, for example: Jackie Johnson, “Is the Global Financial System AML/CFT Prepared?,” Journal of Financial Crime, Vol. 15 No.1 (2008).
indication of a country’s overall compliance. For instance, a country that is fully compliant with 14 of the 49 recommendations, largely compliant with 17, partially compliant with 13, and non-compliant with 5 would have an average level of compliance of 0.61 (1.0 being perfect compliance and 0 being none whatsoever). While this quantitative measure is admittedly imperfect in gauging the degree of AML/CFT compliance, the numerical values are useful in imparting a general sense of how well countries seem to be doing on the surface in defending their financial systems from abuse.

Next, I will qualitatively evaluate the effectiveness of oversight and regulatory systems in the eight case examples. This will be done by examining several of the FATF Recommendations (specifically, #17, 23, 29, and 30) that deal with regulation and supervision. This encompasses not only what authorities have the power to do in terms of inspections, monitoring and sanctions, but how effectively these powers are used. The mutual evaluations provide statistics in some cases—such as how many AML/CFT examinations of different types of institutions occurred each year, how many and what type of enforcement actions (warning letter, monetary penalty, revocation of license, etc) were taken against financial institutions each year, and so on—which allows for further insight into the effectiveness of supervision and oversight.

Results

For each of the eight cases, the quantitative indicators of overall compliance with the FATF 40+9 as well as with the four oversight and supervision-related recommendations is provided. A brief description of the oversight regime of each
country, including the major weaknesses highlighted in the MERs, is also laid out. The analysis and discussion of these characteristics follows in the next section.

**Indonesia**

Average compliance with all 40+9 Recommendations for Indonesia based on its most recent mutual evaluation was 0.35, easily the worst of the eight countries examined. Indonesia’s compliance with the oversight and supervision-related recommendations was slightly lower (0.33), with a rating of “Partially Compliant” on each of the four relevant recommendations. The primary bodies responsible for supervision within the country are Bank Indonesia, which regulates the banking sector; the Ministry of Finance (BAPEPAM), responsible for the securities and insurance sectors; and the financial intelligence unit (PPATK). Banking supervision in Indonesia was found to have improved substantially in recent years, with the MER noting,

> “The statistics concerning examinations and sanctions indicated an enhanced focus on AML supervision by BI in the last two years. Discussion with the private sector confirmed that AML examination capabilities of BI appear to have significantly improved over the recent past and that on-site inspection is professional and in-depth.”

However, the number of supervisory staff responsible for the securities industry was found to be extremely low—just 21 employees. In addition, the assessors found that “non-bank money remitters are currently not forthcoming for registration and licensing though Rules provide for this…It is believed that the number of money remitters operating without any registration or supervisory controls is quite large.” This represents a major problem for Indonesia, since the volume and reliance on both

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36 Indonesia MER, p. 138.
37 Indonesia MER, p. 137.
38 Indonesia MER, p. 129.
incoming and outgoing remittances is very high. Finally, enforcement of non-compliant entities was found to be lacking in Indonesia: only five monetary penalties were assessed by Bank Indonesia over the period 2005-2007. One of the recommendations in the mutual evaluation states, “For imposing sanctions, BI has mostly used written admonitions. Keeping in view the higher level of violations in rural banks, the need is to create an effective deterrent. Money penalties can be one way of doing that.”

Thus, while examination in the banking sector has improved in Indonesia, the same cannot be said of other areas of the financial system, and the enforcement effort against domestic companies was found to be quite weak.

**Egypt**

Egypt’s overall compliance rating based on its 2009 mutual evaluation stands at 0.53, while its average for the four supervision and oversight recommendations was lower, at 0.42. The primary regulators for AML/CFT purposes are the Central Bank of Egypt (CBE), which supervises most of the banking sector as well as foreign exchange and money transfer companies; the Egyptian Money Laundering Combating Unit (EMLCU), which is responsible for the Arab International Bank (AIB), Nasser Social Bank (NSB) and the CBE; the Egyptian Insurance Supervisory Authority (EISA), which oversees the insurance industry; and the Capital Market Authority (CMA), which manages entities in the securities industry. Egypt’s MER notes that significant efforts have been made to supervise banks and brokers in recent years, however, it underlines

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39 Indonesia MER, p. 149.
various shortcomings with respect to the EMLCU’s authority over AIB and NSB (which are quasi-state owned Islamic banks), as well as AML/CFT oversight in the insurance industry. Overall staffing and resources for supervisory agencies was found to be adequate, but there were few AML/CFT specialists within these agencies. One of the major concerns of the assessors appeared to be the availability and use of sanctions to enforce compliance, or lack thereof. The MER highlights the fact that “Powers to impose fines are fairly limited and do not to appear to encompass shortcomings in AML/CFT frameworks…No fine for AML/CFT shortcomings was ever imposed.”41 One of the primary recommendations made by the evaluation team was to enhance the sanctioning powers of authorities, and to consider making enforcement actions public to “further the dissuasiveness of the AML/CFT regime.”42

China

Based on its most recent mutual evaluation in 2007, China’s overall compliance with the 40+9 was 0.50 (0.4966 to be exact), and it received a score of precisely 0.50 on its compliance with the oversight and supervisory recommendations, by way of two “Partially Compliant” and two “Largely Compliant” ratings.43 The People’s Bank of China (PBC) is responsible for the preponderance of AML/CFT related supervision domestically, with other sector-specific regulatory agencies (such as the China Securities Regulatory Commission and the China Insurance Regulatory Commission) focused on prudential oversight apart from AML/CFT issues. The PBC was found to perform

41 Egypt MER, pp.141-143.
42 Egypt MER, p.146.
extensive examination of the banking sector, although the quality of the inspection process could not be ascertained by the assessment team due to the decentralization of the day-to-day examination process, handled by the regional offices of the PBC. In addition, the AML/CFT supervisory program applied to banks had not yet been implemented for the securities and insurance sector at the time of the evaluation. The number of monetary penalties imposed on financial institutions was relatively high, suggesting that examinations were effective at identifying deficiencies. However, the MER voices concerns about the size of the fines and the way they are used by the authorities:

“The practice appears generally to be to penalise institutions for each and every deficiency identified, however small… the absence of a more measured approach to target and sanction (with significantly larger penalties) primarily those deficiencies that are material to the overall compliance culture, may lead institutions to focus excessively on the minutiae and not adequately address the broader structure of AML compliance.”

Thus, while the authorities have the power to enforce AML/CFT deficiencies among domestic entities and are actively employing this tool, it is uncertain as to whether the enforcement process is being used appropriately to promote a strong culture of compliance.

**South Africa**

South Africa’s primary supervisory bodies for the financial industry include the South African Reserve Bank (SARB), which regulates the banking sector; the Financial Services Board (FSB), which oversees financial advisors, the insurance industry and central security depositories; and the Johannesburg Stock Exchange (JSE), which supervises users of the exchange. All of these bodies have been delegated their AML/CFT supervisory powers by the Financial Intelligence Centre Act (FIC Act) of

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44 China MER, p.115.
2001. South Africa’s overall compliance rating was a 0.50 based on its 2009 MER, and its aggregate score for the supervision and oversight recommendations was 0.42.\(^{45}\) While the SARB conducts bank examinations, not all inspections include an AML/CFT component, and various financial institutions were found not to be subject to this type of supervision—for instance, certain securities custodians and leasing companies, as well as money lenders other than banks. In addition, the MER notes that only six staff members of the SARB specialized in AML at the time of the evaluation, and that the FSB lacked authorization to conduct visits to domestic financial institutions in relation to AML compliance.\(^{46}\) Finally, the assessors highlighted the lack of enforcement power held by the SARB, stating, “The SARB has no specific authority to sanction the financial institutions within its jurisdiction for failing to comply with the FIC Act…overall, the SARB’s powers of enforcement and sanction are inadequate to induce compliance with the AML/CFT requirements.”\(^{47}\) Similar concerns were raised regarding the enforcement powers of the FSB and JSE.

**Mexico**

Mexico’s overall compliance with the FATF 40+9 based on its 2008 mutual evaluation was 0.503, while its oversight and supervision rating was a slightly lower 0.50.\(^{48}\) The Secretaría de Hacienda y Crédito Publico (SHCP) is the overall regulatory authority for AML/CFT in Mexico, with four agencies under the SHCP’s umbrella

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\(^{46}\) South Africa MER, pp.136; 140-141.

\(^{47}\) South Africa MER, p.140.

responsible for AML/CFT supervision: the National Banking and Securities Commission (CNBV), National Insurance and Bonds Commission (CNSF), National Retirement Savings System Commission (CONSAR), and Tax Administration Service (SAT).

Mexico’s MER affirms that all of these agencies have adequate powers for monitoring and enforcing AML/CFT controls, and notes that onsite inspections of domestic entities occur regularly. However, it was found that many areas, such as the insurance and bonding sectors and foreign exchange centers, had inadequate oversight mechanisms—although a 2010 law limiting the amount of US dollars that Mexican financial institutions can exchange may alleviate some of the concerns regarding foreign exchange centers.49

In addition, the assessors reported that supervisory agencies appeared to have adequate resources to perform their tasks, along with “an impressive cadre of staff” exhibiting “a high degree of professionalism and technical competence.”50 However, the MER underlined a concern regarding the use of sanctions by the SHCP, asserting, “The range of fines provides flexibility to apply sanctions but may not be proportionate and dissuasive for very large institutions and financial groups…” It went on to note that the average fine levied in 2007 was the equivalent of just $2,200, which was judged to be too small to affect the decision-making of large institutions.51 Overall, the supervision and oversight system in Mexico appeared to be among the best of the eight case examples, perhaps indicating the government’s recognition of the need to stem the enormous drug-related money laundering problem in the country.


50 Mexico MER, p.229.

51 Mexico MER, p.224.
UAE

Compliance with all 40+9 Recommendations for the United Arab Emirates came in at 0.43, the second lowest of the eight case examples, and its numerical rating for the four supervision and oversight recommendations was 0.33, which ties Indonesia for worst in that category. According to its 2008 mutual evaluation, the central bank has statutory responsibility for the supervision of banks, finance companies and other money dealers within the UAE, within which the Banking Supervision and Examination Department (BSED) performs day-to-day oversight activities. The assessment team found the BSED’s procedures for AML/CFT supervision of banks to be relatively thorough and implemented by skilled examiners, and that generally speaking, financial institutions are subject to a full-scope examination (including an AML/CFT component) on a 12-18 month cycle. However, supervision of the insurance and securities industries was deemed to be “far less developed.” In addition, the authorities were found to have no formal inspection powers over hawala dealers, and a voluntary registration process allows them to fall outside of the formal oversight system. Finally, the assessment team points to a lack of sufficient sanctioning powers by the authorities. The MER states, “…the central bank does not have the legal authority to levy financial sanctions (e.g., fines) except in relation to a failure to submit requested data in a timely fashion,” and later notes, “with one exception, no formal enforcement action has ever been taken by the

53 UAE MER, p.101.
54 UAE MER, p.114.
55 Hawala refers to an informal value transfer system based largely on trust between a large network of money brokers. Hawala is prominent in many Middle Eastern and Muslim countries, and some analysts consider it to be especially vulnerable to terrorist financing due to less thorough recordkeeping practices, among other reasons.
56 UAE MER, p.99.
central bank against a financial institution for AML compliance failures.” Based on these remarks, it appears that the UAE still has a long way to go in developing an effective and comprehensive oversight system with regards to AML/CFT controls.

**Brazil**

The quantitative indicators of AML/CFT compliance for Brazil were fairly typical among the eight cases examined, with overall compliance coming in at 0.49 and oversight-related compliance at 0.42. Brazil’s main regulators in the financial sector are the Central Bank of Brazil (BACEN), the Securities and Exchange Commission of Brazil (CVM), and the Superintendence of Private Insurance (SUSEP). Broadly speaking, these entities handle AML/CFT supervision for the banking sector, the securities industry, and the insurance industry, respectively. BACEN is also responsible for many non-bank entities such as mortgage companies, portfolio managers and savings and loans. Brazil’s 2010 MER found that BACEN’s supervision of banks was “overly focused on prudential issues” with not enough attention paid to AML/CFT controls—a belief supported by the fact that only a handful of employees within the central bank were reported to be specialists in money laundering and terrorist financing. In addition, the assessors found that BACEN had only undertaken awareness-raising regarding AML/CFT for the non-bank entities under its jurisdiction, and that it should expand to conduct inspections and enforcement of these institutions. Similar problems were found

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57 UAE MER, p.102.
59 Brazil MER, p.191.
60 Brazil MER, p.168.
with respect to oversight of the securities industry; concerning the CVM, the MER states: “There is concern that supervision of AML/CFT requirements (other than STR reporting) is not effective…Another issue is that the number of AML/CFT-related sanctions is very low.” Indeed, only 25 fines were issued by the CVM over a ten year period dating back to 1999, and BACEN collected the equivalent of just $15.6 million for AML/CFT breaches from 2001-2008. It is thus clear from Brazil’s mutual evaluation that the government can improve its oversight of domestic financial entities in a variety of areas, including staffing, examinations and enforcement.

**Saudi Arabia**

Based on its 2010 MER, Saudi Arabia edged out Egypt with the highest overall compliance rating of 0.54, and the country’s supervisory and oversight system impressed the assessment team enough to merit a 0.67 score for compliance with Recommendations 17, 25, 29 and 30, by far the best of the eight cases. Saudi Arabia’s central bank (SAMA) and Capital Market Authority (CMA) are the relevant supervisory agencies for AML and CFT; SAMA regulates the banking, money exchange and insurance sectors, while the CMA is responsible for overseeing the securities industry. The MER notes that both of these agencies have sufficient financial resources at their disposal, but not enough staff members to carry out their responsibilities comprehensively—the CMA had only four employees handling AML/CFT in 2010. In addition, the assessors raised concerns regarding the examination process in place, noting, “Overall, based on the number of

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61 Brazil MER, p.187.
63 Saudi Arabia MER, p.133.
examination tasks and the fact that they do not cover all units subject to SAMA's supervision…the team was not able to ascertain the effectiveness of the supervisory role played by SAMA.”

The use of sanctions was also highlighted as a potential shortcoming in the report; both the CMA and SAMA were judged to have adequate powers to impose penalties on domestic entities for non-compliance, but the lack of statistics about enforcement actions taken for AML/CFT non-compliance (as opposed to general violations) meant that the assessors were unable to determine the effectiveness of sanctions. This concern regarding enforcement is reflected in the MER:

“During the onsite visit, the assessment team was able to evaluate a sample of full-scope inspection reports, as prepared by the audit firms. The sample was based on a selection by SAMA staff and contained reports on all kinds of inspections. In all cases, the supervisory reports indicated a low level of compliance by FIs [financial institutions] and a low level of corrective measures taken by SAMA.”

Thus, despite its elevated quantitative ratings for supervision and oversight, Saudi Arabia appears to suffer from many of the weaknesses shared by its peers.

DISCUSSION & ANALYSIS OF RESULTS

Overall, the data support the hypothesis that developing countries have done a poorer job implementing effective oversight systems that are crucial for a strong AML/CFT regime than their overall level of compliance with the FATF Recommendations would suggest—indicating that there likely is a false impression that the financial systems in these countries are safer than they really are. The scores for overall compliance in the eight developing countries examined were not significantly worse than those of leading OECD countries; seven of the eight averages fell between 0.4

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64 Saudi Arabia MER, p.137.
65 Saudi Arabia MER, pp.138-142.
and 0.55 (the exception being Indonesia at 0.34), whereas common scores for OECD countries fell between approximately 0.55 and 0.75 (see Figure 1 below). The distinction between compliance with oversight and supervision recommendations was greater, however. In six of the eight developing countries examined, adherence to the recommendations relating to oversight and supervision was poorer than average compliance with all 40+9 Recommendations. The two exceptions to this were China, where the difference between the two was negligible (0.003), and Saudi Arabia, which was somewhat inexplicably given a rating of ‘Largely Compliant’ for all four oversight/supervisory recommendations used.

As seen in Figure 1 (and Appendix B), the selected OECD countries do a much better job when it comes to oversight and supervision than do the eight developing countries. It is thus easy to imagine why someone looking at compliance with the FATF Recommendations in general might believe that AML/CFT vulnerabilities in developing countries are better than they truly are. A close examination of AML/CFT supervision in the eight countries reveals some common areas of weakness that highlight important avenues for improvement.

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66 For some perspective, the low end of the spectrum in terms of overall compliance with the FATF 40+9 is a country like Argentina, whose score based on its 2010 mutual evaluation is a paltry 0.23.

67 The concerns voiced by the assessors regarding Saudi Arabia’s AML/CFT oversight and supervision are similar in both scope and magnitude to those raised for the other countries in the case study. As noted in the previous section, understaffing and inexperience in the supervisory bodies was of significant concern, as were gaps in the areas subject to supervision and the low level of sanctions applied by regulators. It is difficult to understand how Saudi Arabia could then be given a rating of ‘Largely Compliant’ for all four of these recommendations, the same rating allotted to the United States.
One common criticism of the eight case examples regarding the supervisory system was that significant portions of the financial sector were either under-regulated or not subject to AML/CFT regulation at all. While most of the countries appear to have taken significant steps to increase oversight of the banking system, they have failed to pay the same amount of attention to other industries where ML and TF can occur. For instance, in Indonesia the money remittance sector, which plays a huge role in transferring funds in and out of the country for migrant workers, has largely avoided government scrutiny; in the UAE, hawala dealers and the insurance sector are under-regulated. The same can be said of non-bank financial institutions in Brazil. These types
of gaps represent significant vulnerabilities in the overall AML/CFT regimes in these countries, as criminals seeking to launder funds will naturally gravitate towards areas where there is less regulation. A second recurring deficiency stressed in the MERs is that supervisory bodies are understaffed when it comes to the AML/CFT field, and that the personnel that are employed lack sufficient expertise in these areas. In Saudi Arabia, assessors observed that the Capital Markets Authority responsible for overseeing the securities industry “…was understaffed (4 employees only) with basic experience in AML/CFT.”68 In Brazil, there were only six individuals in the principal regulator (BACEN) specializing in AML/CFT issues; the MER states that “…there remains strong concern that six specialists is not a sufficient number of staff for the task.”69 Without the manpower and expertise to undertake extensive and constructive supervision, private sector AML/CFT controls in developing countries will continue to lag behind those in the developed world.

Another shared weakness impeding effective AML/CFT oversight revealed by the mutual evaluations is the lack of sufficient enforcement action against non-compliant entities necessary to create a strong culture of compliance—either because the range of sanctions available is limited or because the array of penalties has simply not been used enough. This shortcoming is particularly acute in Egypt, where it was observed that not one fine for AML/CFT shortcomings had ever been imposed. However, even in a country like China that has levied a large number of fines, the small size of the penalties and the minor technical faults for which they are imposed raised concern for the assessors, who state: “There has to be a question-mark over whether the sanctions regime is acting as an

68 Saudi Arabia MER, p.133.
69 Brazil MER, p.167.
effective mechanism to bring about structural change in institutions, where necessary.”

The belief that sanctions have not been proportionate and dissuasive in the Mexican and South African cases was noted in the Mutual Evaluation Reports as well.

Some perspective can be gained by comparing the common characteristics of supervisory and oversight systems in the eight developing countries examined with those of the United States. The U.S. ranks towards the top of the list in overall compliance with the FATF Recommendations (with a rating of 0.70), but there are a number of countries with better overall mutual evaluations. However, the U.S. has developed an extremely vigorous oversight and regulatory system for the financial sector—despite the bad reputation it has acquired since the recent economic meltdown—for both AML/CFT controls and other prudential issues. According to its most recent MER from 2006, over 10,000 AML/CFT exams were completed for the banking sector alone in 2005, with another 2,000+ in the securities sector. In addition to the more “routine” sanctions and monetary penalties issued for non-compliance, the U.S. took four major actions against domestic financial institutions during the years 2004-2006. These four penalties alone totaled $125 million, serving as a significant deterrent for institutions without adequate AML/CFT policies and procedures in place. The MER asserts,

“The legal authority of the regulators to conduct examinations, to acquire information and to conduct enforcement proceedings against financial institutions and their employees for AML compliance failures is broad, and there is clear evidence that these powers are used extensively and on a regular basis...the penalties are applied without reticence and the general implementation appears to be effective. This is clearly acting as an incentive to institutions to implement effective AML/CFT procedures.”

This sort of robust supervision and enforcement is what’s missing in developing

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70 China MER, p.115.
72 USA MER, p.189.
countries, and the prevention of ML and TF will not be effective without it.

The preceding discussion is not intended to suggest that the FATF’s efforts have been for naught or that significant progress has not taken place over the past decade. Elevating awareness about money laundering and terrorist financing issues and inducing countries around the world to pass laws and take other measures to put in place the foundation for a strong AML/CFT regime is an enormous improvement from a decade or two ago. But this achievement may be overshadowing the bottom line: that much of the world is still not preventing ML and TF at the level they need to be, meaning that these crimes, and all of their pernicious effects, are still occurring with far greater prevalence than they should be. The building of a legal and bureaucratic foundation for AML/CFT is only useful insomuch as the rest of the structure is completed—that is, effective oversight and supervision, including proportionate and dissuasive enforcement actions on domestic financial entities, need to be developed to prevent these accomplishments from becoming half-measures taken to mollify the international community. Even worse is the possibility that private sector actors around the world fail to fully recognize the fact that AML/CFT regimes in developing countries are only partially completed, and instead go about their business with institutions in vulnerable jurisdictions as if they were well-protected from the threat of money-laundering and terrorist financing. This sort of misperception and

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73 A good example of the danger for a financial institution of underestimating the money laundering risk overseas is the case of Wachovia Bank. In March 2010, Wachovia forfeited $160 million to the U.S. attorney’s office and Treasury Department for its involvement in laundering millions of dollars in proceeds from narcotics sales, mostly from funds transfers from Mexican exchange houses. FinCEN’s assessment of a civil monetary penalty states, “Wachovia’s policies, procedures and controls failed to ensure that the Bank gathered and reviewed sufficient information on foreign correspondent account customers to adequately assess risk and potential for money laundering.” While this represents a particularly egregious case given that Wachovia is a sophisticated financial institution, it is illustrative of the dangers of underestimating the ML threat and/or believing that overseas entities have better controls than they do in reality. Not only did Wachovia’s negligent behavior in dealing with Mexican exchange houses result in a huge monetary penalty for itself, it also allowed violent drug cartels to profit from their crimes,
complacency, in which not only financial companies but any business with relationships abroad let their collective guard down, exacerbates the already serious problem that ML and TF pose today.

POLICY IMPLICATIONS

The fact that AML/CFT standards in developing countries are likely perceived to be better than they really are and the dangers that this presents for the international financial system are serious, but governments and international bodies can take action to remedy this situation. The implications for policy makers fall into two distinct categories; the first revolves around eliminating misunderstanding about the current state of AML/CFT controls in developing countries, which could be causing people to become complacent about the dangers of ML and TF, and the second focuses on ways to induce countries to improve their oversight and supervision of domestic entities in order to create effective money laundering and terrorist financing regimes. While action should be taken immediately in both categories in order to reduce the incidence of harmful ML and TF as soon as possible, the first category represents a short-term effort to control undesirable effects of misperception, while the latter involves longer-term efforts to resolve the underlying problems plaguing AML/CFT regimes in developing countries.

A clear implication of the case study is that the perception of AML/CFT progress in the developing world needs to be managed to ensure that everyone—especially those

contributing to insecurity in Mexico and, arguably, the United States. Money laundering can support many types of illicit behavior, such as weapons proliferation and even terrorism, and thus poses a threat to everyone, including financial institutions, who operate in the global environment. See http://www.fincen.gov/news_room/ea/files/100316095447.pdf
deeply involved in the international financial system—are aware of the continuing dangers and risks of doing business globally. Countries that have created a domestic financial system relatively adept at AML/CFT monitoring and prevention should conduct outreach to private sector firms and businesses, prioritizing those that tend to be most involved in international banking and finance (such as the import/export industry), to raise awareness about ML and TF threats emanating from other jurisdictions. Stressing the continuing risks posed by developing countries and providing guidance on how to avoid being inadvertently involved in illicit activity is paramount—not to discourage doing business with such areas, but to promote responsible practices to avoid getting caught up in illegal activity due to ignorance or complacency.

The Financial Action Task Force should consider revising its mutual evaluation process to reduce the chances that its assessments are misinterpreted in a way that overstates the actual effectiveness of AML/CFT controls in any given country. One way to do this would be to make the MERs more country specific; since many jurisdictions have already been evaluated at least once, assessors could use a country’s prior MER to identify which recommendations are most important to improve upon in order to create an effective AML/CFT regime. These recommendations would then be given more weight in subsequent mutual evaluations. While developing a more tailored analysis would undoubtedly create some difficulties—for example, by making the process more subjective and raising the possibility that certain important issues are overlooked or deemphasized—it should also be more useful to the country being evaluated, and could do much to reduce misperception about the how much progress has been made in the AML/CFT realm.
The second and more important issue that policy makers must address is how to induce countries that have taken the initial steps in building a strong AML/CFT regime to finish the job by creating a truly effective system to supervise and enforce AML/CFT controls in domestic institutions. Determining the best approach to accomplish this must begin with an analysis of the underlying reasons for why a given country has failed to sufficiently oversee and enforce their domestic institutions’ AML/CFT controls. More research is needed to identify the undoubtedly complex and interdependent factors underlying the shortcomings in regulation and oversight revealed here, but the reasons can be placed into two broad categories: a lack of willingness (at the political level) and a lack of capacity. If the former is true, the potential solutions will gravitate more towards how to induce the authorities within a country to push for better oversight; the latter would indicate that any solution must center on building the capabilities of the domestic authorities and institutions. Thus, the most appropriate approach will depend on country-specific circumstances; there can be no generic plan that will work irrespective of where it is introduced. More likely than not, the reality is that a lack of both willingness and capacity are contributing factors for the deficiencies identified in the case study, in which case a combination of remedies is needed to solve the problem.

Policy makers are well aware that capacity building measures are a good way to help developing countries strengthen their AML/CFT regimes, and a great deal of aid in the form of technical assistance has flowed to such countries in recent years. However, the research undertaken in this study has highlighted areas that are particularly deficient

74 In addition to individual country programs such as the U.S. Treasury’s Office of Technical Assistance, many international organizations, such as the World Bank, International Monetary Fund, and the Egmont Group of Financial Intelligence Units provide technical assistance for AML/CFT. See, for example: Pierre-Laurent Chatain, “The World Bank’s Role in the Fight against Money Laundering and Terrorist Financing,” International Law Forum, Vol. 6 Issue 3/4 (2008), p.192.
and yet important to a country’s effectiveness in preventing illicit financial activity, and this research can therefore be used to target places where technical assistance and resources will do the most good. Given the recurrent problem of staffing and expertise within supervisory agencies in these countries, for example, more funding for the hiring and training of examiners would probably go a long way in strengthening their oversight systems. This is especially true if increased manpower is directed towards those industries that have thus far escaped intense government scrutiny—like money remitters in Indonesia, hawaladars and insurance firms in the UAE, and most non-bank financial institutions in Brazil. Greater all-around capacity for effective supervision should lead to more enforcement actions against non-compliant institutions, as a larger number of faults are identified. However, effective enforcement also requires a willingness to dole out significant punishment on domestic entities, which is less dependent on resources than on political will.

The most glaring type of deficiency observed in the case study, and one of the single largest impediments to creating a culture of strict adherence to AML/CFT controls in developing countries, has been the lack of enforcement action against non-compliant domestic entities. This, along with several other inadequacies related to the powers and purview of supervisory agencies, is mainly a question of political will. The FATF has shown itself capable of generating change in jurisdictions in the past by using its mutual evaluation process and “name and shame” power to align states’ interests with its own agenda. It should continue to leverage these tools to induce countries to increase their readiness to use sanctions (and, if necessary, to broaden the range of sanctions available). A continued absence of any clear demonstration of dissuasive penalties, whether
monetary or otherwise, could be reason enough to identify that jurisdiction as posing a significant money laundering and terrorist financing threat. This would be very likely to eliminate any lingering reticence in taking significant enforcement action.

Besides relying solely on its established techniques, however, the FATF should also consider a novel approach to prompting countries to step up their enforcement efforts on domestic entities. One possibility is to develop a “name and shame” process for individual financial institutions around the world, as opposed to only naming jurisdictions with sufficiently poor compliance. For instance, the FATF could use information collected through the mutual evaluation process, as well as evidence from the financial intelligence units of countries around the world, to identify banks and other entities that are clearly negligent in their AML/CFT duties, or even complicit in financial crimes. These entities could then be publicly identified as a money laundering or terrorist financing threat by the FATF, along with the jurisdiction in which the institution is based. This would have the double effect of reducing the chances that innocent entities would unknowingly become involved in ML and TF—by warning of the dangers of doing business with a given institution—and causing embarrassment for the government responsible for the supervision of the designated institution. After all, if an international organization based outside the country has the ability to detect shortcomings in a particular company, the fact that the government overseeing it did not take action against that company does not reflect well on that government. Countries could thus be motivated to take strong enforcement action against non-compliant domestic entities to avoid the humiliation of having their dirty laundry aired by others.
This proposed action is not without its own set of challenges and drawbacks, of course. The FATF would need to be willing to potentially undermine the sovereignty of governments by implicitly suggesting that those governments are incapable of managing their own domestic institutions, which would be sure to arouse a degree of bitterness and enmity in the humiliated state. However, the FATF already does this in a sense by sending in outside teams to evaluate states’ AML/CFT controls and make recommendations for improvement (not to mention the naming and shaming of states themselves when necessary), so this extra step would not be completely unprecedented.

Another difficult issue is that the FATF’s designation of a bank or other financial institution could have a significant effect on that entity’s performance, causing its share price to plummet and even bringing about bankruptcy or dissolution. Banks rely heavily on public confidence to stay in business, and that confidence could be eroded by a public accusation of negligence or wrongdoing. Clearly the FATF would want to avoid this situation in most cases, lest it be charged with destroying independent institutions and the resulting loss of jobs. Announcements would need to be carefully styled to prevent them from becoming an institution’s death knell—for instance, by making it clear that the basis of FATF’s designation is strictly limited to AML/CFT-related controls—but the public’s reaction would be impossible to predict with certainty. However, it is reasonable to believe that the process could be managed well enough to avoid such hazards, and if done correctly this process would go a long way in convincing states to take ownership and impose appropriate penalties for AML/CFT non-compliance.
CONCLUSION

The Financial Action Task Force has enjoyed a remarkable amount of success in raising awareness about money laundering and terrorist financing issues and prompting states around the world to commit to countering these serious threats to international security. However, a closer examination of what has actually been done to prevent these crimes in developing countries—as demonstrated in the case study conducted for this paper—supports the hypothesis that many states lack the effective oversight and supervisory systems necessary to ensure that their domestic institutions have robust controls in place. Without sufficient oversight and enforcement efforts on the part of developing countries, it is almost beyond doubt that money laundering and terrorist financing remain pervasive across these jurisdictions. What’s more, the steps that developing countries have taken to comply with FATF Recommendations, which have involved legal and bureaucratic measures necessary but not sufficient to create an effective AML/CFT regime, have led many to believe that they are doing a better job protecting against ML and TF than they actually are. This misunderstanding may be causing many involved in the international financial system to let their guard down regarding the threat of illicit financial crime, increasing the potential for abuse by money launderers and terrorist financiers across the globe.

These circumstances highlight a number of actions that policy makers can take to address the problems faced by developing countries. An outreach campaign by governments and a revision of the FATF’s mutual evaluation process could help reduce the misperception that developing countries are doing better at protecting against ML and TF than they really are. To induce countries to strengthen the regulation and oversight of
the private sector, including enforcement action, the FATF should not hesitate to use its name and shame powers on non-compliant jurisdictions and should consider developing a similar process for individual institutions with particularly grievous AML/CFT records. Only a sustained and imaginative effort to create effective money laundering and terrorist financing controls on a global scale will have a legitimate chance of making the international financial system a safe place in which to operate.
**APPENDICES**

Appendix A: The 40+9 Recommendations

<table>
<thead>
<tr>
<th>Rec #</th>
<th>Topic Covered</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Sufficient scope of the criminal offense of money laundering.</td>
</tr>
<tr>
<td>2</td>
<td>Proving the offence of ML is consistent with the standards set forth in the Vienna and Palermo Conventions.</td>
</tr>
<tr>
<td>3</td>
<td>Measures in place to allow authorities to confiscate money laundering proceeds</td>
</tr>
<tr>
<td>4</td>
<td>Ensure secrecy laws do not inhibit compliance with the FATF recommendations</td>
</tr>
<tr>
<td>5</td>
<td>Customer due diligence by financial institutions</td>
</tr>
<tr>
<td>6</td>
<td>Risk management and due diligence for politically exposed persons</td>
</tr>
<tr>
<td>7</td>
<td>Correspondent banking due diligence</td>
</tr>
<tr>
<td>8</td>
<td>Take measures to ensure new &amp; developing technologies aren't used for money laundering</td>
</tr>
<tr>
<td>9</td>
<td>Relying on 3rd parties for customer due diligence</td>
</tr>
<tr>
<td>10</td>
<td>Financial institutions should pay attention to unusual or complex and large transactions</td>
</tr>
<tr>
<td>11</td>
<td>CDD and recordkeeping applies to designated non-financial businesses and professions (DNFBP)</td>
</tr>
<tr>
<td>12</td>
<td>Suspicious transaction reporting to financial intelligence unit (FIU)</td>
</tr>
<tr>
<td>13</td>
<td>Suspicious reporting is protected by law; illegal to tip-off suspicious reporting</td>
</tr>
<tr>
<td>14</td>
<td>Financial institutions should develop programs against ML and TF (internal controls, compliance &amp; audit)</td>
</tr>
<tr>
<td>15</td>
<td>Apply recommendations 13, 15 &amp; 21 to DNFBP</td>
</tr>
<tr>
<td>16</td>
<td>Effective, proportional and dissuasive sanctions available for non-compliant persons (legal and natural)</td>
</tr>
<tr>
<td>17</td>
<td>Shell banks</td>
</tr>
<tr>
<td>18</td>
<td>Consider requiring all currency transactions above fixed amount to be reported</td>
</tr>
<tr>
<td>19</td>
<td>Consider applying recommendations to businesses/professions other than DNFBP</td>
</tr>
<tr>
<td>20</td>
<td>Attention &amp; scrutiny to transactions &amp; relationships in non-compliant countries</td>
</tr>
<tr>
<td>21</td>
<td>Countries should ensure that financial institutions are subject to adequate regulation and supervision and are effectively implementing the FATF Recommendations</td>
</tr>
<tr>
<td>22</td>
<td>Monitoring/oversight of DNFBP to ensure compliance</td>
</tr>
<tr>
<td>23</td>
<td>Authorities establish guidelines &amp; provide feedback to help entities apply domestic AML/CFT measures</td>
</tr>
<tr>
<td>24</td>
<td>Establish FIU appropriately</td>
</tr>
<tr>
<td>25</td>
<td>Designated law enforcement authorities have responsibility for ML and TF investigations</td>
</tr>
<tr>
<td>26</td>
<td>Adequate powers of supervisors to monitor and ensure compliance by financial institutions with requirements to combat ML and TF, including the authority to conduct inspections.</td>
</tr>
<tr>
<td>27</td>
<td>Countries should provide their competent authorities involved in combating money laundering and terrorist financing with adequate financial, human and technical resources</td>
</tr>
<tr>
<td>28</td>
<td>Cooperation between domestic agencies</td>
</tr>
<tr>
<td>29</td>
<td>Statistics kept to enable review of country's effectiveness in combating ML and TF</td>
</tr>
<tr>
<td>30</td>
<td>Beneficial ownership (legal persons)</td>
</tr>
<tr>
<td>31</td>
<td>Beneficial ownership (legal arrangements)</td>
</tr>
<tr>
<td>32</td>
<td>U.N. conventions (Vienna, Palermo, TF) ratified/implemented</td>
</tr>
<tr>
<td>33</td>
<td>Mutual legal assistance (international cooperation)</td>
</tr>
<tr>
<td>34</td>
<td>Dual criminality</td>
</tr>
<tr>
<td>35</td>
<td>Foreign requests to freeze/seize/confiscate property</td>
</tr>
<tr>
<td>36</td>
<td>Extradition</td>
</tr>
<tr>
<td>37</td>
<td>&quot;Other&quot; forms of international cooperation</td>
</tr>
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</table>
The 9 Special Recommendations on Terrorist Financing:

<table>
<thead>
<tr>
<th>SR 1</th>
<th>1999 U.N. TF Resolution ratified, UNSCR 1373 ratified</th>
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<tbody>
<tr>
<td>SR 2</td>
<td>Criminalization of financing of terrorism, terrorist acts &amp; terrorist orgs</td>
</tr>
<tr>
<td>SR 3</td>
<td>Measures to freeze and confiscate terrorist assets</td>
</tr>
<tr>
<td>SR 4</td>
<td>Reporting suspicious transactions relating to terrorism</td>
</tr>
<tr>
<td>SR 5</td>
<td>International cooperation for TF matters</td>
</tr>
<tr>
<td>SR 6</td>
<td>Alternative remittance providers licensed/registered and subject to FATF recommendations</td>
</tr>
<tr>
<td>SR 7</td>
<td>Wire transfers - accurate &amp; meaningful originator information required</td>
</tr>
<tr>
<td>SR 8</td>
<td>Ensuring non-profit organizations are not being misused for TF</td>
</tr>
<tr>
<td>SR 9</td>
<td>Cash couriers – detection and prevention of illicit cross-border transportation</td>
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</table>
## Appendix B: Compliance Levels – Eight Case Examples and Selected OECD Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Overall Compliance</th>
<th>Compliance with Selected Oversight &amp; Supervision-related Recommendations (17, 23, 29 &amp; 30)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Case Examples</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>0.5374</td>
<td>0.6667</td>
</tr>
<tr>
<td>Indonesia</td>
<td>0.3472</td>
<td>0.3333</td>
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<tr>
<td>UAE</td>
<td>0.4286</td>
<td>0.3333</td>
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<tr>
<td>South Africa</td>
<td>0.5034</td>
<td>0.4167</td>
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<td>Brazil</td>
<td>0.4894</td>
<td>0.4167</td>
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<tr>
<td>Mexico</td>
<td>0.5034</td>
<td>0.5000</td>
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<tr>
<td>China</td>
<td>0.4966</td>
<td>0.5000</td>
</tr>
<tr>
<td>Egypt</td>
<td>0.5347</td>
<td>0.4167</td>
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<tr>
<td><strong>Select OECD Countries</strong></td>
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<tr>
<td>Germany</td>
<td>0.5306</td>
<td>0.5833</td>
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<tr>
<td>France</td>
<td>0.6463</td>
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<tr>
<td>Belgium</td>
<td>0.7569</td>
<td>0.5000</td>
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<td>Switzerland</td>
<td>0.6111</td>
<td>0.5000</td>
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<tr>
<td>USA</td>
<td>0.7007</td>
<td>0.7500</td>
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<tr>
<td>UK</td>
<td>0.7211</td>
<td>0.6667</td>
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<tr>
<td>Japan</td>
<td>0.4514</td>
<td>0.6667</td>
</tr>
</tbody>
</table>

![Compliance in Developing Countries and Select OECD Countries](image-url)

- **Overall Compliance**
- **Compliance with Selected Oversight & Supervision-related Recommendations (17, 23, 29 & 30)**
Overall vs. Oversight-specific Compliance Levels

Overall Compliance - Comparison to Select OECD Countries
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**Miscellaneous**


