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Anti-Money Laundering & Countering the Financing of Terroism: Conundrum for Domestic and International Communities

Tannuva Akbar
MA Candidate, Global Affairs
Munk School of Global Affairs,
University of Toronto

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151 rue Slater, bureau 412A
Ottawa (Ontario)
K1P 5H3

613 236 9903
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Papers from the 17th Annual Graduate Student Symposium

Anti-Money Laundering and Countering the Financing of Terrorism: Conundrum for Domestic and International Communities

Tannuva Akbar

I was born and raised in Bangladesh. Having come from a military family, I have always been interested in global security and national defence. With a passion for security studies, I came to Canada in 2005 to pursue my undergraduate degree in international relations and political science at the University of Toronto. Currently I am a final year student at the Master of Global Affairs program at UofT. During my Masters program, I developed further interests in counter-terrorism policies and financial intelligence on illicit financing. Subsequently, I secured an internship at the Egmont Group of Financial Intelligence Units in the summer of 2014 where I further developed my knowledge on anti-money laundering (AML) and countering the financing of terrorism (CFT). My internship led to a part-time consultant position at the Egmont Secretariat where now I conduct research on AML/ CFT policies and the role of international organizations, governments and financial intelligence units (FIUs).

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Anti-Money Laundering and Countering the Financing of Terrorism: Conundrum for Domestic and International Communities

Introduction

Trends in transnational terrorism, and other related security dilemmas, suggest a shift from traditional military conflict to more sophisticated, but less-understood, types of threats. Intangible, multinational, security threats are becoming increasingly relevant and more difficult to understand and manage. The growing global concern to protect the integrity of the international financial system and to prevent its misuse, such as financing acts of terrorism; funding illicit proliferation of weapons of mass destruction; or laundering the proceeds of transnational organized crime, is indicative of the major security threats that countries now face. Understanding these threats requires the collection and sharing of financial intelligence. As the modern era of globalization paves the way for more technological advancements, the movement of illicit funds in support of various criminal activities such as terrorism, drugs, and arms and human trafficking, has become much easier. As a result, alongside national governments' endeavors, there are other organizations around the world that are now actively working to combat money laundering and terrorist financing.

By examining the existing barriers against improving financial intelligence via improved international cooperation, this paper asserts that Anti Money Laundering and Countering the Financing of Terrorism (hereinafter AML/CFT) efforts require strong domestic regulations in order to enable a strong international collective response. This paper will also highlight Canada's role in fighting money laundering (ML) and terrorist financing (TF) and focus on some of the best practices. Additionally, this paper will explore from a macro perspective how reputational risk is an overrated incentive for many international financial institutions, some of which are seemingly not seriously committed to prevent ML and TF. Finally, this paper will conclude with recommendations on improving domestic and international responses to AML/CFT issues in order to help bridge the security gap in the international realm.

Money Laundering (ML) and Terrorist Financing (TF):

The IMF defines money laundering as "the process by which a person conceals or disguises the identity or the origin of illegally obtained proceeds so that they appear to have originated from legitimate sources."[1] According to UN estimation, the amount of money laundered internationally in one year is 2-5% of global GDP, or $800 billion - $2 trillion in current US dollars.[2] Similarly, terrorist financing is defined as "the financing of terrorism can be described as the process by which a person tries to collect or provide funds with the intention that they should be used to carry out a terrorist act by a terrorist or terrorist organizations as defined in the International Convention for the Suppression of the Financing of Terrorism as well as in any one of the treaties listed in the annex to that Convention."[3] With the rise of new financial instruments, nations are finding it increasingly challenging to achieve an effective solution to fighting global ML/TF.[4] To facilitate the policing of money laundering and terrorist financing, many international organizations have established policies and standards of cooperation. One such organization is the Financial Action Task Force (FATF), an intergovernmental body that collaborates with other observers and member countries to "promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system".[5] The FATF has developed 40 recommendations for its member countries and works to generate the necessary political will to reform national legislations and regulations.[6]

Funding Terrorist Campaigns and International Transfers

Although there has been a shift away from financially state sponsored terrorism since the Cold War, the use of some of these techniques still continue.[7] Firstly, charities contribute significantly to terrorist financing. According to the monograph on terrorist financing that accompanied the 9/11 Commission Report, al Qaeda had access to numerous foreign banks and their branches, where they took advantage of weak financial controls in order to transfer money.[8] The report goes on to mention that "there are some 300 private charities in Saudi Arabia alone, including 20 established by Saudi intelligence to fund the Afghan Mujiheddin that send upwards of US$6 billion a year to Islamic causes abroad."[9]

Secondly, terrorist groups may be self-funded through criminal activities, primarily via drug trafficking, narcotics dealings, human smuggling, robbery and kidnapping. To name a few, Columbia's rebel groups such as the FARC, the ELN, the AUC, and Peru's Shining Path participating in illegal cocaine dealings; Al-Qaeda in Afghanistan and Pakistan trading opium; and Hezbollah in Lebanon and Syria and PKK in Turkey smuggling opium, hashish and tobacco..[10] Additionally, illicit trade in natural resources, including the tanzanite market, led to an investigation by the U.S. State Department in 2002.[11] The investigation resulted in the Tuscon Tanzanite Protocols, which is an international agreement demanding more transparency and safeguards in the tanzanite market. Moreover, terrorists have also tapped into extractive markets that include oil, precious metal and timber.[12]

Recently, the dynamics of how terrorists fund themselves have changed. For example, in the case of the Islamic State of Iraq and Syria (ISIS), most of their terrorist activities are self-financed in subsidiary activities such as kidnapping, extortion, robbery, smuggling, etc. ISIS has been making a tremendous amount of money the selling of illicit oil from Syria and Iraq to Kyrgyzstan. In September, estimates place ISIS's "daily income at around $3 million, giving it a total value of assets between $1.3 and $2 billion, making it the world's best-funded terrorist group. By this standard, ISIS draws more income than many small nations, including Tonga, Nauru, and the Marshall Islands."[13] It is evident that ISIS's ability to control territory and engage in resource abusive activities is becoming increasingly dangerous.

One of the main methods used to transfer these funds internationally is the exploitation of financial systems and bypassing financial controls. Terrorist groups often have experts capable of hacking bank accounts, tampering with identifications and manipulating the wire transfer system internationally.[14] Terrorists also often use the informal value transfer systems (IVTS) for untraceable banking transactions.[15] One of the many names of IVTS is *hawala,* which is an ethnic network in the Middle East that received a lot of attention post 9/11. In recent times, examples of *hawalas* to transfer money worldwide are seen in Qatar.[16]

AML/CFT Efforts: How Domestic Barriers Impact International Cooperation

After attaining a theoretical understanding, let us examine how domestic barriers adversely impact international cooperation to combat ML/TF. Barriers such as weak domestic regulatory, a lack of political will to cooperate, bank secrecy, and other legal and non-legal issues deter a coordinated approach to the problem. The International Monetary Fund (IMF) reports that in certain jurisdictions there are gaps in the requirements placed on financial services businesses (FSBs), such as a lack of information on beneficial ownership or licensing and financial statements. Another key barrier includes inadequate resources to monitor the operation of regulated FSBs properly. The IMF's report on Standards and Codes (ROSCs) notes the absence of a program for effective on-site visits and, sometimes, the absence of sufficient resources to conduct desk-based regulation adequately.[17]

One foundational basis for successful international cooperation in response to ML/FT threats is to encourage a level of trust and understanding between FIUs. The member FIUs of the Egmont Group operate within their domestic legislation to combat money laundering, terrorism financing and other predicated offences. FIUs have the authority to detect, identify, investigate, prosecute and confiscate the earnings of the crime within their territories. Unfortunately, there is an asymmetry in terms of how much information and power is given to an FIU to generate broader international cooperation and effective communications with other FIUs. A report produced by the Operational Working Group of Egmont in 2011 asserts that many countries lack access to financial information or are reluctant to share it. A number of FIUs lack the systems needed to track information exchange requests as well as responses and are unable, or unwilling, to respond to these requests. The FIUs powers to disseminate defined types of information to reporting entities and national authorities are limited as well. FIUs have the power to cooperate widely only with 39% of recipients, and only 40% of defined types of information are widely available to share domestically.[18] The comparison of FIUs powers to access information domestically and to disseminate it internationally reveals that the latter is considerably narrower.

Moreover, the diverse structures of FIUs pose limitations for individual FIUs to access or share important information to maintain domestic transparency and accountability. For example, 70% of FIUs have administrative status, 13% have police status, and 17% have hybrid status.[19] So, depending on how a country empowers its FIU and how it is structured, the effectiveness is varied. Many FIUs fall under different organizational umbrellas such as the Ministry of Finance, Central Bank, Independent or Hybrid structure, and consequently, FIUs lack the ability to query tax or other law enforcement authorities to exchange information.[20]

Finally, the report noted that some FIUs received low quality responses to their requests and some required signing a Memorandum of Understanding (MOU) to disseminate domestic information internationally.[21] According to the Egmont Group Charter, all members defined as a FIU, "prepared a model MOU for the exchange of information, created the Egmont Secure Web (ESW) to facilitate information exchanges, embarked upon numerous initiatives to develop the expertise and skills of the FIUs' staff and to contribute to the successful investigation of matters within the FIUs' jurisdictions."[22] Despite the Charter obligation, members do not comply with financial intelligence requests. Some MOUs are drafted in a way that limits information sharing or take longer to get into action. Domestic barriers to gather and exchange critical financial intelligence information has complicated ML/TF combat efforts globally.

Canada's Role in Fighting Money Laundering (ML) and Terrorist Financing (TF):

To illustrate this framework in a Canadian context, consider how the Canadian FIU, the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC), is successfully contributing to AML/CFT policies. FINTRAC was established in 2000 under the Ministry of Finance and is primarily responsible for collecting and analyzing suspicious financial activities reports, including large cash transactions and electronic fund transfers. FINTRAC also monitors compliance and disclosure procedures and ensures that information is disseminated to the proper authorities: such as law enforcement agencies, CSIS, or other agencies designated by legislation in to support of investigations and prosecutions.[23]

In 2001, Canada amended the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA). The Act requires that a report be filed with FINTRAC when there are reasonable grounds to suspect that a transaction is related to money laundering or terrorist financing offences. On February 1, 2014, new regulations to this Act came into force. The new regulations clarify the implications of a business relationship by emphasizing ongoing monitoring and record keeping regarding the purpose and intended nature of the business relationship.[24] According to the 2014 Mutual Evaluation Follow-Up Report by the FATF, Canada has made significant progress in terms of improved legislation on customer due diligence and on their

fragmented risk assessment. As a G8 country, Canada undertook an initiative addressing the broader risk assessment of various sectors. More specifically, in June 2013, Canada published its Action Plan on Transparency of Corporations and Trusts in support of the G8 countries' commitment to demonstrate leadership in improving their respective countries to prevent the illegal use of corporations and trusts.[25] This Canadian led G8 Action Plan "commits to developing a new money laundering and terrorist financing risk assessment framework and conducting a formal assessment of these risks domestically to better inform the development and implementation of effective policies and operational approaches to mitigate risks." [26] The emergence of such practices has essentially led standard setting bodies such as FATF to create a risk based approach, in which "countries, competent authorities, and banks identify, assess, and understand the money laundering and terrorist financing risk to which they are exposed, and take the appropriate mitigation measures in accordance with the level of risk."[27]

Additionally, the FATF report highlights significant improvements made by Canada regarding the level of compliance with the FATF recommendations, particularly No. 5, 23, and 26.[28] In 2008, Canada also implemented a federal registration authority for money service businesses (MSBs), which was managed as a private sector outreach program. This was an effort by the Canadian government to better regulate and communicate with the MSB sector. FINTRAC has signed MOUs with domestic agencies such as the RCMP, provincial and municipal police agencies, CSIS, CRA, and CIC that enables more detailed and effective arrangements for exchanging information. MOUs signify a commitment between FIUs and effectively facilitate the flow of information. These agencies conduct investigations, and if warranted, bring charges against the individuals involved.[29] With increasing concerns over homegrown terrorism, Canada is setting exemplary initiatives to deter many kinds of ML/TF threats at home and abroad. Hopefully, Canada's commitment to constantly improving the domestic AML/CFT laws regarding receiving and disclosing critical financial intelligence information, managing sanction regimes, and increasing resources of law enforcement and investigative authorities will play a pivotal role in the realms of defence and security.

Reputational Risk and AML/CFT Legislations:

The concept of reputational risk and its relationship with AML/CFT is an important one. By definition, "reputation is ultimately about how your business is perceived by stakeholders including customers, investors, regulators, the media and the wider public."[30] Hence, reputational risk is a danger to the good name of the business or entity and has the ability to deteriorate the confidence of the stakeholders and the public. Reputational risk can occur due to the misdeed of an employee or the company itself through violation of certain laws regarding good governance, corporate social responsibility, transparency and accountability. While reputational risk is defined quite cohesively, the conundrum lies in the fact that big banks and financial institutions can continue to make profits despite paying huge fines incurred by facilitating illicit financing or money laundering. The same banks that put billions of dollars into their compliance department also violate many UN sanctions rules. The reputational risk from this bad publicity seemingly does not incentivize them to stop engaging in the business of money laundering, terrorist financing or sanctions busting. Therefore, where is the reputational risk?

The relationship between reputational risk and lack of information exchange is broad enough itself to require an entire separate article devoted to the subject. However, in the context of this paper, I will take a macro level approach to connect reputational risk and domestic barriers to combat ML/TF issues. Reporting entities such as banks and mortgage and insurance companies are obligated by law to report any suspicious financial activities to the national FIU. According to FATF Recommendations No. 2, 29, 31 and 34, it is clearly stated that FIUs, LEAs (law enforcement agencies) and all reporting entities should cooperate and coordinate domestically for information exchange.[31] Nevertheless, reporting entities are primarily in the business of making

money, thus providing information on their customers is often contrary to their goals. Therefore, reporting entities fail to address this conflict of interests because they fear being isolated or having their reputations tarnished.

As the IMF has noted, there are bank secrecy laws that are meant to provide privacy and security to its customers and policies to combat ML. However, there is no clarity of laws between commercial or investment banks with regulators or authorities who want to investigate further for STRs or CTRs for ML and TF. An increasing number of banks are repeatedly fined for misconduct due to lax bank regulation practices every year. As a rough estimation, "in the past five years, global banks have paid out more than $60 billion in fines and penalties to the Justice Department and regulators over misleading investors on mortgage securities, allowing sanctioned entities to access the U.S. financial system, manipulating interest rates, and other problems."[32] Ineffective evaluation of specific banks or countries may be due to discrepancies between various laws which consequently contributes to a lack of information exchange. Expansion of their capability to gather and share intelligence among investigative, law enforcement, regulatory authorities and private sectors on all aspects of ML/TF or breach of law is a necessity.

The IMF, the Basle Committee on Banking Supervision (BCBS) and the FATF, among other organizations, are mandated to prevent money laundering across the globe and have set international standards to do so. However, to date these standards have not been very effective. Big investment banks including Barclays, UBS, and HSBC, have broken AML/CFT and U.S. sanction rules and facilitated illicit money transfers, which essentially allowed their institutions to be misused by criminals, and in extreme circumstances, terrorist organizations.[33] These banks have large budgets to pay fines when they break AML/CFT legislation. A new global compliance survey created by Veris Consulting shows that approximately 66% of the survey's respondents reported that their AML and Office of Foreign Assets Control (OFAC) compliance budgets have increased over the last three years. However, 32% reported their budget as being inadequate. Only 8% of the respondents confirmed to have devoted enough resources to AML and OFAC compliance.[34] Therefore, it is time to re-evaluate how well some international financial institutions comply with their legal obligations. These institutions are not deterred by AML/CFT legal requirements and the prospect of large multi-million dollar fines. Recently, BNP Paribas evaded the U.S. sanctions rule and paid a $9 billion dollar fine.[35] The bank has refused to cooperate with the investigation and ignored all previous warnings by the authorities. Subsequently, the Chairman of the Bank has stepped down because of the fine and for transferring billions of dollars to U.S. blacklisted countries such as Sudan and Iran.

Multiple case studies conducted in the 1990s and 2000s show that internal controls and compliance processes of big banks do not prevent them from profiting from illicit money transfers. In 2005, FinCEN accused the Banco Delta Asia (BDA) for getting involved with illegal activities including counterfeit currency and smuggling tobacco products into North Korea.[36] The BDA case study clearly depicts that banks often facilitate money laundering, and that the fines that they have to pay often do little or nothing to deter them. Over the last few years, for various transgressions, the financial sector has collectively acquired $30 billion in fines alone and paid more than $100 million in legal fees. Ironically though, the financial sector is still profiting and banks are still attracting investors.[37] "Too-big-to-jail" is a concept that regulators often struggle with which is a big deterrent for broader cooperation to enforce the laws that they have created to punish financial institutions.[38] Serving all the different stakeholders' interests through political lobbying results in frustration and anger among many.[39]

It is apparent that reserving money to pay for fines has become a general practice for big banks and is now a normal part of the cost of doing business on their balance sheets. In July 2012, HSBC set aside almost $2 billion dollars to cover fines and, later in the same year, set aside another $500 million euros when it released its third quarter results.[40] This type of actions raises question of the bank's compliance process and how

effective it is to stop them from gaining profit by assisting in illicit financial transactions. It is a reasonable question to ask whether non-compliance is already accounted for in the business model. While HSBC paid a large amount in fines, the federal lawmakers in the U.S. had decided not to indict the bank as it could jeopardize the U.S. and the world's economic health. Again, this conflict of interests and leniency shown when punishing the bank raises big questions. It was reported, that "given the extent of the evidence against HSBC, some prosecutors saw the charge as a healthy compromise between a settlement and a harsher money-laundering indictment. While the charge would most likely tarnish the bank's reputation, some officials argued that it would not set off a series of devastating consequences."[41]

Policy Recommendations

In order to be effective, policy recommendations to address ML/TF issues must engage all stakeholders including the regulatory bodies, banking sectors and governments on both the domestic and international level. Generally, more programs are needed in order to evaluate legal, non-legal, technical and constitutional barriers in each jurisdiction. In turn, this will almost certainly boost the degree of information exchange between the FIUs. For example, The Egmont Group is building the framework and platform to facilitate trust among FIUs, which will lead to eradicate the domestic barriers for knowledge sharing and improve the collective action. A more effective way to implement this framework would be to remove any communication barriers and conflict of political and economic interests among all of the participating actors. Moreover, all reporting entities must be strictly monitored in order to ensure that they are disseminating information to their respective domestic FIUs.

At a domestic level, governments need to enact stronger regulations; every FIU should be given the authority to remove power asymmetry both domestically and internationally. That would imply that every FIU should be able to acquire information from other law enforcement and tax agencies and should be empowered with the proper resources as well as the capacity to access the required information. As was discussed earlier in this paper, the structural inconsistencies of FIUs impacts the timing, the type and source, and the quality of requests sent or received. Despite structural differences, every state should equip itself to share information on an international level by allowing the FIUs to coordinate better. In this case, FATF Recommendation No. 29 needs more specification with regards to a preferred structure of an FIU.[42] With regards to MOU, the Egmont and FATF standards imply that bilateral or multilateral MOUs could be useful as long as they are completed in a timely manner and that covers a wide range of countries. It is evident that MOUs increase trust and accountability by ensuring due diligence on regulatory laws for parties involved and it should not be used as a tool to hinder efficiency.[43]

At the same time, if every FIU is structured in a way that encourages information exchange and knowledge sharing, and is given the appropriate amount of authority to investigate, confiscate, arrest and prosecute actors involved with ML/TF acts, there will be a greater level of trust which will, in turn, generate more cooperation amongst various actors. As stated earlier, the Egmont Group is building the framework and platform to improve relations and facilitate trust among FIUs, which will hopefully eradicate the domestic barriers for knowledge sharing and improve the collective action. The more effective way to implement that would be to remove any communication barriers and conflict of political and economic interests among all the different actors. All the reporting entities must be strictly monitored to make sure they are disseminating information to the domestic FIUs.

On a broader level, the primary focus to combat global terrorist financing should be to enhance larger cooperation and disseminate information among regional and international organizations. The UN, FATF, IMF and the EU are relentlessly trying to enhance international collaboration through conventions, resolutions, and recommendations, as well as setting standards and evaluation mechanisms. One of the major ways

FATF can maintain international best practices is by imposing international pressure and targeted financial sanctions on the regimes that are involved with terrorist financing (refer to Recommendation 6).[44] FATF Recommendation 6 also requires countries to comply with the United Nations Security Council Resolutions (UNSCRs) such as UNSCR 1267(1999) and UNSCR 1373(2001)[45] and it is a powerful tool to deter countries in ML/TF activities. Furthermore, since FATF has partnerships with international organizations, especially the IMF and World Bank, it can provide not only technical aid to countries that are seeking compliance with FATF recommendations, but also to isolate those states who refuse to cooperate.

Finally, it is necessary to understand that reputational risk is not a good incentive for the big banks to stop engaging in illicit money transactions. The U.S. in particular needs to enforce the US Patriot Act on the financial sector and private hedge funds, as well as the Bank Secrecy Act and the Federal International Emergency Economic Powers Act regulations. In 2014, the Federal Financial Institutions Examination Council (FFIEC), updated the manual used by examiners to assess compliance by financial institutions with the Bank Secrecy Act and anti-money laundering requirements. The manual contains an overview of compliance program requirements, risks, risk management expectations, industry best practices, and examination procedures. Measures like this should be taken more frequently and proactively to protect the integrity of the financial system.. Financial institutions worldwide need to enforce stronger Group Reputational Risk Committee (GRRC) in their compliance process as well as other compliance and reporting measures to be more transparent. Moreover, banks or executives facilitating ML/TF efforts should be indicted to set examples.

To conclude, this paper argued that strong domestic legislation is required for an effective international response to fight money laundering and terrorist financing. Evidence from the Egmont Group shows that the lack of domestic capacity can lead to a weak international response. Additionally, this paper demonstrated that reputational risk is doing very little to strengthen compliance with AML/CFT efforts. Finally, this paper discusses multiple policy recommendations that must be implemented by individual states as well as by international organizations. Global governance to fight money laundering and terrorist financing can only be enforced when all the various actors are cooperating with each other. Money laundering and terrorist financing is exacerbated with the rise of advance technology and, hopefully, countries will soon be equipped with the right tools to keep up and eventually eradicate this global problem.

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