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Chasing Dirty Money

Money laundering is the conversion of criminal incomes into assets that cannot be traced back to the underlying crime. Over the past three decades, the number and scope of laws and regulations aimed at combating money laundering have expanded dramatically.

The anti–money laundering (AML) effort by the United States began with the passage in 1970 of the Bank Secrecy Act, which was largely domestic in nature and covered only depository institutions. Since then, anti–money laundering has become a highly structured international regime that regulates a wide variety of institutions. Not all of them—casinos are an example—are normally viewed as part of the financial system.

The emergence of international terrorism as a major policy concern in recent years has led to a further ratcheting up to cover yet more institutions and activities. Box 1.1 examines the connections between the AML regime and efforts to combat terrorist financing.

Growth of the global anti–money laundering regime has generated relatively little public controversy. The banking sector initially resisted increased government interference in its relationships with clients, but the sector has since learned how to accommodate AML requirements in ways that impose relatively modest costs and inconveniences on both banks and their customers. Fears about the effects on the international competitiveness of US banks have also faded as other nations have imposed similar regimes. Privacy considerations have rarely been a major issue, despite the fact that the structure represents a considerable investment of public authority and public and private resources in the collection of information.

Notwithstanding the increased authority and investment represented by the anti–money laundering regime, few assessments have been carried out

Box 1.1 Anti–money laundering and combating terrorism financing

The attack on the United States on September 11, 2001, led to stepped-up efforts to move the war against terrorism and its financing to the forefront of national and international anti–money laundering regimes. However, long before the tragic events of 9/11, international initiatives to control money laundering incorporated efforts to combat terrorist financing. For example, a number of countries already had explicitly included the financing of terrorism as a predicate or underlying offense in their anti–money laundering regimes, and the Financial Action Task Force (FATF) and the Egmont Group of Financial Intelligence Units (FIUs) reviewed a number of cases involving terrorist financing. The United States reported to the FATF that it designated 30 foreign organizations as terrorist organizations in 1997, and seized $1.4 million in cash and property in connection with an antiterrorism case in 1998. In 2000, the United States and the FATF highlighted the potential connection between the financing of terrorism and *hawala* and other informal value transfer systems.

The tools developed nationally and internationally as part of the anti–money laundering regime can also be used in dealing with the financing of terrorism. First, regime tools can be used as investigative devices to learn something not only about the origins of funds but also their destinations. Customer due diligence, for example, can help determine not only who customers are but also what they do, where their money comes from, what they are doing with it, and where it is transferred to. Second, the regime can be used as a prosecutorial device, as in a 1998 US confiscation case involving a scheme to finance terrorism in the Middle East, or in the more recent US case involving a Chicago-based charitable organization, Benevolence International Foundation (even though the money laundering charge in that case was dropped as part of a plea bargain). Third, combating the financing of terrorism involves close international cooperation in the exchange of information, blocking funds, and closing down channels used to transfer funds.

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of either its achievements or consequences. This study's aim is to begin the task of evaluating the effectiveness of the global anti–money laundering regime. It describes the phenomenon of money laundering itself, to the extent that the available fragments of information allow, as well as the status of the current AML regime. This is followed by an analysis of its effectiveness in achieving three goals: reducing crime, protecting the integrity of the core financial system, and controlling three types of global "public bads"—terrorism, corruption, and failed states. The study concludes with recommendations on how the AML system and analysis of its effectiveness could both be improved.

The process of preparing this study revealed that there is a dearth of quantitative data about money laundering and efforts to control it. Nor has there been much analysis of what few data exist. The available information consists of case descriptions, raw accounts of law enforcement events (such as convictions on money-laundering charges or numbers of reports of suspicious activities), and anecdotes from investigators, prosecutors, or, on rare occasions, the criminals themselves. The academic literature falls

Box 1.1 *(continued)*

There are differences as well, of course, between the general anti–money laundering regime and the specific variant applied to terrorist financing. First, terrorist financing generally (although not exclusively) involves financial flows that originate in legitimate activities to support illegitimate activities, rather than the reverse process in which funds from illicit activities are made to appear licit. Although most other money laundering originates with illegitimate activities, even here one traditional technique is the exploitation of legitimate activities, especially those handling large amounts of cash such as casinos or grocery stores. This points to the importance of financial institutions not only knowing their customers but also knowing what those customers are doing, where they get their money, and where it is being sent.

Second, terrorist financing typically involves smaller amounts of money than does traditional money laundering, often far less than $100,000. Combating such relatively small-scale laundering can be far more difficult—sometimes like looking for a needle in the haystack.

Third, the stakes are higher in combating terrorist financing in that the amounts involved may be small, but the potential benefits to society from prevention and confiscation are huge. Thus, the objective is not to contain or reduce but to eliminate the activity because the benefit-cost ratio of doing so is high.

Finally, while the goal in most other money-laundering activities can be linked to some degree or other to the profit motive, in terrorist financing the profit motive (other than cost minimization) is largely replaced by noneconomic motives, particularly political ones. This may further hamper detection.

The basic question is the extent to which the authorities can proactively use the anti–money laundering regime to attack and eliminate terrorist financing and terrorism itself. The simple answer is that the regime can make a major contribution to combating terrorism, but some of the differences sketched out above imply the need for, at the very least, more intense application of existing anti–money laundering instruments as well as the use of supplementary mechanisms.

into three broad categories: (1) practical law review articles primarily directed toward identifying the necessary components of an effective AML regime and explaining the complex statutes in force to control money laundering; (2) criminological and historical analyses, many of which are highly judgmental and value-driven; and (3) crude economic analyses of the extent of money laundering.

Money Laundering and Its Control

Money laundering is conventionally divided into three phases: *placement* of funds derived from an illegal activity, *layering* of those funds by passing them through many institutions and jurisdictions to disguise their origin, and *integration* of the funds into an economy where they appear to be legitimate. Although the anti–money laundering regime has many objectives—including the aforementioned goals of reducing crime, preserving financial system integrity and controlling terrorism, corruption, and failed states—

those objectives are for the most part compatible and do not present operational conflicts.

No credible estimates are available as to the volume of money laundering, or its distribution across countries and activities (chapter 2). Certainly the aggregate annual figure is in the hundreds of billions of dollars, but whether that figure is a small number of hundreds or more than a trillion is unknown. The vagueness of such estimates is a result both of disagreements over how to conceptualize money laundering and of weaknesses in the techniques used to quantify it. As a consequence, estimated changes in the volume of money laundered cannot be used as a measure to judge the effectiveness of the global anti–money laundering regime.

Moreover, aggregate figures conceal as much as they reveal. The adverse social consequences of a million dollars laundered to finance a terrorist act, on the one hand, and a million-dollar embezzlement, on the other, are so different that adding together the two figures would not produce a useful statistic for policy purposes. What is needed—but not available—is reliable figures for the major types of offenses that generate the total amount.

Money can be laundered in many different ways that can involve a variety of businesses and professions (chapter 3). Major drug traffickers face a unique money-laundering problem—namely, the need to clean large quantities of currency (much of it in small bills) on a frequent basis. Most other criminal offenses generate funds that can be more easily concealed. Surprisingly little evidence exists that much money laundering involves professionals who provide services to multiple clients. Many cases involve laundering by the offenders themselves (in embezzlement cases, for example) or relationships between an offender and someone who carries out a few transactions solely for that person.

The underlying or "predicate" crimes that make it necessary to launder proceeds can be divided into five categories: drug trafficking, other "blue-collar" crimes, white-collar crimes, bribery and corruption, and terrorism. These crimes differ in terms of their reliance on cash, the quantities of money involved, the severity of their negative social impact, and whom they affect. As a result, policy decisions may have different consequences for each category. At least for some activities and offenders—most notably major drug traffickers—good-quality money-laundering services appear to be hard to find. They are certainly expensive, with regular reports of laundering costs as high as 4 to 8 percent of the gross amounts.

As discussed in chapter 4, the AML regime consists of a prevention pillar (customer due diligence, reporting, regulation and supervision, and sanctions) and an enforcement pillar (a list of predicate crimes, investigation, prosecution and punishment, and confiscation). Globally, the prevention pillar has developed more rapidly, while in many nations the enforcement pillar is weak. International financial institutions—primarily the Inter-

national Monetary Fund (IMF) and the World Bank—now play a major role in assessing primarily the implementation of the prevention pillar throughout the world.

Chapter 4 describes in considerable detail the AML regime in the United States and its evolution. It summarizes the prevention pillar's coverage of various financial and nonfinancial entities, and then contrasts prevailing coverage with that of the mid-1980s. An examination of the five national money-laundering strategies presented to the US Congress between 1999 and 2003 reinforces a number of key points about the structure and evolution of the US regime, particularly the two-pillar framework and the elements of each pillar. The chapter also reviews efforts over the past 15 years to establish a global AML regime and compares and contrasts the US AML regime with regimes in other countries. The chapter concludes with consideration of the gross financial cost of the US AML regime to the government, private-sector institutions, and the general public. On the basis of several assumptions and a few rough guesses, the conclusion is that the cost is substantial but not overwhelming—on the order of $7 billion in 2003, or about $25 per capita.

Chapters 5 through 7 assess the effectiveness of the global AML regime and its progress with respect to the three goals of reducing crime, protecting the integrity of the core financial system, and controlling terrorism, corruption, and failed states. Applying a single framework to assess an AML regime with respect to each of these goals is not the best way to carry out such an evaluation; instead, those measures deemed most appropriate to judge the effectiveness with respect to each goal are used on a case-by-case basis. Under current circumstances, only indirect measures of effectiveness can be applied.

Chapter 5 argues that enforcement activities under the US AML regime have not been intense. While the number of suspicious activity reports filed has risen rapidly in recent years, as has the value of assets confiscated, total seizures and forfeitures amount to an extremely small sum (approximately $700 million annually in the United States) when compared with the crude estimates of the total amounts laundered. Moreover, there has not been an increase in the number of federal convictions for money laundering. A very speculative estimate of the risk of conviction faced by money launderers is about 5 percent annually. Data from other industrialized nations indicate even lower levels of enforcement.

It is natural for economists to think of the AML regime as an effort to control an illegal market, in this case the market for money-laundering services. However, using that framework to understand better the functioning and effectiveness of the AML regime results in surprising findings. The available evidence suggests that most money laundering is not carried out as a separate activity by professionals, but rather is often part of the underlying offense or involves ad hoc assistance. This implies that price signals

may be very weak and that market analysis may not provide useful insights. On the other hand, it may well be that the market framework needs to be more thoroughly analyzed, a worthwhile task for future study. Both theoretical and empirical work is needed to determine whether it is in fact useful to think of money-laundering controls in terms of the demand for, and supply of, illegal services with an implicit or explicit price.

For this study, assessing the effectiveness of the AML regime in reducing crime meant relying on indirect indicators such as suspicious activity reports, prosecutions and convictions, forfeitures and seizures, and prices paid for money-laundering services. The indicators provide some support for the proposition that the AML regime has contributed to the overall effectiveness of law enforcement by providing an additional tool.

With respect to protecting the integrity of the core financial system (chapter 6), the AML regime established in major jurisdictions over the past 15 years has changed how banks and other financial institutions do business. Today's AML regime has induced banks to take their obligation to avoid direct contact with criminal money seriously. Banks generally have implemented reporting systems and developed monitoring techniques that make them much less attractive for the placement phase of money laundering. However, while the global system that has emerged presents tangible obstacles to using banks and mainstream financial institutions for the placement of funds, the effectiveness of the AML regime with respect to the layering phase of money laundering is much more difficult to assess.

The AML regime today appears to be reasonably effective in protecting the integrity of the core financial system in major financial centers. However, it was not possible for this study to apply systematically the preferred assessment instrument, which is close examination and cross-classification of money-laundering cases, to determine the size of the financial institutions involved and the nature of their involvement.

With respect to each of the global "public bads"—terrorism, corruption, and failed states—chapter 7 concludes that each is individually complex enough that an AML regime can only contribute modestly to combat it. On terrorism, for example, the standard of zero tolerance, while defensible, is essentially impossible to achieve. By the indicator of amounts frozen or seized, the global AML regime has had limited success in combating terrorism since the end of 2001. Moreover, international cooperation in this area has been uneven.

Conclusions and Recommendations

The anti–money laundering regime and its associated laws and regulations represent a means to multiple ends. Money laundering is not itself the target; the regime primarily aims to reduce the activities that generate the money to be laundered (e.g., drug dealing, corruption, terrorism). Preserving

the integrity of the core financial system is a different type of AML goal, as the aim is not so much to reduce money laundering as to move it to other channels.

A central policy question is whether the anti–money laundering regime needs to expand further, given the regime's rapid growth across countries and financial and nonfinancial businesses and professions in recent years. To date, very modest evidence that a particular channel (for example, real estate brokers or life insurance agents) has been used to launder money has provided a justification for bringing that channel into the net of AML regulation. Little systematic evidence has been advanced that these extensions of the AML regime, with the costs they impose on legitimate businesses and their customers, will do more than marginally inconvenience those who need to launder the proceeds of their crimes.

In the years ahead, it is likely that the pace of expansion of the AML regime will slow and that the focus will shift to improving global implementation of the current regime. As part of this consolidation process, increased cooperation will be important in a number of areas. Cooperation between the public and private sectors is critical, since the current flow of information is primarily from private to public, without significant feedback. Another important area for cooperation involves technical and financial assistance to poorer jurisdictions, in which an effective AML regime is essentially a luxury good.

The international community will also have to continue to grapple with the substantial differences in objectives, regulatory structures, and philosophies that impede effective coordination. Ratification and implementation by the major nations of the new UN Convention Against Corruption will be an important signal of willingness to cooperate on these matters.

For its part, the United States faces numerous challenges going forward, such as satisfying the revised Forty Recommendations issued in 2003 by the Financial Action Task Force, which was established by the G-7 summit in Paris in 1989 to examine measures to combat money laundering. Among the recommendations that have prompted debate in the United States are those to expand coverage of the AML regime to lawyers, accountants, and auditors, and to deal with special purpose vehicles, legal structures that are sometimes used to disguise beneficial owners of assets.

The United States also needs to demonstrate its commitment to a strong global AML regime by voluntarily submitting to a full IMF/World Bank assessment of its financial sector, including regulations affecting money laundering and terrorism financing. For the same reason, the United States should expand the list of crimes committed abroad (including tax evasion) that can lead to money-laundering prosecutions domestically.

Another recommendation is that the US executive branch resume preparing a National Money Laundering Strategy on a regular basis, but in a different manner than the five strategies produced from 1999 to 2003. While the strategy does not need to be redone annually, it should provide

systematic reports on progress in implementing the objectives identified in preceding strategies, along with more analytical assessments of how well the system is working.

The US government should also find ways to encourage better use of the database of suspicious activity reports, which at present appears to be an evidentiary supplement rather than a source of new cases. Banking regulators need to create a database of cases involving financial institutions to examine the extent of the money-laundering threat to the core financial system and to assess progress in containing that threat.

Finally, the global AML regime needs to be strengthened through development of a systematic research program using economic tools, starting with more sophisticated assessment of the costs of the AML regime. Other important research-related activities include creating a database of existing cases that provides a detailed description of the prices, methods, and predicate crimes involved. This would represent a first step toward analyzing the existence and mechanics of the market for money-laundering services. The market-model framework for money laundering needs to be better developed; of particular importance is whether the model can incorporate more opportunistic modes of converting the proceeds of crime into forms that cannot be traced.

Scholars are inclined to emphasize the importance of research, but in the case of money laundering and finding ways to combat it, the need for greater research is particularly acute. The fact is that, to date, an elaborate system of laws and regulations that affects the lives of millions of people and imposes several billion dollars in costs annually on the American public has been based to a substantial degree on untested assumptions that do not look particularly plausible. While the failure to evaluate systematically the AML regime has not as yet impeded its expansion either in the United States or elsewhere, at some stage it should and most likely will. The system needs careful examination before any further expansion is actively contemplated.