

MONEY LAUNDERING AND ILLEGAL TRANSFERS

“Money laundering” is the term used to describe disguising the illicit origin of the criminal proceeds of drug sales, fraud, corruption, and other crimes by bringing them back into the financial circuit of the legal economy. It owes its name to Chicago gangster Al Capone, who used the cash-intense business of laundries to hide his illegal alcohol proceeds during the Prohibition era of the 1920s and early 1930s.

An estimated \$1.5 trillion to \$3 trillion circulates around the world as illegal money transfers. These transfers take place using the banking sector as well as in the form of bogus invoices for exports and imports, unusually priced real estate transactions, or new electronic payment methods, like digital cash or e-gold. Although money laundering took place in ancient Chinese trading, it became criminalized only in the late 1980s. Since the inclusion of terrorism financing in laws to combat money laundering after the September 11 attacks, money laundering has developed into a matter of international safety and security. Fighting it turned from targeting Al Capone to targeting al-Qaeda.

Historical Background

After several decades of an unsuccessful U.S. war on drugs, the administration of Ronald Reagan chose a new method of “combat”: If drug dealers and other criminals could not be pursued directly, then at least they should be discouraged by not being able to reap the monetary benefits of their acts. Thus, in 1986, money laundering became criminalized in the United States with penalties of up to 20 years’ imprisonment and \$500,000 in fines. Further legal arrangements were made that permitted seizing, freezing, and confiscation of assets by the authorities.

Because money laundering is a crime that respects no borders, Washington made strenuous efforts to convince the international community of its impor-

tance. At a global level, policy aimed at addressing money laundering started with the UN Convention on Drugs and Narcotics of 1988. In 1989, the Financial Action Task Force (FATF), an intergovernmental body tasked with combating money laundering, was established by the member countries of the G-7. Since then, international efforts to combat money laundering have proceeded apace. The FATF now comprises 34 member jurisdictions and two regional organizations, representing most major financial centers in the world. The fight against money laundering accelerated after the terrorist attacks of September 11, 2001. Thwarting terrorists by targeting their financing became part of the policies to combat money laundering generally. The FATF publishes no fewer than 40 recommendations to fight money laundering and nine recommendations to combat terrorist financing, with which countries that are suspected of permitting money laundering or failing to combat it adequately have to comply.

Member governments face regular scrutiny and, in the event of noncompliance with the recommendations, are subject to blacklisting for noncooperation. This can be economically harmful, because these countries risk the possibility that important international banks will refuse to do business with them. In this way the FATF sets the international standards. Countries have to convert these standards into national law, adapting their administration and law enforcement to combat laundering and terrorism. Lawyers in ministries, police officers, public prosecutors, and judges are all involved in the fight against money laundering, and special agencies, often known as Financial Intelligence Units (FIUs), must be established to fight laundering in each country. Countries have to introduce plans to implement ongoing customer due diligence (CDD), to identify nondomestic politically exposed persons (PEPs), and ascertain beneficial ownership of offshore accounts. Banks, real

estate agents, notaries public, and traders in expensive goods are all obliged to screen their clients and to identify persons, activities, or transactions suspected of laundering money or financing terrorism. The FIUs collect suspicious transaction reports. Supervisory authorities are involved in controlling the compliance of banks and other sectors with the regulations aimed at combating money laundering. Some countries, like the United States, have high sanctions for not reporting suspect transactions, including a fine of up to \$250,000 or five years' imprisonment.

Launderers and Their Techniques

The definition of money laundering relates to predicate offenses, activities that generate the proceeds that make laundering necessary. Hiding or disguising the source of certain proceeds does not amount to money laundering unless these proceeds were obtained through criminal activity. The United States has developed a list of over 130 predicate crimes for money laundering. Because more and more predicate offenses have been added to the definition over the years (today financing for terrorism and tax crimes are included), the amount of laundering is assumed to have increased.

Because money laundering takes place in secret, estimates of how much is being laundered vary considerably, from several hundred billion dollars to about US\$3 trillion. The first rough estimate of the International Monetary Fund in 1998 said that laundering and illegal transfers totaled 5 percent of world GDP, then about \$1.5 trillion (about \$2 trillion in 2011 dollars). This amount still seems reasonable in light of the findings of the sophisticated economic and econometric models that followed. A much higher estimate was given by analyst Raymond Baker in 2005; he calculated that for every dollar of development aid given to the third world, \$10 flows back into rich countries through capital flight. But his definition includes all sorts of (legal) capital flight in addition to money laundering; nevertheless, his results are discouraging to those trying to fight laundering and illegal transfers.

When it comes to deciding which countries are most attractive for launderers, small countries and offshore islands are often found atop FATF blacklists. Indeed, some small islands openly compete for criminal money and might have more incentives to attract laundered money without having to deal with the underlying predicate crime. However, the world's largest launderer in volume has been and still is the United

States, which accounts for about half of global laundering. This explains the great interest on the part of the United States in a global fight against laundering, say experts. Launderers prefer rich countries, which have well-developed financial markets and large trade volume, enabling them to hide their illegal activities. Small islands, where each inhabitant becomes the legal but non-active head of hundreds of companies, are not a good disguise in the long run.

Launderers have many ways of hiding their illicit proceeds. A launderer first collects the small bills of cash from drug sales on the street and tries to deposit them in a bank (this is the placement phase). A cash courier then deposits the money into another country's bank if the domestic banks are very strictly controlled. After the money is in a bank account, it can be sent around the globe, using fake companies and fake bills and loans to disguise the original transaction (the layering phase). In this way, the criminal money is diluted, like a drop of ink falling into water. After the money is no longer identifiable as deriving from criminal activity, it can be invested in legal businesses (integration phase).

Because policy to combat money laundering originally focused mainly on regulating the banking sector, criminals have discovered new methods of laundering their ill-gotten gains. One technique consists of trade-based money laundering. Individual "A" uses drug money to buy a very expensive watch he exports for, say, US\$100,000 to individual "B" in another country, but lists only \$50 on the invoice. "B" receives the expensive watch, sells it and puts the \$99,050 in a bank account in his home country for the exporter. Scholar John Zdanowicz has calculated that almost \$200 billion flow from and to the United States through unusually high or low product prices.

In addition, Brigitte Unger and Joras Ferwerda have shown that the real estate sector is also used by criminals who launder money by buying houses and other property. Speculation is typical in this market, the economic and legal owners can differ, and real estate properties can be used for engaging in criminal activities or for generating legal rent income.

The development of new payment technologies has given criminals new ways to launder money. For example, they can buy legitimate prepaid automated teller machine (ATM) cards or smartcards, use dirty money to add value to the card, and then withdraw the newly cleaned funds from an ATM anywhere in the world. Mobile phone payments are an espe-

cially popular method for making transactions in the Middle East. In addition, electronic payment transfers such as Eurobonds, eCash or digital cash can conceal the money's origins and keep owners anonymous.

Combating Money Laundering

The hope is that efforts to combat money laundering will make drug dealing a less profitable business and will therefore deter drug dealers or other criminals from engaging in such activities. But not all money launderers are drug dealers. They can rely on a large group of facilitators, such as bank employees, notaries, lawyers, real estate agents, and accountants. For example, a bank employee might overlook a suspicious client; a notary or lawyer might accept cash for signing off on the buying of a business; a real estate agent might overlook a large increase in a house's price because a buyer wants to launder a large amount of money; and an accountant might overlook strange export and import activities at his company. Money laundering is a white-collar crime. In addition, the more people it involves, the larger the share of the community that gets drawn into the underworld.

Unger and others have identified some 25 negative effects that money laundering and illegal money transfers can have on the economy. Laundering infiltrates society and politics with criminals; it can crowd out entire branches of honest business; it can destabilize financial markets; and it can lead to less growth, more corruption, and more crime, among other effects. However, it should not be overlooked that criminally obtained money has all the same positive features of liquidity as legitimately obtained money. The UN has noted that international organized crime injected several hundred billion U.S. dollars into the world economy during the financial crisis. Out of a concern that disrupting any positive flow of liquidity and additional opportunities for profit in the banking sector, even if it derives from criminal sources, some countries hesitate to fully comply with international agreements on deterrence.

The Future

Even after decades of efforts aimed at combating money laundering, no decline has occurred in the revenue of crime and money laundering. In part, this is due to a broadening of the definition of money laundering. But it also shows that criminals have found new ways to launder money. Less controlled

parts of financial markets (such as over-the-counter derivatives trading), electronic money, trade-based money laundering, and the real estate sector have offered new opportunities for launderers. At the same time, policies to combat money laundering has become fiercer, involving more and more sectors. Dealers in large sums of money, like buyers and sellers of diamonds or cars, are under increasing legal obligations in much of the world to report suspicious transactions, as are notaries and lawyers. However, the latter group is especially concerned about maintaining attorney-client privilege, which guarantees confidentiality of such interactions by law.

European countries with legal systems that are less adversarial than that in the United States face the problem of having to transform and adjust their systems more in the direction of control and punishment rather than of educating and finding common solutions with the private sector. At the moment, the inclusion of tax evasion in the definition of money laundering is an issue likely to face some resistance in Europe. It means that money launderers, whether they are drug dealers, tax evaders, or facilitators, will all be treated in the same way as terrorists, namely as threats to national security. Some European critics—particularly in countries where tax evasion is often seen as sport rather than a major crime—fear this will allow government to gain additional power to spy on people's economic activities. But the confiscation of criminally obtained money and its use for social purposes has also met with great success in some European countries, such as Italy, with widespread support among the public.

The speed with which this new policy field has developed around the world in recent years is, say experts, nothing short of astonishing and means that money laundering will remain high on the policy agenda of many governments in the future. It also means that it will be the subject of further academic inquiry, alongside tax evasion, tax compliance, and underground economic activities generally.

Brigitte Unger

See also: Corporate Social Responsibility; Crime, Organized; Government Corruption and Transparency; Regulation, Business and Financial; Terrorism.

Further Reading

Baker, Raymond. *Capitalism's Achilles' Heel—Dirty Money and How to Renew the Free-Market System*. New York: John Wiley & Sons, 2005.

- Cox, Dennis W. *Introduction to Money Laundering Deterrence*. Hoboken, NJ: Wiley, 2010.
- Gnutzmann, Hinerk, Killian J. McCarthy, and Brigitte Unger. "Dancing with the Devil: Country Size and the Incentive to Tolerate Money Laundering." *International Review of Law and Economics* 30 (2010): 244–252.
- Masciandro, Donato, Elod Takats, and Brigitte Unger. *Black Finance: The Economics of Money Laundering*. Cheltenham, UK: Edward Elgar, 2007.
- Naylor, R.T. *Wages of Crime: Black Markets, Illegal Finance, and the Underworld Economy*. Ithaca, NY: Cornell University Press, 2004.
- Rawlings, Gregory, and Brigitte Unger. "Competing for Criminal Money." *Global Business and Economics Review* 10:3 (2008): 331–352.
- Schneider, Friedrich, and Ursula Windischbauer. "Money Laundering: Some Facts." *European Journal of Law and Economics* 26:3 (December 2009): 387–404.
- Truman, Edwin, and Peter Reuter. *Chasing Dirty Money: The Fight Against Money Laundering*. Washington, DC: Institute for International Economics, 2004.
- Unger, Brigitte. "From Al Capone to Al Qaeda: Regulating Money Laundering." In *Handbook of Regulation*, ed. David Levy. Cheltenham, UK: Edward Elgar, 2011.
- . *The Scale and Impact of Money Laundering*. Cheltenham, UK: Edward Elgar, 2007.
- Unger, Brigitte, and Joras Ferwerda. *Money Laundering in the Real Estate Sector*. Cheltenham, UK: Edward Elgar, 2011.
- Zdanowicz, John S. "Trade-Based Money Laundering." *Review of Law and Economics* 15 (December 2009): 855–878.

Web Sites

- Financial Action Task Force: www.fatf-gafi.org
 United Nations Office on Drugs and Crime (UNODC):
www.unodc.org

Documents

Document 1: Money Laundering Control Act (United States), 1986

One of the first statutes of its kind anywhere in the world, the U.S. Money Laundering Control Act of 1986 defined and criminalized a host of activities associated with converting illegitimate financial gains into assets that appeared to be unassociated with criminal activity. Originally aimed at money obtained through drug dealing, the act has since been expanded—most notably, through the 2001 USA PATRIOT Act—to disrupting the financing of terrorists and terrorist organizations.

www.ffiec.gov/bsa_aml_infobase/documents/regulations/ML_Control_1986.pdf

Source: Federal Financial Institutions Examination Council.

Document 2: UN Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (excerpts), 1988

In response to the growing problem of illicit narcotics production, trade, and use, the United Nations convened a meeting in 1988 to draw up a convention setting out the rules for multinational cooperation in combating the drug trade and drug abuse. Building on the pioneering work of the United States, the convention included a number of provisions aimed at dismantling the global financial underpinning—including money laundering and illegal money transfers—of the illegal trade. The following are the relevant excerpts of the 1988 UN convention on the illicit traffic in narcotics.

The Parties to this Convention . . .

Aware that illicit traffic generates large financial profits and wealth enabling transnational criminal organizations to penetrate, contaminate and corrupt the structures of government, legitimate commercial and financial business, and society at all its levels . . .

Article 5 Confiscation

3. In order to carry out the measures referred to in this article, each Party shall empower its courts or other competent authorities to order that bank, financial or commercial records be made available or be seized. A Party shall not decline to act under the provisions of this paragraph on the ground of bank secrecy . . .

Article 7 Mutual Legal Assistance

1. The Parties shall afford one another, pursuant to this article, the widest measure of mutual legal assistance in investigations, prosecutions and judicial proceedings in relation to criminal offences established in accordance with article 3, paragraph 1.

2. Mutual legal assistance to be afforded in accordance with this article may be requested for any of the following purposes: . . .

- f) Providing originals or certified copies of relevant documents and records, including bank, financial, corporate or business records;
- g) Identifying or tracing proceeds, property, instrumentalities or other things for evidentiary purposes.

Source: United Nations Office on Drugs and Crime.