# ‘Measuring compliance’

prepared for the conference ‘Tackling Money Laundering’, 2 and 3 November in Utrecht, by Joras Ferwerda, MSc. and Silvester Bosma, MSc., based on their master thesis: A combined paper on ‘The Economics of Crime and Money Laundering’ and ‘The Effect of Anti-Money Laundering Policy on Economic Growth’

**1. Money Laundering**

“The term ‘money laundering’ is derived from the habit of the gangster Al Capone funneling his ill-gotten gains through launderettes to construct the pretence of a legitimate income.” (van Duyne, 2003, p. 73) Nowadays, governments are still fighting (the consequences of) money laundering. The statement at the October 1996 Annual Meetings in Washington D.C. of the IMF’s Interim Committee—its highest decision-making authority—featured money laundering as one of the most serious issues facing the international financial community (Camdessus, 1998). The Dutch Ministry of Finance as well as the Dutch Second Chamber share this belief. (Ferwerda and Bosma, 2005)

Although the IMF describes money laundering as one of the most serious issues facing the international financial community (Camdessus, 1998), the effect of anti-money laundering policy seems to be uncertain. “As crime has risen to the top of the nation’s domestic policy agenda, so has the need for a body of policy-relevant knowledge about crime, for theoretical ideas and empirical findings that can translated into popular discourse and carved into public laws.” (DiIulio, 1996, p.3)

So it seems fair to conclude that the international society is in need of a theory and an empirical estimation that can give an adequate measure of the effects of anti-money laundering policy.

Unger et al (2006) estimated the amount of money laundering in the Netherlands on 18 to 25 billion euro, which is approximately 5% of its GDP. This report also presents a list of 25 effects of money laundering on society, which are both positive and negative and have an effect in both the short and long term. This list includes effects on crime rates, economic growth, imports, exports, statistics, terrorism, the solvability and liquidity of the financial sector, etc. After identifying all effects and reviewing its literature, they conclude that, “most literature on money laundering effects is pure speculation. […] Furthermore, […] one source refers to the other source, without much of an empirical solid back up.” (Unger et al, 2006)

We therefore tried to produce such an empirical solid back up in our thesis for two of those effects; the changes in crime rates (done by J. Ferwerda) and economic growth (done by Z.S. Bosma). In this thesis we developed a database on the degree of anti-money laundering policy in different countries, which is the central aspect of this article.

## 2. Anti-money laundering policy

"Money laundering is harmful, because it *necessarily* coexists with crime" (Takáts, 2006). Money that is in need of laundering is a result of illegal activities that harm the economy. These externalities are not corrected by the market itself because when illegal funds are presented to an institution the funds will not be rejected. This is because the social costs are external for this institution. It is therefore that fighting money laundering requires government intervention.

In 1989 at the G-7 Summit in Paris the Financial Action Task Force on money laundering (FATF) was established. In response to a mounting concern over money laundering and the threat towards the banking system and financial institutions the FATF had to develop, adopt and implement measures designed to counter money laundering. In 1990 the FATF implemented a series of forty recommendations[1] that governments should apply to ensure that effective anti-money laundering programmes are in place. In 1996 and 2003 these recommendations where revised in order to keep up with developments within the money laundering scene.

However the membership of the FATF was not global and therefore the forty recommendations were not implemented globally until 2001, when it was executed by the IMF and WB. "Winter 2001 constitutes a turning point for the international community in the fight against money laundering […]. It was decided to give primary responsibility for these assessments to the IMF and WB: with their global membership they could assure a more uniform and widespread application of the Recommendations (Recs), unlike the FATF with his voluntary membership." (Arnone and Padoan, 2006)

In order to check compliance with the forty recommendations, countries were assessed by several institutions. IMF, FATF, Worldbank and Moneyval all did assessments of compliance with the forty recommendations of their member countries.

When conducted in the same way with the same rules these assessments are a perfect mean of calculating the effect of anti-money laundering policy. However the assessments we

[1] Although also the combat against terrorist financing is assessed, we will concentrate solely on the combat of money laundering

analyzed were different in quality, shape and size. The length of the reports differed from 14 pages for Germany to 361 pages for France. There were assessments that had an old way of reporting, and there were assessments according to the new style of reports, called the detailed assessments. In the first, there was only text, with some of them specified to specific recommendations or groups of recommendations, while the latter had always a table at the end of the text with per recommendation, a level of compliance and a summary of the remarks given for that recommendation. As Arnone concluded "as a result of the way the assessments were made and even their layout, the assessments differed widely in quality, content, layout, and even across institutions and countries, making it very difficult to make sensible cross-country comparisons and analysis." (Arnone and Padoan, 2006)

Therefore, we will have to make a guideline which could be used to assess all countries in our dataset in the same way, with the same classifications. This dataset then can be used to compare countries and their anti-money laundering policy.

## 3. Creating the database

For this project, we developed an extensive and unique database. To create a comprehensive and consistent database, we started with making a guideline that assisted us when making choices. We created part of this guideline before analysing the countries, while we developed the other part of the guideline during the analysis. During the analysis, some recommendations and impediments showed up more then once, for these recommendations and impediments we created a standardized value or reduction. Because we find it important that the creation of this database is not only useful for our research, but also for others, we chose to publish here our method for creating the database. This gives other researchers the opportunity to check the database, and, moreover, to update and even expand the database. When other researchers would like to also include the recommendations concerning terrorist financing, we advise them to also create this kind of guideline.

### 3.1. The first step: choosing which scale to use

The first step of creating the database was, as mentioned above, creating a general guideline for applying which number to each recommendation. The very first step was the decision on which scale to use. We decided to use a scale of numbers from 0 to 5. This scale has been chosen partly arbitrarily. There were two main reasons for choosing this scale. First of all this is a scale often used in researches and on evaluation forms. The second reason was that the general index we had in mind consisted of six categories. This brings us to the second step; creating a general index.

### 3.2. The second step: creating a general index

The second step of creating our guideline is deciding what each number represents. Because the recommendations differ a lot and because interpretation of the recommended action(s) can be broad, we thought of six broad categories, which can be applied in general. Worth mentioning is that this scale is only the second step, which means that this guideline is overruled by all decisions that were taken later. This means that you cannot apply this index to all recommendations. Also worth mentioning is that some recommendations have a deviant character, which means that these wordings could not be applied literally, then a more rather freely interpretation of the general index is needed. Below, we show our general index used for all recommendations as long as we did not develop an overruling guideline.

General index of the scale:

0 = No policy or action performed
1 = Only some policy or action performed / there has been an attempt or some advice
2 = Still a lot to be done
3 = Some problems or some sectors uncovered
4 = Minor shortcomings / considerations for improvement
5 = Comprehensive implementation

### 3.3. The third step: creating overruling guidelines

Of course, we could not classify all recommended actions or shortcomings within this general index; there will always be cases of doubt. In these cases, we tried to search for the best scale and relinquished decimals (e.g. two and a half). If cases with doubts kept returning for the same recommendation, we created an overruling guideline for that specific recommendation. We also created overruling guidelines when the same recommendation or impediment kept returning, to secure the consistency of our database. This also secures consistency when we or other researchers update or extent the database.

1. Palermo convention not implemented: -1
2. Penalties low: -2, penalties quite low: -1
12. For each uncovered sector: -1

15. Maximum for each part of the recommendation: a) 2, b) 1.5 and c) 1.5
16. For each uncovered sector: -2
18. When shell banks are forbidden, but the relation with it is not: 2 i.e. -3
20. Maximum for the first part: 2 and for the second part: 3
24. Maximum for each part of the recommendation: a) 2, b) 3
32. Request for statistics (sector or process specific): -1
35. Palermo convention not implemented: -2, Vienna convention not implemented: -2, other relevant conventions not implemented: -1
38. No forfeiture fund: -2

Not specific for one recommendation:

Danmark – If Greenland and Faroer do not apply to a recommendation: -1

Newly implemented not yet effective: -2

**3.4. Double check**

Not all the above guidelines are always easy to apply and discussion about the number of points is possible most of the time. We therefore created a safety net, to minimize subjective application of the guidelines. We both read the complete assessment of a country and applied (separately) points to all the recommendations. These points are still visible in the database. Our next step was then discussing each recommendation with each other, even when we both had the same number of points. This was because it could happen that we both subtracted one point, but for different reasons. This means that we both missed something, but both something else, so then the final subtraction of the points should be two. After the discussion we decided the number of points, and why, and wrote down the reason and the location where the applicable remark can be found. Although it might be easy to compare our two assessments by just taking the average, this is not how it went. Therefore, it could happen that one of us gave five points and the other three points, but that we decided after the discussion to apply - in an extreme case - zero points.

**3.5. Conclusion on the database**

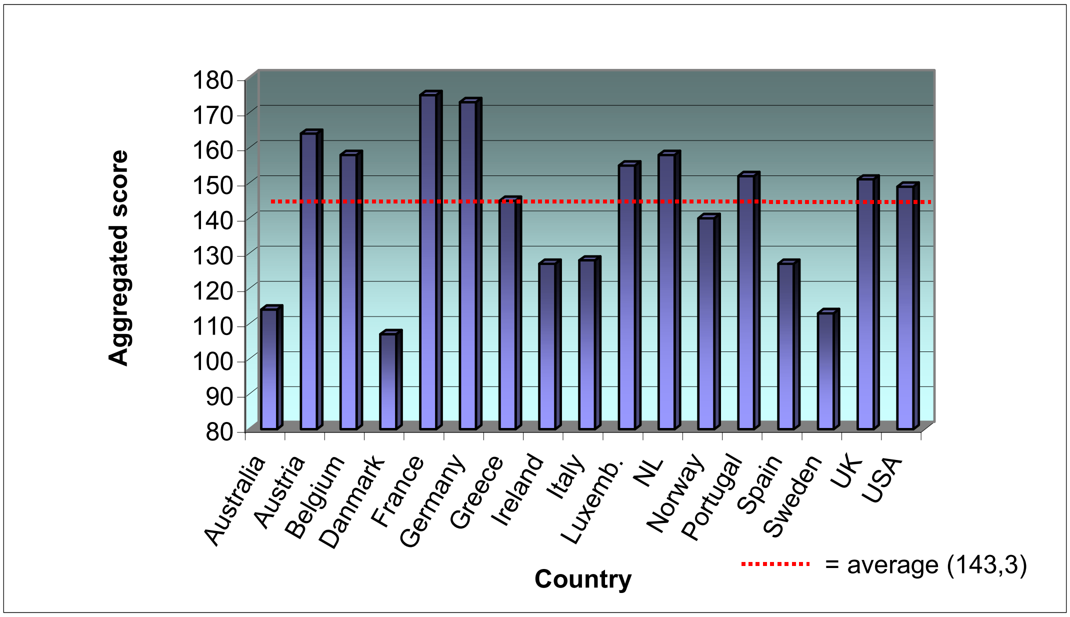
By analysing the assessments of different international organisations on the forty recommendations, we created a database for 17 countries on 40 different aspects, which means the creation of a database with 680 numbers and arguments for these numbers. This was quite some work, but we are convinced that we therewith created a unique and useful database.

## 4. Results of the database

*The results per country*

As can be seen in figure 4.1, Denmark, Sweden and Australia have relatively the lowest score in our analysis with 107, 113 and 114 points respectively compared with an average of 143,3. If we analyze the comments applicable to Denmark, one remark catches the eye; Greenland and the Faroer Islands do not apply to nine recommendations, which gives Denmark a reduction of nine points.[2] But if Denmark applies its laws and regulations to Greenland and the Faroer islands, it has a score of 116, which is still one of the lowest scores in our analysis.

Figure 4.1 The aggregated compliance score for each country[3]




Source: Own database.

It is remarkable that Australia is one of the countries with the lowest scores, while they have the reputation of having a good regulatory system embodied in the institution AUSTRAC. For instance, Cuéllar (2003, p.379) remarks, “the Australian government’s anti-money

[2] As can be read in chapter 3, we decided to give one point of reduction for each time we saw this remark.
[3] The scale of the aggregated score starts at 80 to make the differences between countries better visible.

laundering system […] provides wire transfer and currency reporting information to the Australian government's financial intelligence unit (AUSTRAC), almost in real time. Instead of relying almost entirely on subjective suspicious activity reporting, AUSTRAC uses expert systems and link analysis to analyze all currency transaction reports and international wire transfers." Unger et al. (2006, p.149) states that, "Australia has an efficient network of interagency cooperation between the private and public sectors in combating money laundering that may be of interest to other FIUs." Then why has Australia such a low score in our assessment, while others praise Australia for its efficiency? If we take a look at the scores of Australia for each separate recommendation we see a score of zero points (no policy or action performed) for recommendation 5-9. All these five recommendations are about the same aspect, but in different categories. It is important that financial institutions do not allow anonymous accounts (R.5), also for politically exposed persons (R.6), and pay even more attention to this in relation to cross-border correspondent banking (R.7), new technologies (R.8) and performed by third parties (R.9).[4] So it seems that one aspect is divided over several recommendations, which leads to more extreme differences, it might therefore be useful to divide the recommendations into categories.

If we take a look at the other two countries with a relatively low score, Denmark and Sweden, we see that Denmark has also a low score for these recommendations with only two points for the same five recommendations (5-9), and although Sweden has a better score on these recommendations, it still has two recommendations with zero points and one recommendation with a score of only one point (the other two are a four and a five). So it seems that the countries with a low score especially lose point in this category, which is about Customer Due Diligence (or in more simple words; know your customer).

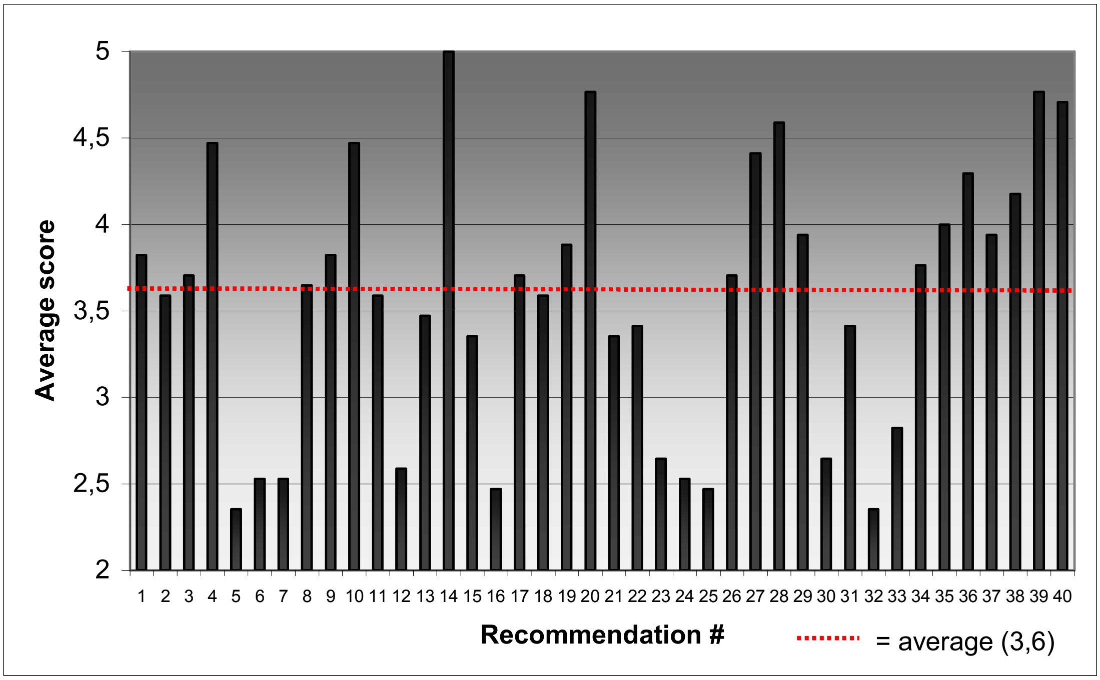
The countries with a relatively high score in our assessment are especially France and Germany with 175 and 173 points respectively, compared with the average of 143,3. A quick glance at their scores shows us that France has no score of zero (no policy or action performed) on any recommendation, while Germany has only one. Remarkably is that the number of recommendations with a score of one (only some policy or action performed) is the same, none for France and one for Germany. This makes us conclude that they both have a rather complete set of laws and regulations on anti-money laundering.

[4] The remarks in this sentence are an extreme simplification of the recommendations, for the complete text of each recommendation, see the forty recommendations.

*The results per recommendation*

Most remarkable in figure 4.2 is obviously the average score of 5 (comprehensive implementation) on recommendation 14. This means that all countries (in our research) have a good set of laws so that financial institutions and their employees are protected while doing their job in good faith, and are prohibited from disclosing the fact that a suspicious transaction is reported. (For the full text of this recommendation, please consult the forty recommendations)

Figure 4.2. The average score of all countries on the 40 different recommendations[5]




Source: Own database.

Also recommendation 20 has a relatively high average score with 4,76. All countries have a comprehensive implementation of this recommendation[6], except for Norway, which has a score of 4 (minor shortcomings / considerations for improvement) and Spain with its score of 2 (still a lot to be done). While for Norway it is recommended to continue their research techniques, there are no steps taken in Spain to encourage the development of modern techniques, which is where this recommendation is about.

[5] The scale of the average score starts at 2 to make differences in the average score better visible.

[6] Recommendation 20: Countries should consider applying the FATF Recommendation to businesses and professions, other than designated non-financial businesses and professions, that pose a money laundering or terrorist financing risk. Countries should further encourage the development of modern and secure techniques of money management that are less vulnerable to money laundering.

The good news is that none of the recommendations has a real low average score. Relatively the lowest average scores are found for recommendation 5 and 32 with both an average of 2,35. A reason for the low scores on these recommendations could be that they are both rather broad. Recommendation 5 is about customer due diligence (which in short is know your customer as a financial institution) and contains a list of aspects that are important where more then ten different aspects could be divided. Also recommendation 32 is rather broad, it says that countries should be able to review their complete system of anti-money laundering with the use of statistics on this aspect. Because the reports gave us the aspects that need consideration or improvement, we developed a method of subtracting points when aspects are criticized. When a recommendation is about many aspects, there is more often a point of criticism to be found compared to tightly formulated recommendations.

## 5. Conclusion

We developed a database by analyzing assessments of several international organizations on the anti-money laundering policies of different countries. These assessments find their origin in the 'forty recommendations', a set of recommendations for countries in the fight against money laundering. From these assessments we used all comments on the forty different recommendations to create a database which consisted of 680 numbers. Each number represented a degree of compliance, according to our own-created guideline, and was funded by an argument derived from the available assessments. We did this for 17 different countries; Austria, Australia, Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, United Kingdom and the United States. These countries were selected because money laundering worldwide is "heavily concentrated in Europe and North America" (Walker, 1999, p.25), and because of consistency reasons with our previous work (Ferwerda and Bosma, 2005).

## 6. Literature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- Takáts, E. (2006) *A Theory of "Crying Wolf": The Economics of Money Laundering Enforcement*, Paper presented at a workshop organized by Donato Masciandaro at Bocconi University, Milano, March 2006
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- Walker, J. (1999) How Big is Global Money Laundering?, *Journal of Money Laundering Control*, Vol. 3 No. 1


## 7. Appendix

Example/part of the database:

| Cou | R | J | S | D | **F** | Final score is based on |
|---|---|---|---|---|---|---|
| AUS | 1 | 4 | 5 | 1 | **4** | (8) Criminalised at state and territory level and these offences vary in comprehensiveness |
| AUT | 1 | 4 | 3 | 1 | **3** | (120) Palermo not implemented and ratified (Table 10 - sentence 3) Raise penalty level for simple ML offences |
| BEL | 1 | 5 | 5 | 0 | **5** | (7) OK |
| DAN | 1 | 4 | 4 | 0 | **4** | (Table) Greenland and Faroer not fully consistent, range of predicate offenc… |
| FRA | 1 | 5 | 5 | 0 | **5** | (149) Palermo + Vienna implemented, Criminalization extensive |
| GER | 1 | 5 | 4 | 1 | **5** | (6) Criminalized on basis of Palermo and Vienna |
| GRE | 1 | 3 | 2 | 1 | **2** | (140) Expand ML to all serious offences and dual criminality |
| IRE | 1 | 5 | 5 | 0 | **5** | (7) Broad ML offence |

| | | | | | | |
|---|---|---|---|---|---|---|
| ITA | 1 | 5 | 4 | 1 | **5** | (In text and table no indications for deduction of points have been found) |
| LUX | 1 | 2 | 2 | 0 | **2** | (7, table 2, 22) Palermo not ratified, scope too limited |
| NL | 1 | 4 | 4 | 0 | **4** | (113) Palermo not implemented |

*Cou = ISO-coded country name, R.= Recommendation number, J = First score applied by Joras Ferwerda, MSc. S = First score applied by Silvester Bosma, MSc. F = Final score, after discussion. (between brackets are the paragraph numbers or table numbers where the argument is found)*