

Tjalling C. Koopmans Research Institute

Tjalling C. Koopmans



Universiteit Utrecht

**Utrecht School
of Economics**

**Tjalling C. Koopmans Research Institute
Utrecht School of Economics
Utrecht University**

Janskerkhof 12
3512 BL Utrecht
The Netherlands
telephone +31 30 253 9800
fax +31 30 253 7373
website www.koopmansinstitute.uu.nl

The Tjalling C. Koopmans Institute is the research institute and research school of Utrecht School of Economics. It was founded in 2003, and named after Professor Tjalling C. Koopmans, Dutch-born Nobel Prize laureate in economics of 1975.

In the discussion papers series the Koopmans Institute publishes results of ongoing research for early dissemination of research results, and to enhance discussion with colleagues.

Please send any comments and suggestions on the Koopmans institute, or this series to J.M.vanDort@uu.nl

ontwerp voorblad: WRIK Utrecht

How to reach the authors

Please direct all correspondence to the first author.

Brigitte Unger
Utrecht University
Utrecht School of Economics
Janskerkhof 12
3512 BL Utrecht
The Netherlands.
E-mail: b.unger@uu.nl

Frans van Waarden
Utrecht University
University College
Campusplein 1
3584 ED Utrecht
the Netherlands
E-mail: f.vanwaarden@uu.nl

This paper can be downloaded at: <http://www.uu.nl/rebo/economie/discussionpapers>

Attempts to Dodge Drowning in Data. Rule- and Risk-Based Anti Money Laundering Policies Compared

Brigitte Unger^a
Frans van Waarden^b

^aUtrecht School of Economics
Utrecht University

^bUniversity College
Utrecht University

August 2009

Abstract

Both in the US and in Europe anti money laundering policy switched from a rule- to a risk-based reporting system in order to avoid over-reporting by the private sector. However, reporting increased in most countries, while the quality of information decreased. Governments drowned in data because private agents feared sanctions for not reporting. This ‘‘crying wolf’ problem’ (Takats 2007) did not happen in the Netherlands, where the number of reports diminished but information quality improved. Reasons for this can be found in differences in legal institutions and legal culture, notably the contrast between US adversarial legalism and Dutch cooperative informalism. The established legal systems also provide for resistance to change. Thus lowering sanctions in order to reduce over-reporting may not be a realistic option in a legal system which traditionally uses deterrence by fierce criminal and private legal sanctions. Furthermore, a risk-based approach may not be sustainable in the long run, as litigation may eventually replace a risk-based approach again by a rule-based one, now with precise rules set by the courts.

Keywords: money laundering, anti money laundering policy, risk based regulation, rules, standards, comparison of legal systems, tort law

JEL classification: K00, K13, K14, K20, K41, H41, L51

1. Introduction

Awareness has grown that money laundering is harmful. It makes crime pay, changes the cost-benefit calculation of criminals (Becker 1968) and enhances their incentives to engage in criminal activities. Also in other respects can money laundering have negative effects on society, economy and politics. Honest business may get crowded out. Financial markets may lose integrity and that could have serious impact on large financial centers and their reputation. Corruption may increase in some sectors and eventually in the whole economy. The underworld could get intertwined with the upperworld. Launderers and other criminals could undermine politics which poses a threat to democracy. Terrorist financing is nowadays also considered part of money laundering and poses additional threats to society.

Governments have, therefore, found it necessary to combat money laundering. In order to do so, money laundering risks, potential money launderers and laundering transactions have to be identified. For this, governments are dependent on information of the private sector. Financial institutions and transaction partners or intermediaries involved in businesses prone to money laundering, like second hand car dealers, real estate agents, casinos or lawyers, encounter (potential) money laundering transactions in their daily business. They may or could see dubious transactions which they may suspect of money laundering. Governments need hints as to which transactions from which persons or companies seem dubious. Private businesses must be willing to give such information and if necessary actively search for it. They must filter their transactions for possible cases of money laundering. Private businesses are not likely to submit such information voluntarily, as it could threaten their reputation and relations with their clients. They would have to be forced to do so. The government has the authority to do so, but it has to follow the rule of law, that is, enact formal legislation. In the interest of legal security it has to make explicit what information the private sector has to provide, what negative or positive incentives back up this obligation, and under which conditions the sticks and/or carrots will be applied.

In the following several regulatory approaches to money laundering reporting will be discussed and evaluated, notably rule-based and risk-based regulation. The rule-based approach implied that governments enacted regulations imposing rather precise norms on private business to adhere to, in this case precise norms as to what transactions to report to public authorities. By contrast, the risk-based approach gave private actors more discretion what to report. The regulations instructed private business to report transactions that *they* considered suspicious of possible money laundering, i.e. it gave them vaguer criteria as to what transactions to report. The risk-based approach did not only mean that private actors had to estimate the risks of a transaction being suspect of money laundering; it also meant that they themselves ran the risks of getting accused of false reporting or more in general of being held responsible for whether they did a good job or not. In section 2 we will elaborate the differences between rule- and risk-based regulation and discuss some of the advantages and disadvantages of them. A rule-based approach provides precise rules and hence legal certainty, but it also encourages formalistic over-reporting. This is why many countries switched to a risk-based approach, in the hope of reducing over-reporting. Yet it often had the opposite effect, and encouraged even more relatively useless-over-reporting, also called the 'crying wolf problem' (Takats 2007, Dalla Pellegrina and Masciandaro 2009). In section 3 we will then compare the reporting systems of two countries, the United States and the Netherlands. Both countries moved from rule- to risk-based regulation. Yet, the consequences were rather different, almost the opposite, as we will show in section 4. Under the new risk-based approach the amount of reporting in the US increased (and as Dalla Pellegrina and Masciandaro 2009 show, also in many other countries), whereas it decreased in the

Netherlands. However, the quality of information provided by the private sector to the government in the US declined, whereas there is no indication that it worsened in the Netherlands. On the contrary, it seemed to have improved, judging by the relative number of convictions for money laundering which were in recent years much higher in the Netherlands than in the US. In section 5 we try to find an explanation for this puzzle: More or less similar regulatory measures have different policy outcomes as they are conditioned by intermediary variables, notably the differences in legal systems, that is, in legal institutions and legal cultures. Section 6 then draws conclusions and discusses some alternative regulatory measures and the future fate of risk-based regulation.

2. On Rule- and Risk-Based Regulation

2.1. The Long-Term Historical Trend: From Broad and Vague Standards to Detailed and Precise Rules

Governments can be more or less precise in the legal obligations which they impose upon citizens and business. In the law and economics literature, it is customary to call precise norms *rules* and less precise ones *standards* (Ehrlich and Posner 1974, Diver 1983, Kaplow 1992, Schäfer 2002).¹ Rules are clear and straightforward and draw precise boundaries between legal and illegal behavior. Standards, however, ‘are general legal criteria which are unclear and fuzzy and require complicated judiciary decision making’ (Schäfer 2002: 1) Typical standards are found in English common law, such as the standard of ‘due diligence’² or of ‘reasonable care’ in tort law, of ‘duty of care’ and of ‘fiduciary duty’ (Johnson et al 2000), or the prohibition of behavior such as negligence, invasion of privacy, nuisance, fraud, deception, murder, restraint of trade, etc. Such broad terms require specification and that is done when courts apply them (or not) in concrete cases. Over the course of time such broad and vague standards have acquired rather precise meanings through judicial decisions.

The legislator can enact laws with either precise, detailed norms or with broader and vaguer standards. In the case of the latter, those implementing and enforcing the law, public administrators, inspectors, judges but also private actors, have a greater discretionary authority. That affects the costs involved. The formulation of a broad standard is easily done and hence cheap. It is usually also easier to get a parliamentary majority if not consensus over norms such as the right to freedom and privacy or a ban on discrimination and slander. Disagreement comes over the detail, over the operationalization, and over how to balance it against other standards, e.g. slander versus free speech. Therefore, broad standards entail significant costs in implementation and enforcement. Posner (1998) identified the following costs: of the specification of the norm, of the process of adjudication, and of the legal uncertainty due to the large discretionary authority of the bureaucrats and judges, which could force subjects to take possibly unnecessary preventive measures.

¹ It must be said that the term standards is also often used for the opposite, for detailed and precise norms, notably outside of the law and economics world, e.g. among socio-legal scholars and in general discourse on technical standards (a.o. Voelzkow 1996). Technical standards are highly specific norms that allow for ‘standardization’. There, broad general norms are often referred to as ‘principles’ or ‘doctrines’.

² Made more concrete in the ‘customer due diligence’ standard in anti-money-laundering regulations.

Historically, there has been a trend to reduce the legal uncertainty stemming from the discretion of judges. In English common law this was based on the principle of the force of precedent of earlier judicial decisions. In order to inform judges about those earlier decisions treatises containing collections of common law decisions were compiled, and they were somewhat generalized in the famous ‘Commentaries on the Laws of England’ by William Blackstone in the later 18th century, which was easier to carry around. In civil law countries the codification movement of the 18th and 19th centuries deduced more general but still concrete rules out of customary law in those countries, and using Roman law as a basis. These general rules were collected in codices such as the Code Napoleon or the Allgemeines Landrecht of Prussia, both from around 1800 (Koselleck 1967), which were quite detailed. Schäfer (2002: 5) mentions that the Prussian code ‘had more than 19.000 articles, four times more than the modern civil code and the criminal code of Germany taken together’. These law books gave precise guidance to citizens, administrators, and judges, as they defined in detail what was lawful and what unlawful. Their freedom was limited, but so was their freedom from arbitrariness. This legality and consistency increased certainty and predictability, thus also facilitating economic transactions by reducing their risks and uncertainties. It became easier to conclude economically efficient contracts, as costs could be calculated easier ahead of time.

Given this tradition of increasing precision in regulation it was not surprising that the first Anti-Money Laundering laws in most countries, including the Netherlands and the US, were so-called *rule-based*. They contained clear formal criteria given by the state to business. Whether a transaction could be called unusual or suspicious, was decided by the regulator. He set the criteria for identification of a potential money laundering case. For example every transaction above a certain threshold amount was considered suspect or unusual and had to be reported. Governments wanted to minimize the discretion of the private actors whose information it wanted. On the one hand to be sure that any possible money laundering transaction would be reported, on the other hand to keep the risk and uncertainty for business low.

The rules were clear and transparent, thus provided legal certainty and legal equality, as all subjects of the regulation were confronted with the same precise norms. But this approach had also disadvantages. Criminals could manipulate their transactions so that they would be just below the threshold. The formal rule could lead to over-reporting and high reporting costs for the private sector. It was rigid, formalistic, bureaucratic, and entailed high administrative burdens and hence was considered ineffective and inefficient.

2.2. Now back again from Precise to Vaguer Norms with the Move from Rule- to Risk-Based Regulation

Frustration over this formalism and rigidity led countries to replace rule-based AML-regulation in the early 2000s (and in the US already in 1996) by what is called *risk-based* regulation, leaving more discretion to the subjects of regulation with reporting duties. This change happened at a time when everywhere governments introduced supposedly less bureaucratic, more subject-friendly, more responsive regulations (Ayres and Braithwaite 1992, Hutter 2005, 2006). In the new AML-regulation, business got some freedom to judge whether a case was ‘risky’, whether it could be a money laundering case, and whether it should be reported. This change marked a turn-around from the long-term historical trend from vague to more precise regulations, namely a move back again from precise to vaguer norms.

It has become popular as it promises to have many attractions over rule-based regulation. It offers the prospect of less obedience merely for the sake of obedience, less formalism, less administrative burdens both for the subjects of regulation and its enforcers, in short, less ('unnecessary') bureaucracy. That is, it would also be cheaper. It aims to do so by simplifying and focusing, on critical points, on those parts in a system or process - such as the enforcement of regulations - where things could go wrong, where the risks are greatest. This requires first an identification of possible risks and subsequently an estimation and assessment of both the probability and the seriousness or impact of these risks. As is done also in Risk-Based Auditing or in HACCP (Hazard Analysis and Critical Control Point) methodology. Assessing risks seems best done by those best placed to do so, the experts. These can include the ones concerned, the 'locals' of regulation: in the first place the regulators, supervisors, inspectors, enforcers, but often also the subjects of the regulation.

Hence risk-based regulation requires that one leaves some room for maneuver, for appraisal, for sound judgment to those closely involved. And those subsequently use the experiences and knowledge they have gained in the process of regulatory enforcement to improve and focus the regulations further. This is another attraction of the risk-based approach. It befits democracy, where citizens are both the authors of regulations and their subjects. Risk-based regulation offers to respect these subjects, to make use of their experience and knowledge, to take their judgments seriously, as useful contributions to rule development and application. Citizens and companies, subjects of the law, are treated as resourceful actors, rather than ignorant children who have to be taught a lesson. As a consequence, it is hoped that rule observation could be realized by intrinsic rule internalization, rather than by extrinsic threats with carrots and/or sticks. Thus it promises to enhance not only the effectiveness and efficiency of regulations, but also their legitimacy. Who would not like freedom, less bureaucracy, more legitimacy and still social order?

Risk estimation can be done both by the subjects and the enforcers. They are different in kind however and differ from the rule based approach where the regulator assesses the risk. Let us clarify this with the example of a simple traffic rule: pedestrians have to stop for a red pedestrian traffic light. Rule-based regulation would mean: any cross-over while the light is red is a transgression of the rule and ought to be punished. The assumption is that the regulatory authority knows what is good for its citizens, when it is safe to cross. And he does, because he steers also other traffic lights that tell others at the crossing to stop when yet others can go. The command 'do not cross, otherwise you risk your life' is also told others, though at different times. If everyone concerned around a crossing obeys the commands of the lights, traffic can flow safely.

Risk-based regulation could first of all mean that we give the pedestrian the discretion to decide whether crossing is risky or safe enough to do. Such discretion can be based on the assumption that he or she is capable enough to estimate the risk of crossing-over; and on the assumption that he or she has an interest not to get hit. Punishment for crossing-over would then only be justifiable in case the pedestrian is an obvious reckless jaywalker, e.g. because intoxication has reduced his capacity for sound judgment. A red pedestrian traffic light under risk-based regulation would no longer be a prohibition to cross, but a warning to be careful, just as the zebra crossing stripes are. Which is what is usually the case in actual practice.

Risk estimation can also be done by the enforcers. For them, it is impossible to enforce the rule perfectly, that is, to punish any disregard of a red pedestrian traffic light - short of installing cameras at every light (and fitting citizens with a 'license plate' on their back, or another more modern electronic identifier). The police cannot be present at every traffic light. It

has limited resources, and on top of that: enforcing pedestrian traffic lights has low priority. The enforcer has to make choices: whether, where, and when to control. If they do check, they have several options. First, spot checks, based on random selections of lights and times. Second, incidental or accidental enforcement, whenever police(wo)men see someone transgressing the rule while they are on the beat or just happen to pass by. Third, they can base enforcement on risk estimations and concentrate controls on known risky places and times: near blind curves; close to a senior citizens home whose inhabitants cross slowly; when children leave school; when the pubs close.

After all, the concept of risk-based regulation is derived from older 'risk-based auditing'. Auditors can not control all processes and all data when auditing a large corporation. Hence so-called system- or process-based auditing has gradually been replaced by risk-based auditing. Auditors focus on known risky or critical phases or elements rather than that they try to follow all the complete administrative processes. They focus on the points where experience has shown that 'things could go wrong', where chances are for mistakes, malpractices, or outright fraud to happen. The importance of such points is based on an estimation of both a) the probability that something fishy could occur, and b) the impact or the seriousness of its consequences. The aim of internal auditing controls is to manage risks to acceptable levels in the organization (Griffiths 2007).

Critical point concentration of inspections and enforcement requires that enforcers assess in turn the risk assessment of citizens, i.e. such risk-based regulation is based on double risk assessment. Enforcers have to estimate whether and when infants, teenagers, or elderly can or care to oversee and evaluate the risks they run in crossing. Sound enforcement may also imply adjusting the disciplinary reaction to the conditions of transgression and categories of transgressors. It may not make much sense to fine infants. Better is to give traffic lessons in school or to appoint volunteer 'lolly-pop (wo)men' (crossing guards), and equip them with a uniform and a fried-egg-shield, which should give them some authority, both over the children and the car drivers. That is, educate children to make sound judgments and protect them as long as it is necessary.

Such double risk assessment is what is done with risk-based AML-regulation. First, banks assess the risk or possibility that a transaction could be suspicious. Subsequently the risk that their estimation may be right or wrong is in turn assessed by state inspectors. In this way the knowledge, expertise and sound judgment of the lower-level employees at street- and shop floor level can be used. They may know the 'real world' of transactions, the tricks money launderers use. And in their daily work they are likely to have developed an intuitive feeling allowing them to identify possible money laundering cases. After all, commercial businesses are used to risk assessment and risk management, and have developed methods to guide them more systematically in that. By leaving them the freedom to develop their own explicit or implicit criteria for money laundering cases, the rules might be more effective. They might more easily separate the sheep from the goats. Such more focused information would be more useful. Furthermore, such a less rigidly bureaucratic procedure would produce less false alarms, it was expected. Thus the private sector could save on reporting costs, and the administration on having to deal with redundant information from over-reporting.

2.3. The Risks of Risk-Based Regulation

Risk-based regulation is not without risks, for the regulator, as well as for the regulatees. Leaving the subjects some discretion to decide what to report entails the risk for the government that detection, assessment, and reporting is done sloppily and/or that it is done arbitrarily. There may be under-reporting or over-reporting, the government may get not enough, not the right or too much information. As different businesses with a reporting duty may take this task more or less seriously reporting might be erratic, and lack homogeneity and standardization.

The reporting businesses also run risks. They risk identifying a legal transaction as a potential illegal one, and could get sued under private law by the accused. In order to reduce this risk, US federal law has tried to shield banks from such lawsuits from clients for reporting them. But banks of course they still run the risk of losing customers. On the other side banks run the risk to get fined for under-reporting. The uncertainty over whether or not one should report a certain case means also legal uncertainty; and as different banks are likely to take different reporting decisions or follow different strategies, this ambiguity could get further enhanced.

The risk to be held liable may induce businesses with a reporting duty to play it safe, by reporting as many cases as possible. Takats (2007) has called this the ‘*crying wolf*’ problem. His model explores the principal-agent problem between government law enforcement agencies and banks. The government uses auditors and banks to obtain information about their clients. None of them like to give this information, which creates the agency problem. But most auditing models focus on the disclosure of verifiable information, while in this case of money laundering the information is unverifiable.

In this setup harmful excessive reporting might be the result. ‘Intuitively, if the bank identifies all transactions as suspicious, then it fails to identify any one of them - exactly as if it would not have identified a single one. Thus, ‘crying wolf’ can fully eliminate the information value of reports. ‘crying wolf’ can arise because excessively high fines for false negatives force the uncertain bank to err on the safe side and report also transactions, which are less suspicious. In the extreme case the bank is forced to report all transactions, thereby fully diluting the information value of reports’ (Takats 2007: 5).

Over-reporting has the added advantage that the bank can protect its customers by diluting their information in the mass and drowning the government in information. It might even be done intentionally. Banks have at least an incentive to do so. The government expects banks to reveal and accuse its own customers, but they are the ones who bring in money and profits. Reporting units, so Takats, might behave strategically and on purpose dilute information by over-reporting, by behaving like the little boy in the fairy tale and ‘crying wolf’ so often, that when the wolf actually appears (when there is really a money laundering case) no one will take the cry serious.

The seriousness of this risk for the bank depends of course on the administrative costs of over-reporting, the chance to get caught with intentional dilution, and the sanctions which that carries with it, monetary or otherwise, e.g. reputation.

How these risks have affected the actual reporting behavior in the two countries that we focus on in this paper, the US and the Netherlands will be discussed below in section 4. However, first we will compare in section 3 their AML-regulations and reporting duties. We have selected these two countries, because though they face a similar regulatory change from a rule based to a risk based reporting system, they are almost each other’s opposite on some dimensions of the legal system (see section 5) and, as we claim, as a consequence, in their performance.

3. Comparing the American and Dutch AML-Reporting Systems

3.1. Differences in Regulation

According to Walker (1999) and Unger (2007) the US is the largest money launderer in the world. Half of the globally laundered funds are probably transferred through American banks, according to estimates of some lawmakers (FBI, 2001). Hence it is not surprising that the US has been among the first countries to enact regulatory measures to counter the threat, and it has also developed one of the strictest anti-money laundering regulations.

The Banking Secrecy Act (1970) curbed banking secrecy to fight money laundering. It was followed by a series of laws, each of them further strengthening money laundering enforcement: The Money Laundering Control Act (1986), the Annunzio-Wylie Money Laundering Act (1992), the Money Laundering Suppression Act (1994), The Money Laundering and Financial Crimes Strategy Act (1998) and finally the USA Patriot Act (2001) (Takats 2007, fn.1).

The first specific AML-act was the one of 1986 (Title 18, US Code Sec. 1956), which had already also an extraterritorial reach. If the offence is committed by a US citizen or by a non-US citizen who conducts at least part of the offence in the United States, and if the transaction involves more than \$10,000, such a person can be prosecuted. In addition to its heavy criminal penalties of up to 20 years in prison and \$500,000 in fines, the law permits civil penalty lawsuits by the government for the value of the funds or property involved in the transaction (<http://www.altassets.net/casefor/countries/2002/nz2627.php>). After 9/11, terrorist financing has been included as a predicate crime in the money laundering definition in the Patriot Act. With this, preventing money laundering became a matter of national security.

Originally, the regulations were rule-based. Money laundering enforcement relied on the private sector reporting to public law enforcement agencies. Money transfer offices and banks had to provide two kinds of reports: rule-based and discretionary reports. Thus banks file a rule-based Currency Transaction Report (CTR) for cash transactions exceeding \$10,000. Rule-based was less risky both for the private sector and the government. As there were explicit criteria for reporting, it was a standard disclosure problem. Bank reports were ex-post verifiable.

The precision of rule-based regulation had however also disadvantages. Not only banks but also money launderers were aware of the criteria for suspected money laundering and could circumvent them. Thus they could 'smurf', i.e. break down large cash deposits of over the reporting threshold of \$10,000 into smaller ones just below it (Takats 2007, p. 8).

The weaknesses of rule-based reports led the US in 1996 to introduce a discretionary report, the Suspicious Activity Report (SAR). This report is filed for any activity that the bank considers 'suspicious'. If a bank spots several transactions just below \$10,000 it could identify them as suspicious because they hint at smurfing. The definition of suspicious was left vague on purpose, in order to keep both money launderers and banks in uncertainty. This made it difficult for money launderers to circumvent the rules. And it forced banks to keep on the alert and continually updating their understanding of how money laundering could be and was done. 'This intentional vagueness can be understood as another form of constructive ambiguity' (Takats 2007: 8). CTRs still co-exist next to SARs. There were more than 37 million CTRs filed between 2004 and 2006 (<http://www.gao.gov/new.items/d08355.pdf>). But according to experts SARs are much more important for enforcement (Reuter and Truman 2004, Ch. 5).

By changing from a rule- to a risk-based approach the government tried to reduce the administrative burdens on business and introduced both a more pragmatic and more effective

policy on business. However, by giving business strong incentives to take this task seriously – i.e. by sanctioning neglect with serious fines – the unintended outcome was less effectiveness and efficiency. As Takats (2007) argued, this policy forms an incentive for business to over-report suspicious financial transactions, drowning government agencies in data and thus not really identifying potential money laundering transactions.

The Netherlands took a different approach. As a member of the European Union, the Dutch anti-money laundering policy is first and foremost shaped by the EU, which in turn is strongly influenced by the policies of the Financial Action Task Force on Money Laundering (FATF), an intergovernmental body established by the G-7 (meanwhile G-8) in 1989. The FATF has developed forty recommendations (plus nine on terrorism financing), which the EU has translated into several directives, which have to be transposed into national law by the member states.

The first EU directive ‘for the prevention of the use of the financial system for the purpose of money laundering’ (91/308/EEG) included an identification and a reporting duty of suspicious financial transactions for financial institutions. The Netherlands transposed this first Directive of 1991 with the Act on the Identification for Financial Services (*Wet identificatie bij financiële dienstverlening - Wif*) and the Act of Reporting Unusual Transactions (*Wet melding ongebruikelijke transacties - Wet Mot*).

The second EU Directive (2001/97/EG) on money laundering extended the reporting obligation beyond financial services to other economic sectors. Since 2001 car dealers, sellers of ships, art and antiques, and of gold, silver and jewellery and since June 2003 also lawyers, notaries public, tax consultants, accountants and real estate agents are under reporting duty in the Netherlands. In 2001 money laundering was also included as an offence in the Dutch Penal Code (Nederlands Wetboek van Strafrecht, artikel 420bis, 420quater and 420ter 18th of October 2004). According to this law, all serious offences are predicate crimes for money laundering. In the Netherlands laundering includes (as in the US) self-laundering (if a criminal launders his proceeds himself)³ and can be punished by up to 4 years in prison (note the difference in severity with the US) in addition to the punishment for the underlying crime.

The third and most recent EU Directive on money laundering (2005/60/EG) replaced the first one and broadened the definition of money laundering by including terrorist financing. It was transposed into Dutch law with the 2008 Act on the Prevention of Money Laundering and Terrorism Financing. In order to use information more efficiently, a single reporting institution, the Financial Intelligence Unit FIU Nederland, was established and became part of the national police KLPD (Korps landelijke politiediensten) in 2006.

3.2. Differences in Reporting Duties

What?

In the US any transaction suspected of a criminal content has to be reported in a Suspicious Activity Report. ‘If the financial institution knows, suspects, or has reason to suspect ...any known or suspected Federal criminal violation, or pattern of criminal violations...’ has to be reported (http://www.fincen.gov/forms/files/f9022-47_sar-di.pdf). SAR reporting duties clearly refer to *suspicious* transactions only. However, SAR is not only aimed at money laundering, but

³ For the problems that occur within the EU due to different money laundering definitions, e.g. some countries excluding self laundering, see Unger (2007).

has a much broader field of application, as it regards any crime, including financial crimes such as insider abuse, computer abuse, and all sorts of criminal violations against financial institutions themselves.

In addition all US businesses have to fill out a Currency Transaction Report (CTR) for any cash transaction exceeding 10,000 US dollars, no matter whether they consider them suspicious or not. These CTR-obligations are strictly rule-based.

The Dutch government requires the reporting of *unusual* rather than *suspicious* transactions. Under the rule-based approach 'unusual' was just a different label for 'suspicious', since strict and precise rules determined what had to be reported. The difference might have become more important under the risk-based approach, since 'unusual' is a much broader category than 'suspicious'. Grandma buying a car for 20,000 Euro for her grandson with cash saved under her pillow is an 'unusual' transaction, however not 'suspicious' for money laundering. However, the more the risk-based approach was implemented in the Netherlands, the more the reporting duties for 'unusual transactions' became alike the US reporting duties for 'suspicious transactions', so that the difference nowadays is rather one of labeling than of deeper meaning.

In 2005, already in anticipation of the Third EU AML-Directive and a risk-based approach, the Netherlands developed an indicator list defining unusual transactions. This list consists of three objective indicators and a subjective one. The first one refers to transactions with specifically blacklisted *countries* (a blacklist which is currently empty though). The second objective indicator refers to *crimes* related to money laundering which have to be reported to the police anyway. The third one concerns the *type* of the transaction and the *amount* which has to be exceeded and differs by economic sector which has a reporting duty. Fourthly, the list has a subjective criterion, namely 'a transaction where there is reason to assume that it is related to money laundering or terrorist financing.' (Annual Report of the FIU Nederland 2006: 75). Transactions are unusual if one or more of these four criteria is satisfied. The last indicator requires to identify transactions 'where there is reason to assume a relation to money laundering', which comes close to what the US labels suspicious transactions. As the Dutch reporting behavior analysis shows (see below), the subjective factor plays an increasing role in reporting (FIU Nederland 2008) especially for the transactions reported by financial institutions. What the Dutch kept calling unusual transactions became in actual fact suspicious transactions reporting. Thus the Dutch and the US reporting of transaction requirements are very similar under the risk-based approach.

How much?

In the Netherlands all transactions which are believed to be unusual *and* related to money laundering have to be reported to the FIU, regardless of the amount involved. Transactions exceeding a certain threshold, (in combination with changing the currency or other criteria), always have to be reported. In the US with regard to money laundering only suspicious transactions exceeding 5000 US dollars have to be reported in the SAR, and transactions exceeding 10,000 US dollars must be filed in both reports. The main difference between the two countries is that transactions below a threshold of 5000 US dollars are not covered under the American reporting duties, while they are under the Dutch. The threshold for mandatory reporting is in the Netherlands much higher than in the US (15,000 Euro for financial institutions, 25,000 Euro for dealers in big values) compared to 10,000 US dollars in the United States (FIU Nederland 2008).

Who?

The Dutch duty to report unusual transactions applies to more reporting units than in the US to the SAR. The US SAR has to be filled out by financial institutions, casinos, money services businesses, and by securities and futures industries, whereas the Dutch reporting obligation also applies to car and diamond dealers, real estate agents, notary publics, and accountants. However, the Dutch reporting system restricts itself to one reporting list only, whereas US firms may have to file both a SAR and a CTR for the same case.

Recipient of the SARs in the US is the Financial Crime Enforcement Network (FinCEN), which might forward them to law enforcement agencies for further investigation. In the Netherlands, unusual transactions are reported to the Financial Intelligence Unit (FIU) Nederland. This organization analyzes and classifies the filed reports as to whether they are suspicious or not. Thus in the Netherlands a government agency does the screening whether an unusual transaction is also a suspicious one, while in the US private business is supposed to have done that already. Thus the Dutch government is in principle less dependent on the private reporting agents and could by doing the filtering itself, improve the quality of the information.

Figure 1 gives an overview over the change from the rule-based to the risk-based approach in both countries. In both countries the regulator intended to switch to the risk-based approach in order to reduce over-reporting, to improve the quality of information and to establish a more effective and efficient reporting system.

Figure 1. Different AML-regulatory approaches and their use in the US and the Netherlands

	Reporting in the US	Reporting in the Netherlands
Rule-based approach	<div style="border: 1px solid black; padding: 5px; margin: 10px auto; width: 80%;"> Clear and transparent criteria for reporting <i>Over-Reporting</i> </div> US till 1996 (only Currency Transaction Report CTR)	Netherlands 2001 - 2004
Risk-based approach	<div style="border: 1px solid black; padding: 5px; margin: 10px auto; width: 80%;"> Vague and possibly subjective criteria for reporting <i>Less Reporting, better quality and more efficiency??</i> </div> US since 1997 (Suspicious Activity Report SAR) (but still CTR required)	Netherlands since 2005 (objective and subjective indicator list)

4. Comparing the American and Dutch AML-Reporting Performance

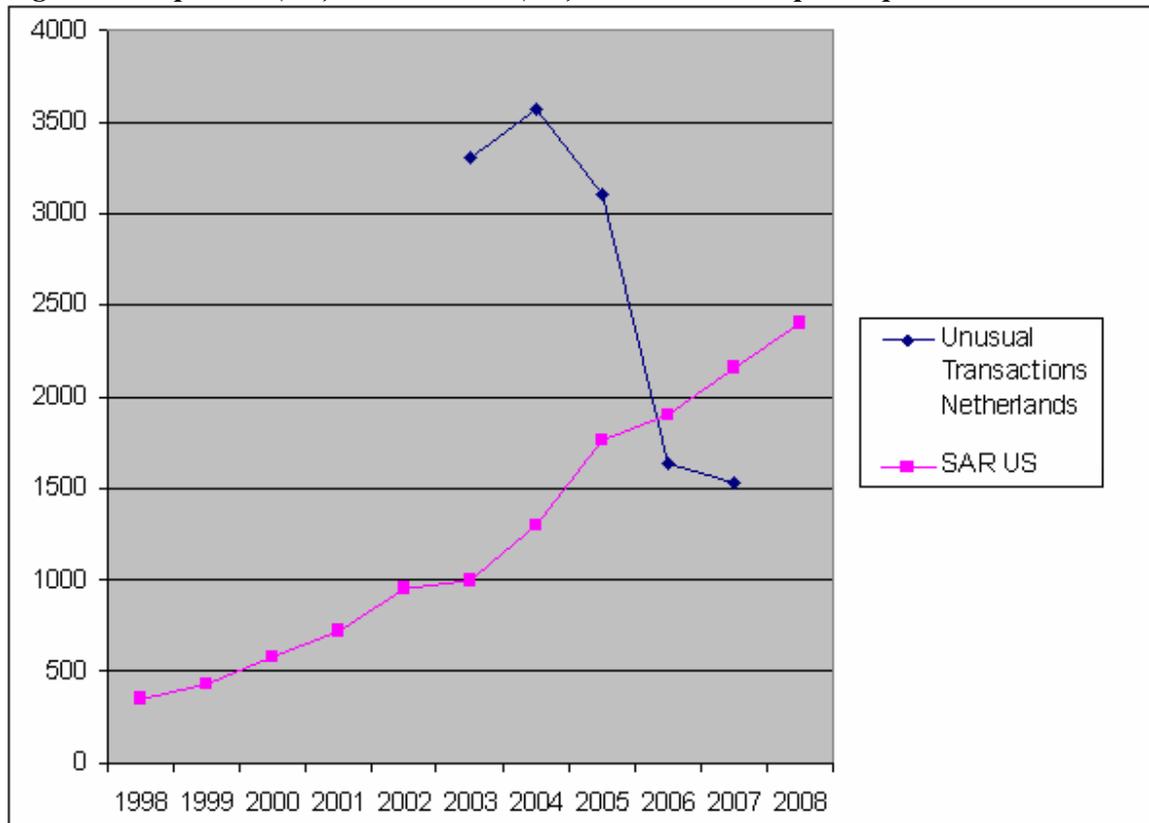
Differences in the Number of Transactions Reported

Considering these differences in regulation and reporting duties one would expect the Dutch private sector to report more cases under the rule-based approach, as the threshold for that is lower. Such is indeed the case. Before the introduction of the risk-based approach the Dutch reported about 3.5 times more per million inhabitants than the Americans (see Figure 2). Under the new risk-based approach this picture changes dramatically when correcting for structural changes⁴. Figure 2 compares American and Dutch reporting scores per million inhabitants, corrected for money transfers. In the Netherlands the latter account for 88% of unusual transactions reported in 2007 and for 90% of suspicious transactions classified by the FIU, but only for 9% of their value (FIU Nederland 2008, see also Table 1). This means that the money transfer agents report a lot of very small transactions and all transactions above 2000 Euro. Most of them would have fallen below the American threshold of US \$5000 for reporting duty.

Without such money transfers, unusual transaction reports per unit population in the Netherlands fell drastically from 50,631 in 2005 to 25,093 in 2007. They were in 2007 only about half from what they were two years before that (Figure 2). By contrast, the US saw a sharp increase in reporting. The February 2009 report from the US Government Accountability Office (GAO) noted that between 2000 and 2007 suspicious activity report (SAR) filings by depository institutions nearly quadrupled, from 163,000 to 649,000. In 2008 there were 733,000 SAR reports filed by financial institutions. In Figure 2 they are included as related to unit of population. Thus in the Netherlands unusual transaction reporting per million inhabitants fell sharply from 3102 in 2005 to 1532 in 2007- even below the US rate of suspicious reporting (2152 in 2007 and 2400 in 2008).

⁴ The Dutch reported in 2007 214,040 unusual transactions (FIU Nederland 2008). The development over time in the Netherlands is obscured by structural changes - changes in the reporting criteria and enlargement of the number of reporting units - and especially by some incidental events. An important incidental event was that two major money transfer businesses, Western Union and MoneyGram, were licensed as money transaction offices in the Netherlands by the Dutch Central Bank and as such fell under the reporting duty. Such incidental events can have a substantial impact in a small country. It explains the strong increase from 172,873 to 214,040 reported unusual transactions in 2007 (FIU Nederland 2008: 62).

Figure 2. Suspicious (US) and Unusual (NL) Transactions Reported per mln Inhabitants



Sources: FinCen diverse years, www.fincen.gov and www.gao.gov
 Annual Report FIU Netherlands 2008 and own calculations
 For the Netherlands: reports excluding money transfers

The sharp fall in reporting in the Netherlands, excluding money transfers, coincides with the introduction of the new indicator list for unusual transaction reporting in 2005. This list did not only raise one of the objective criteria for unusual transactions from minimal 10,000 to 15,000 Euros for banks, but it also introduced, in anticipation of the new European risk-based approach, the aforementioned fourth subjective criterion for ‘unusual’ transactions. As a consequence reporting by banks went down and administrative costs of banks fell by about 20 percent (= by 8 million Euros). 94% of bank reporting was based on the subjective criterion. (http://www.minfin.nl/nl/onderwerpen_financiele_markten/integriteit/wet_melding_ongebruikelijke_transacties). Banks did a good job, as their auditor, the Dutch FIU, considered 50% of their reports also suspicious (Table 1).

Table 1. Number of Unusual Transaction Reported and of the Subcategory identified as Suspicious by the Financial Intelligence Unit in the Netherlands, by Reporting Sector in 2007

Reporting Sector	Unusual Transactions	As Pct of Total Reports	Nr. Unusual Cases identified by FIU as Suspicious	Pct 'Successful' Private Reports
Money Transfer Businesses	188,947	88,2	40,893	22
Casinos	1,129	0,5	250	22
Credit Card Companies	1,415	0,7	58	4
Money Exchange Offices	617	0,3	304	49
Banks	5,900	2,6	2,848	48
Traders of Goods with High Value (diamonds, cars, ships)	14,106	6,6	957	7
Government (Customs, Tax and Supervising Authorities)	1,347	0,6	77	6
Life Insurance	27	0	18	67
Investment Funds, other Financial Services	14	0	0	0
Liberal Professions of which:	538	0,3	251	47
- Accountants	86	0	64	74
- Lawyers	11	0	6	55
- Notaries-public	407	0,2	157	39
Real Estate Agents	4	0	3	75
Tax Consultants	9	0	4	44
Business Advisors	16	0	13	81
Independent Legal Advisors	3	0	0	0
Trust Companies	3	0	3	100
Total Transactions excluding Money Transfers	25,093	11,8	4,763	19
Total Transactions including Money Transfers	214,040	100	45,656	21

Source: FIU Nederland 2008

Table 1 shows also the number of unusual transactions reported by various private sector agents, the percentage from the total reports that each of these groups provided, and the number of reported cases that the Dutch Financial Intelligence Unit screened as suspicious transactions that could be forwarded to the public prosecutor. The last column 5 divides the amount of suspicious transactions as identified by the FIU by the amount of unusual transactions reported by the private sector, as an indicator for 'successful' reporting by the private sector.

Increased risk for the private sector, due to their new task to make risk-assessments, led them to report less rather than more unusual - read suspicious - transactions. They apparently did not feel the need to play it safe and report any possible AML-risk to the government thus drowning it in data.

This outcome is in sharp contrast with the model prediction of Takats (2007) and of Dalla Pellegrina (2009) and with experiences of other European countries mentioned by them. They expected and found an increase of reporting, and they reasoned that increased risk for the private sector induced it to play it safe by reporting more.

4.2. The Quality of Information

Takats (2007) and Dalla Pellegrina and Masciandaro (2009) also note that in addition the number of reports considered useful to start investigations, and eventually to promote money laundering prosecutions, has fallen or remained low in most countries. That speaks even more of an overflow of useless AML information. This problem was identified already earlier by Pieth and Aiolfi (2003) for the US and by KPMG (2003) and Gold and Levi (1994) for the UK.

Not so in the Netherlands. The number of *unusual* transactions per head in that country was already below the number of *suspicious* ones per head in the US, as Figure 2 shows. But the percentage of suspicious ones that the Dutch Financial Intelligence Unit filtered out, was relatively high. Overall, 21% of the cases reported by the private sector were identified as suspicious (Table 1). That is an indication of the relatively high quality of the data provided by the private sector. They did not report much, but what they reported was relatively useful. Especially the banks did a good job. While they accounted only for 3% of the total unusual transactions reported, every second report of an unusual transaction was classified as suspicious by the FIU, and those accounted for 54% of the suspicious transactions value. Other sectors that provided good quality data were - percentage wise - money exchange offices (49%), life insurances (67%) and the liberal professions (47%).

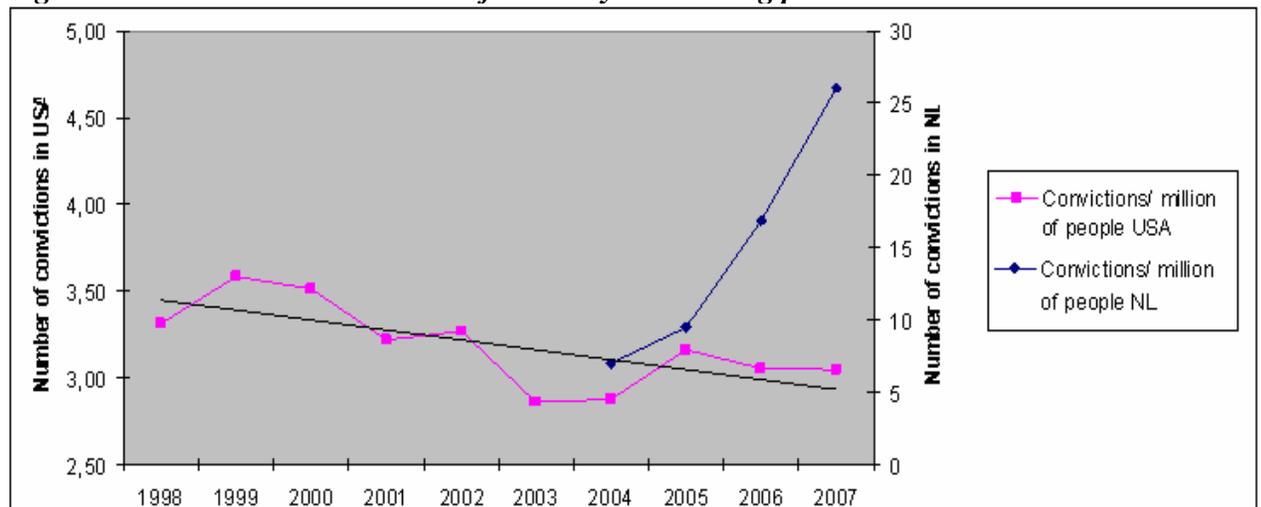
Relatively successful filtering was on the one hand the result of less but better quality information from the private sector. But on the other hand it was also because the Dutch public authority FIU had access to additional information, which helped it in identifying suspicious transactions. It could link the data on unusual transaction reports with data from police files, tax authorities, the Chamber of Commerce, social security authorities, its detailed access to all bank accounts, etc. A person who has an unusual transaction of e.g. buying jewels but has a very low income is classified as suspicious by the FIU. So is a company who appears repeatedly in unusual transactions and is located in areas prone to money laundering such as the Virgin or the Cayman islands or who has a police record. Thus the diluted information of the private sector can get more *purified* by the government's disposal over additional data. The Dutch found a different way than suggested by Dalla Pellegrina (2009) to reduce the asymmetric information gap between the public principal and the private actors: not a supervisor who checks on the private sector's information quality, but an agency which has additional information to fill the information gap between principal and agent.

This comes of course at a price, namely less protection of a citizen's right to privacy. By being legalized to combine different databases, which the government has at its disposal, it intrudes quite deeply in the privacy of citizens. This is, for a democratic country like the Netherlands, indicative of quite a high public trust in the government. Most other Western democratic populations would object to such a form of data combining and mining, especially countries like Germany and Austria which have a recent authoritarian past. The latter e.g. still insists very much on bank secrecy.

4.3. Convictions

A good indicator of success is the number of convictions for money laundering. Between 2002 and 2007, a total of 2,787 cases for money laundering reached the public prosecutor in the Netherlands. Of these about 70% was prosecuted further and in 1200 cases someone was convicted: 865 cases ended with a jail sentence (partly conditional), 288 in a work sanction, and 68 in a money fine of between 140 and 1 million Euros (Algemene Rekenkamer 2008: 79). While the number of unusual transactions declined after 2004, the number of convictions rose sharply, from 113 in 2004 to 427 in 2007 (FIU Nederland 2008: 26). The number of 1200 comes down to 15 per year and per million inhabitants. That is more than five times the rate in the US, which according to Takats (2007) and the Federal Justice Statistics hovered around 3 convictions per million inhabitants in 2005.⁵ As figure 3 shows, while the conviction rate went up sharply in the Netherlands, that in the US declined.

Figure 3. Dutch and US Convictions for Money Laundering per mln. Inhabitants



Bron: Federal Justice Statistics Resource Center

www.irs.gov/compliance/article/0,,id=11302,00.html and OECD Statistics, FIU Nederland 2008

5. Explaining the Differences

How to explain this Dutch exceptionalism of low reporting rates but relatively high quality as indicated by high conviction rates? Exceptional, compared to the opposite in the US: very high reporting rates but low conviction rates.

The differences in sanctions are significant. The ‘crying wolf’ problem in the US is caused by private business wanting to play it safe. And they do so, because under-reporting is risky for them, given the high sanctions the government has placed on it. Fines have even increased since the Patriot Act. Failing to file SARs led to fines of \$25 million for Riggs Bank,

⁵ These US data relate to federal court convictions. According to Reuter and Truman (2004, p.108), there is some evidence from inmates in jail surveys that there are little convictions on money laundering by state courts.

\$24 million for Arab Bank, \$50 million for AmSouth Bank and \$80 million for ABN-AMRO Bank in the years following 09/11.

By contrast, non-reporting by Dutch banks and other actors involved in transactions does not get sanctioned much in the Netherlands. The maximum fine is 150,000 Euros and the probability that someone is fined for not fulfilling his reporting duty is almost nil. Between 2002 and 2007 371 cases of non-reporting⁶ were passed on to the public prosecutor (Algemene Rekenkamer 2008, p. 81). This is on average 75 offences per year. In three quarters of the cases the prosecutor himself set a fine between 175 Euro and 11,250 Euro. The rest of the cases were forwarded to the judge, who imposed sanctions between 150 Euro and 150,000 Euro.

In order to reduce the ‘crying wolf’ problem in the US, Takats (2007: 8) has plead for a reduction of fines and an introduction of reporting fees, to give banks a cost incentive to internalize the externality caused by their over-reporting into their calculations. The Dutch case of low fines, low reporting, but relatively high convictions would give him right.

However, it is not always so easy to turn the knob of sanctions. There may be constraints both in the legal and the political system to raise or lower sanctions. The size of politically and legally legitimate sanctions differs between countries. The US legal system typically imposes heavy sanctions, both under criminal as well as civil law. Underlying that are some strongly ingrained cultural values, such as that individuals and organizations are free and independent but as such also responsible for their deeds and deserve to be punished if they misbehave. In addition, there is also a strong belief that heavy sanctions can and will correct behavior, that they will affect the cost-benefit analysis of free rational calculating individuals in such a way as to deter misbehavior, as is also often assumed in the US law and economics approach.

By contrast typical for the Dutch legal culture was that as far as enforcement is concerned, the emphasis has been less on punishment and immediate and harsh sanctions, but more on information, advising, and education of potential transgressors. That holds for businesses which transgressed standards for product quality, health and safety at work, or environmental pollution, but also for individuals who do not abide with traffic rules, identification obligations, or committed crimes against life, liberty and property of others. Many minor and business offenses are no transgressions of criminal but of administrative law. And wherever criminal law was invoked, sanctions were not heavy and were not immediately, without respect of persons, imposed.

The belief system behind this was that criminal behavior was considered less the free choice of an individual, but the consequences of circumstances beyond his control - poor youth, poverty, mental disease, opportunity - and judges were willing to take account of that in their judgments. Society, rather than the criminal, was to blame for crime. The criminal was actually the victim. Incarceration would only add to his problems, such as psychic problems, loss of social contacts, wrong social contacts, drug addiction, stigmatization, resulting in even less chances on the labor market. The emphasis was on resocialization, rehabilitation, reintegration, education, and prevention rather than on revenge. If punishment was unavoidable, preference was for alternative forms of it. Typical for the difference in approach are the incarceration rates. In 2004 the Netherlands had 101 prisoners per 100,000 inhabitants, while the US had 721 (CEPEJ 2006).

Tort law provides punishment in civil cases. Though under English law this has developed as an important deterrence for inflicting harm on others and as such has been valued by law and economics scholars (e.g. Shavell 2007, De Geest and Dari-Mattiacci 2007), in the US

⁶ Offenses against the Law of Reporting Unusual Transactions (Wet Mot), the Law of Identification services (Wid) and the Sanctiewet 1977.

it has expanded very much, in the eyes of many too much (Kagan 2001, Van Waarden 2001) . The frequency and height of demanded and awarded compensatory and punitive damages in the US are infamous. Fear of such liability has induced formalistic legalism in the US economy and society, such as detailed safety warning labels or extensive due diligence in economic transactions. Such tort litigation has been unimportant in the Netherlands. Victims have not started proceedings readily, because the rules on proof of causality have been rather strict and courts did not award high damages. Hence it did not pay to litigate, all the more so because there were alternative ways to get compensation, e.g., through the social security system and private insurance.

In addition, many comparative studies of regulatory enforcement in different countries have shown that European, and in particular Dutch, rule enforcers - policemen, labor and food inspectors, environmental controllers - followed a more consensual enforcement style, compared to American inspectors, who were known for a more rigid, strict and adversarial style, immediately imposing heavy sanctions. (among others Bardach and Kagan 1982, Badaracco 1985, Brickman, Jasanoff and Ilgen 1985, Vogel 1986, Wilson 1985, Van Waarden 1995, 1999). Traditionally, state-industry relations in the US have also been much more adversarial and distrustful than in Europe (Lee and Ross 1980). The US had early on independent regulatory agencies, which had the task to closely supervise business. Thus in the US, business met the government of old mostly as regulator, inspector, controller, rather than supporter and ally. In those cases where Dutch (or Swedish or British) policemen or inspectors did impose sanctions and such cases made it to an administrative or criminal court, judges often acquitted or reduced the sanctions in exchange for promises of the accused to mend their ways. Typical for the cooperative relation between state and industry is also that the new norms for reporting unusual (read suspicious) transactions of 2005 (mentioned in section 5.2.) were developed in close cooperation between government agencies and the various trade associations of the involved economic sectors, such as the banking association.

More in general, playing it safe and defensive reporting is likely to be also influenced by the broader legal system. And the Dutch and American legal systems differ substantially, not only and so much in the substance of the law, the criterion on which La Porta et al (1998) distinguished common law and three varieties of civil law countries, but in form, that is, legal institutions and legal procedures, such as court procedures and the importance of judges versus lawyers (see also Damaska 1986), the importance of case law versus statutory law, and in the ease and inclination to litigate. A standard indicator for such procedural differences is the number of lawyers per 100,000 inhabitants. The Netherlands had in 2005 84 lawyers per 100,000 inhabitants (up from 16 in 1970), compared to the 373 lawyers per 100,000 inhabitants for the US (Van Waarden 2009b)⁷.

US defensive reporting seems the logical thing to do in a legal system which Kagan (among others 1997, 2001, 2007) has called ‘adversarial legalism’, and which he considered very fearsome as well as ‘woefully inefficient and erratic’. He writes: ‘The United States has a “legal style” that remains distinctive. Its lawyers and judges are uniquely aggressive and creative -- or, as critics would put it, presumptuous. In no other country do aggrieved citizens so often haul highway departments, prison wardens, and business corporations into court. Germans may file

⁷Barzilai (2007) comes to somewhat different numbers because he seem to have used a different definition of lawyers (Van Waarden 2009b used the official numbers of the American Bar Foundation). Barzilai came to only 230 lawyers per 100,000 inhabitants. Yet the US scored also in his ranking in the top, while the Netherlands was the lowest scoring Western-Industrialized country. Below it were mostly East European and Asian countries.

many tort suits, but nowhere is the tort law system so extravagantly costly, erratic, and fearsome as it is in the United States. A growing number of excellent socio-legal studies carefully compare different national approaches to a particular social problem—such as compensating injured people, regulating nursing homes, or cleaning up toxic waste dumps. These comparisons generally point to several distinctive characteristics of the *American* government process: 1. more complex bodies of legal rules; 2. more formal, adversarial procedures for resolving political and scientific disputes; 3. more *costly* forms of legal contestation; 4. more punitive legal sanctions; 5. more frequent judicial intervention into political and administrative decisionmaking; 6. more political controversy about legal rules and institutions; and 7. more legal uncertainty and malleability.’ (Kagan 1997: 166-7)

Important is not only the severity of conflict and punishment, but, - notwithstanding the importance of principles as the rule of law, legal certainty and legal equality - the uncertainty over whether one will be prosecuted, sued, sanctioned, and how heavy the sanction will be. Many institutional factors contribute to this uncertainty in outcomes, among them the inquisitorial court procedure, where lawyers rather than judges *de facto* lead the procedures, the highly fragmented court system, the presence of jury adjudication, and last but not least enterprising lawyers driven by contingency fees.

Adversarial-legalism is not only legalistic because of the importance in the US of values such as the formal equality for the law and its universalistic application, that is, that its force should fall on all citizens equally; but also because the fierceness of the legal conflict, the often severe sanctions, and the uncertainty of outcomes induce people to play it safe, to be formalistic and choose to ‘go by the book’ (Bardach and Kagan 1982).

By contrast, the Netherlands has almost the complete opposite legal system: consensual rather than adversarial, informal rather than formal, flexible rather than rigid, and pragmatic rather than principled as one of us has argued elsewhere (Van Waarden 2009a, 2009b). Blankenburg (1997) called the Dutch style of regulatory enforcement and conflict settlement a ‘litigation avoiding legal culture’, Bruinsma (2005) spoke of ‘informal pragmatism’ and van Waarden (2009b) of ‘consensual informalism’ to emphasize the contrast to adversarial legalism. The formal legal institutions are also rather different from the US. Continental European countries use an inquisitorial court procedure (see Damaska 1986 for the differences between adversarial and inquisitorial), in which the litigant lawyers play only a minor role and where the judge steers and influences the process; the centralized Dutch state has also a rather simple and coherent court system, unlike the fragmented one in the US federal state, which offers much less possibilities for enterprising lawyers to get their way at least somewhere; and the Dutch have no jury adjudication.

It is understandable that in a fearsome and formal legal system as that of the US businesses (and their legal counsel) want to play it safe, stick to the rules, avoid risk and rather over- than underreport. The Dutch legal system is much less fearsome for business. Hence the latter can afford to save on administrative costs of reporting unusual transactions by keeping it modest.

To sum up, if one wants to avoid defensive over-reporting of transactions suspected of money laundering, it may not be so easy to change some rules and sanctions, as Takats (2007) wants. They are very much part and parcel of the legal system in which they have come about and function.

6. Summary and Conclusion

How to dodge drowning in data? How to increase the effectiveness and efficiency of AML-reporting by private actors? How to give them an incentive to report transactions that they would consider suspicious, using their expert knowledge and intuition, while deterring business to over-report? Is the shift from rule-based to risk-based regulation helpful in this respect?

The risk-based approach was developed because the rule-based approach did not work well, both in the US and in Europe including the Netherlands. The rule-based approach led to over-reporting as many of the reported transactions had nothing to do with money laundering, but at least there were clear criteria about what to report and it was easy for the government to control this reporting and to impose fines on banks that did not report according to these criteria.

The shift from a rule- to a risk-based approach implies that ‘suspicious behaviour’ is no longer defined by the government in the form of fixed rules but by many different actors, mostly experts on the street- and shop-floor of the financial services sectors. Private actors like banks, and in many countries notaries publics, accountants, real estate agents, and public implementation and law enforcement actors like the customs, the police and the public prosecutor, have to and can develop their own interpretation and definition of ‘suspicious behaviour’ of a client or a transaction. The new risk-based approach has led to a large range of differing definitions and concepts of ‘suspicious transactions’. In short, it has increased uncertainty for all actors involved.

The private sector can on the one hand profit from this. A risk-based approach might leave more room for manoeuvre to the private sector to determine suspicious behaviour, but it is also much more difficult for the government to control the quality of the information and to impose a fine for wrongful reporting. Banks could try to protect their customers by drowning the government in data, by creating a ‘crying wolf’ problem, so that the real culprits cannot easily be identified. However the marketing possibilities of this are limited. It is a bit difficult for banks to openly advertise this to attract customers.

The risk-based approach creates not only opportunities for the private sector to use its discretion, it also creates uncertainty. And that may be an additional motive for over-reporting: just playing it safe and report anything that somehow could smell like money laundering. Over-reporting could in principle be risky. Identifying a legal transaction as a potential illegal one may get banks into trouble with the accused, who might sue them in private court. In order to reduce this risk, the US law has stated that banks cannot be sued by their clients for reporting them. However, under-reporting is risky in the relation with the government. Banks may get heavily fined for that. As Takats (2007) has argued, as a consequence banks are likely to follow a risk-averse strategy and over-report. And we have seen that in many countries they do (Dalla Pellegrina and Masciandaro 2009).

The different results between the US and the Netherlands that we discussed in this paper indicate that whether or not over-reporting will take place under a risk-based regime depends also on the legal system: its institutions and the cultural values of which these institutions are an expression. A legal system such as US adversarial legalism, with its strict public rule enforcement, fierce criminal and administrative sanctions and fearsome tort law induced a general attitude of private actors to play it safe. In such a legal system over-reporting is much more likely than in a legal system as that of the Dutch, where regulatory enforcement is much more flexible and lenient, where sanctions are much lower, and where the threat of liability claims is minimal.

The eventual effect of new regulations depends also on the pre-existing legal-institutional framework of a country in which they are introduced, as also La Porta et al (1998: 1114) indicated. That implies that if one wants to evaluate the actual deterrent effectiveness and efficiency of regulation versus tort liability, that is, of sanctions under public versus under civil law (De Geest and Dari-Mattiacci 2003 and 2007), or of precise rules versus broader standards (Schäfer 2006), it might be wise to take the pre-existing legal context, e.g. the fierceness of tort law, into account. Schäfer differentiates between poor and rich countries. Similarly, one could differentiate between different (tort) law traditions.

Furthermore, such legal systems are not easily changed. They are the product of decades if not centuries of development of public policy, regulation and case law. Legal systems are in particular path dependent, given the importance of precedent in the interest of legal certainty and legal equality. Thus modifying them is not an easy policy option, certainly not if only to increase the effectiveness and efficiency of anti-money laundering policy.

Takats (2007) has argued for lower fines for wrongful money laundering reporting. It is questionable whether such is legally possible or has political legitimacy in politics and legal systems, such as that of the US, which express the belief that all vices can be rooted out by severe punishment. It might be easier in more flexible systems like that of the Netherlands, but there sanctions on wrongful AML-reporting are already very low.

Dalla Pellegrina and Masciandaro (2009) build a theoretical model to reduce the asymmetric information problem by introducing a third player into Takats' principal agent problem: A supervisor, who can through his skills and expertise identify complicated money laundering constructions, herewith evaluate the risk of laundering and the effort made by the reporting unit. With this, the supervisor reduces the asymmetric information between the public agencies and the private sector reporting units. The role of the supervisor in their model is to increase the incentive for correct reporting by increasing the risk for the lying private sector reporting unit to be detected.

However, it remains questionable whether this solves the problem. The uncertainty over what a suspicious transaction is may hold also for the supervisor, and he may also want to play it safe, by allowing or facilitating over-reporting. Furthermore, there will still be a problem of asymmetric information between the government and this supervisor, involving principal agent problems, irrespective of whether he or she is publicly or privately employed. Even publicly employed supervisors may eventually come to share interests with the subjects he is to supervise or develop so much understanding for the difficulties of the private sector that he may be more on their hand than on that of the public authorities, as the extensive 'capture' literature on US 'independent' regulatory agencies has taught us (Bernstein 1955, Mitnick 1980). The government will still have to 'trust' its supervisors. If not, the problem will only be displaced, and a new supervisor of the supervisor will have to be appointed. In principle the chain of supervisors of supervisors is endless. This will only add to the costs of the regulatory system, that is, make it increasingly less efficient.

Indeed, many economic sectors have seen the burgeoning of what could be called a veritable 'control industry' (Van Waarden 2007). Checks have been piled upon checks. A good example is provided by the American accounting scandal, which produced the Sarbanes-Oxley (SarboX) act in 2002. Suddenly it turned out that the supposedly 'independent' external supervisors, the accountants, could not be trusted any more. The law created a new regulator, the Public Company Accounting Oversight Board (PCAOB). In line with the rigid and adversarial policy style that has characterized American regulators for decades (Van Waarden 1999), it executes the new stricter rules very precisely and rigidly. The greater external controls have lead

to extra layers of internal control. 'At KPMG, the auditors are now reviewed not only by their boss, who focuses on business growth, but also by risk experts, who rate how well the accountant complied with the firm's rules' (Byrnes 2003: 68). Also in the companies checked by accountants new levels of control have been built in. 'Companies have spent at least 1 billion dollars adopting new Sarbanes-Oxley rules. Corporate audit committees are gathering more often for longer meetings and asking tougher questions' (Byrnes 2003: 68). So by now we at least have 7 levels of control: PCAOB – Top management of accountancy companies – their risk experts – the accountants – the management of the companies that will be checked – company accountants committees – company accountants – the final bookkeepers.

History teaches us that time and again the effectiveness of the controls is questioned. And subsequently the costs of the control system increase, decreasing its efficiency.

But perhaps the problems posed by the uncertainty of risk-based regulation will disappear as risk-based regulation itself is likely to disappear eventually. The subjects of regulation will want to reduce that uncertainty. Risk-based regulation will in the beginning lead to an increase in misunderstandings and legal insecurity, reduced intelligibility, transparency and predictability. Clients might feel mistreated by wrongly being classified suspect, and appeal to the Courts. Banks might feel unfairly fined because of wrong monitoring of suspicious transactions and appeal to the Courts. In the long run the definition of suspicious transactions and of the monitoring of these transactions will converge, if not by mutual agreement among the actors themselves, then by the Courts. Convergence through case law and the Courts will eventually change the risk-based approach back again into a new rule-based approach. However, in this new one the rules are not anymore set by the legislators, but by the Courts in their case law. Not politicians will be ruling anymore, but lawyers. This will take time though and will first lead to a period of legal insecurity, accompanied by trial and error, such as higher number of appeals, more police investigations, privacy violations, et cetera. In short, it will produce costs to private and public organizations and to society at large, i.e. it is not efficient. But over time precision, clarity, transparency and predictability will eventually re-emerge as risk-based regulation regresses back to de facto rule-based regulation.

The same could be the fate of another supposed innovation in regulation: principle-based regulation. The British Financial Services Authority (FSA) has recently pushed this as another industry-friendly and efficient form of regulation. It has elaborated this in 11 basic principles, such as 'the financial firm must conduct business with integrity', 'with due skill, care and diligence', 'must maintain adequate financial resources', 'must observe proper standards of market conduct', 'must pay due regard to the interests of its customers and treat them fairly', and 'must arrange adequate protection of clients' assets'. Firms will want to play it safe and to know what the FSA considers to be 'adequate', 'proper', or 'due regard'. When are they indemnified against sanctions or liability claims? Legal systems have many such broad and hence vague principles - legality, opportunity, proportionality, equality, legal certainty, discrimination - but these have over time acquired rather precise meanings in the legal discourse. The aim of the FSA-principles is to reduce red tape and to lower the costs of filling out forms and reporting. However, it could very well increase the costs of liability claims and litigation. The operationalization will produce a lot of lawyering and new (and old) forms of bureaucracy.

This process can be illustrated by the 30 years history of the HACCP quality standards developed by the US FDA and USDA in food quality control. What started as risk-based regulation has developed into a set of detailed SOPs (standard operating procedures) for the identification of potential hazards and of critical points in processes where these hazards could occur, for preventive measures with critical limits for each control point, for procedures for

monitoring critical control points, for required corrective actions when monitoring has shown that a critical limit has not been met, for procedures to verify that the system is working properly, and for keeping records to document the HACCP system. These SOPs, which are officially 'recommendations' but de facto mandatory standards as they are recognized and referred to by the judicial authorities, make up now 123 pages. The risk-based system has evolved into a rule-based one.

Whether or not risk- and principle-based regulation will regress again to rule-based regulation, and how soon, will depend on a number of factors. A major one is the likelihood and frequency of litigation over the regulation. Without litigation no case law. Whether or not citizens or firms litigate is in turn dependent on the degree of actual enforcement. With less enforcement there are less conflicts over the interpretation of the regulation. Though the American federal government tried to protect reporting banks from litigation by those reported, it is not unimaginable that the complicated multi-layered US legal system will provide sufficient loopholes for inventive and aggressive lawyers or state public prosecutors to sue.

That means that a legal culture characterized by strict enforcement and frequent litigation, as that of the US, will sooner produce more specific operationalizations of broad and vague norms such as what 'suspicious' transactions are. Where the problems of over-reporting are greater, in the US, the solution will come from the gradual disappearance of risk-based regulation and the re-appearance of a new rule-based approach, with the precise rules now being set by courts and case law. Where the problems are less, as in the Netherlands, there will be less litigation, and it will take more time before risk-based regulation will revert back to rule-based. Thus the legal system itself will provide the solution where it is most needed. Unless public authorities introduce once again another regulation 'innovation'.

References

- Ayres, Ian, and John Braithwaite (1992) *Responsive Regulation: Transcending the Deregulation Debate*, Oxford: Oxford University Press
- Algemene Rekenkamer 2008, *Bestrijden witwassen en terrorismefinanciering*, Tweede Kamer, vergaderjaar 2007-2008, 31477, nrs 1-2, 's Gravenhage 2008, http://www.rekenkamer.nl/9282000/d/p444_tk31477_1en2.pdf
- Annual Report FIU Netherlands 2007, *Jaaroverzicht 2006*, The Hague 2007, <http://www.fiu-nederland.nl/>
- Annual Report FIU Netherlands 2008, *Jaaroverzicht 2007*, The Hague 2007, <http://www.fiu-nederland.nl/>
- Badaracco, Joseph L. (1985), *Loading the Dice. A Five-Country Study of Vinyl Chloride Regulation*, Harvard Business School Press, Cambridge.
- Baker, Raymond (2005) *Capitalism's Achilles Heel*, John Wiley, 2005.
- Bardach, Eugene, and Robert A. Kagan (1982) *Going by the Book: The Problem of Regulatory Unreasonableness*, Philadelphia: Temple University Press.
- Barzilai G (2007) The Ambivalent Language of Lawyers in Israel: Liberal Politics, Economic Liberalism, Silence and Dissent. In Halliday TC, Karpik L, Feeley M (eds) *Fighting for Political Freedom*, 247-279, Hart Publishing, Portland.
- Bernstein, Marver H. (1955) *Regulating Business by Independent Commission*, Westport, Conn. (Greenwood Press)
- Blankenburg E (1997) Civil Litigation Rates as Indicators for Legal Culture. In David Nelken (ed.) *Comparing Legal Cultures*, 41-68. Dartmouth Publishing Co, Aldershot.
- Blankenburg E (1998) Patterns of Legal Culture: The Netherlands compared to Neighboring Germany. In *The American Journal of Comparative Law* 46, 1-41.
- Blankenburg E, Bruinsma FJ (1994) *Dutch Legal Culture*. Kluwer, Deventer and Boston.
- Brickman, Ronald, Sheila Jasanoff, and Thomas Ilgen (1985), *Controlling Chemicals: The Politics of Regulation in Europe and the United States*, Cornell University Press, Ithaca.
- Bruinsma FJ (2005) Judges and Lawyers in the Netherlands - An Overview from 1970 till 2000. In Felstiner WLF (ed.) *Reorganization and Resistance. Legal Professions Confront a Changing World*, 67-92. Hart Publishing, Portland.
- CEPEJ (2006), European Commission for the Efficiency of Justice, *European Judicial Systems*, Strasbourg, Council of Europe, 2006.

Cioffi J (2009) Adversarialism vs Legalism: Juridification and Litigation in Corporate Governance Reform. In *Regulation and Governance* 3: 3

Damaska M (1986) *The Faces of Justice and State Authority: A Comparative Approach to the Legal Process*. Yale University Press, New Haven.

Dalla Pellegrina, Lucia and Donato Masciandaro (2009) *The Risk Based Approach in the New European Anti Money Laundering Legislation: A law and economics view*, Review of Law and Economics, December

Diver, C.S. (1983) 'The Optimal Precision of Administrative Rules', in *Yale Law Journal*, pp. 65-109

Ehrlich, I., and R.A. Posner (1974) 'An Economic Analysis of Legal Rule Making', in *Journal of Legal Studies*, pp. 257-286

Es, P.C. van (2007) '*Informatieplicht en geheimhoudingsplicht van de notaris*', in: Meer spreken, minder zwijgen?, Preadvies KNB 2007, Den Haag, p. 56 - 61.

Ferwerda, Joras (2009) 'Compliance', in *Review of Law and Economics*, December

FinCen (2008), The SAR Activity Review – By the Numbers Issue 10 (May 2008),

FIU Nederland 2008, Jaaroverzicht2007, <http://www.fiu-nederland.nl/>

Geest, Gerrit de, and Guisepe Dari-Mattiaci (2003) '*On the Intrinsic Superiority of Regulation and Insurance over Tort Law*', 10th Joint Conference between the Geneva Association for the Study of Insurance Economics and the European Association of Law and Economics (EALE), Seminar

Geest, Gerrit de, and Guisepe Dari-Mattiaci (2007) 'Soft Regulators, Tough Judges', in *Supreme Court Economic Review* Vol. 15, pp. 119-140

Gold, M. and Levi M. (1994), *Money Laundering in UK: An Appraisal of Suspicious – Based Reporting*, Police Foundation, London.

Hutter, Bridget M. (2005) *The Attractions of Risk-Based Regulation: Accounting for the Emergence of Risk Ideas in Regulation*, CARR Discussion paper, 33. Centre for Analysis of Risk and Regulation, London School of Economics and Political Science, London, UK

Hutter, Bridget M. (2006) 'Risk, Regulation, and Management', in Taylor-Gooby, Peter and Zinn, Jens, (eds.) *Risk in Social Science*. Oxford University Press, Oxford, UK, pp. 202-227

IMF (2005) International Monetary Fund, Technical Review of the Quality and Consistency of the AML/CFT Assessments, Report by the Independent panel of experts on behalf of the IMF

and World bank (report of the independent panel of experts in name of the IMF and the World Bank), Washington DC, 2005.

Johnson, Simon, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Schleifer (2000) 'Tunneling', in *The American Economic Review*, Vol. 90, No. 2, Papers and Proceedings of the One Hundred Twelfth Annual Meeting of the American Economic Association (May), pp. 22-27

Kagan RA (1997) Should Europe Worry About Adversarial Legalism? In *Oxford Journal of Legal Studies* 17, 165-83.

Kagan RA, Axelrad L (2000) *Regulatory Encounters. Multinational Corporations and American Adversarial Legalism*. University of California Press, Berkeley.

Kagan RA (2001) *Adversarial Legalism. The American Way of Law*. Harvard University Press, Cambridge, MA.

Kagan RA (2007) Globalization and Legal Change: The "Americanization" of European Law? In *Regulation and Governance* 1, 99-120.

Kaplow, L. (1992) 'Rules versus Standards. An Economic Analysis', in *Duke Law Journal*, pp. 557-629

Kaplow, L. (1999) 'General Characteristics of Rules', in Boudewijn Bouckaert and Gerrit de Geest, (eds) *Encyclopedia of Law and Economics, Vol. V, The Economics of Crime and Litigation*, No. 9000, Cheltenham: Edward Elgar, pp. 502-528.

KPMG (2003), *Money Laundering: Review of the Regime for Handling Suspicious Activity Reports*, National Criminal Intelligence Service, London.

Koselleck, Reinhard (1967) *Preussen zwischen Reform und Revolution: Allgemeines Landrecht, Verwaltung und soziale Bewegung von 1791 bis 1848*, Stuttgart: Ernst Klett Verlag

La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, Robert W. Vishny (1998) Law and Finance, in *The Journal of Political Economy*, Vol. 106, No. 6 (Dec.), pp. 1113-1155

Laar, Margriet van.Guus Cruts, van Gageldonk, Croes, Ooyen-Houben,Meijer, Ketelaars (2007), Situation 2006, *The Netherlands, Report to the European Monitoring Center for Drugs and Drug Addiction*, Trimbos Institute, Utrecht, <http://www.wodc.nl/onderzoeksdatabase/national-report-2006-emcdda.aspx>

Lee FA, Ross BH (1980) *Business Regulation and Government Decision-Making*. Winthrop, Cambridge, MA.

Levi, Michael and Peter Reuter (2006), Money Laundering, *Crime and Justice*, Vol 34, 2006, pp. 289-375. 9.

Masciandaro, Donato, E. Takats and B. Unger (2007), *Black Finance, The Economics of Money Laundering*, Edward Elgar, Cheltenham UK., 2007.

Mitnick, Barry (1980) *The Political Economy of Regulation*, New York (Columbia U.P.)

Pieth M. and Aiolfi G. (2003), *Anti – Money Laundering: Leveling the Playing Field*, Basel Institute of Governance, Working Paper, n.1.

Reuter, Peter and Victoria Greenfield (2001), ‘Measuring Global Drug Markets: How good are the numbers and why should we care about them?’ *World Economics* 2 (4), October-December 2001.

Reuter, P and Edwin M. Truman (2004) *Chasing Dirty Money: The Fight Against Money Laundering*, Institute for International Economics, November 2004.

Schäfer, Hans-Bernd (2002) ‘Legal Rules and Standards’, *German Working Papers in Law and Economics*, Vol 2002, paper 2

Schäfer, Hans-Bernd (2006) ‘Rules versus Standards in Rich and Poor Countries: Precise Legal Norms as Substitutes for Human Capital in Low-Income Countries’, in *Supreme Court Economic Review*, University of Chicago Press, Vol. 14, pp. 113 - 135.

Shavell (2007) Liability for Accidents, in: A. Mitchell Polinski and Steven Shavell (eds), *Handbook of Law and Economics*, Vol.1, Chapter 2, pp.139-182.

Schoot, C.R.A, van der (2006) ‘Organised crime prevention in the Netherlands. Exposing the effectiveness of preventive measures’, Boom Juridische Uitgevers, 2006.

Takats Elod (2007), *A Theory of ‘crying wolf’: The Economics of Money Laundering Enforcement*, IMF Working Paper No 07/81, April 2007 <http://ssrn.com/abstract=979035>

United Nations Office on Drugs and Crime (2006). ‘*World Drug Report 2006*’. 2 volumes http://www.unodc.org/pdf/WDR_2006/wdr2006_volume1.pdf

Unger, Brigitte, G. Rawlings, M. Busuioc, J. Ferwerda, M. Siegel, W. de Kruijf, K. Wokke (2006), *The Amounts and the Effects of Money Laundering, Report for the Dutch Ministry of Finance*, February 2006, <http://www.minfin.nl>

Unger, Brigitte 2007 *The Scale and Impacts of Money Laundering*, Edward Elgar: UK, March 2007.

Van Waarden F (1995) Persistence of National Policy Styles: A Study of their Institutional Foundations. In: Unger B, Van Waarden F (eds) *Convergence or Diversity? Internationalization and Economic Policy Response*, Avebury, Aldershot, 333-372.

Van Waarden F (1999) European Harmonization of National Regulatory Styles? In Vervaele JAE et al (eds) *Compliance and Enforcement of European Community Law*, Kluwer Law, Deventer, 95-124.

Van Waarden F (2001) Institutions and Innovation: The Legal Environment of Innovating Firms, in: *Organization Studies* 2001 vol 22:5, pp. 765-795.

Van Waarden F (2002) 'Market Institutions as Communicating Vessels: Changes between Economic Coordination Principles as a Consequence of Deregulation Policies'. In Hollingsworth JR, Mueller KH, Hollingsworth EJ (eds) *Advancing Socio-Economics. An Institutional Perspective*. Rowman and Littlefield, Lanham, Boulder, New York and Oxford, 171-212.

Van Waarden F (2009a) Power to the Legal Professionals. Is there An Americanization of European Law? In *Regulation and Governance* 3: 3

Van Waarden, F (2009b) 'From Corporatism to Lawyocracy. On Liberalization and Juridification', in *Regulation and Governance* 3: 3

Voelzkow, Helmut (1996), *Private Regierungen in der Techniksteuerung, eine sozialwissenschaftliche Analyse der technischen Normung*, Frankfurt am Main, Campus Verlag.

Vogel, David (1986), *National Styles of Regulation. Environmental Policy in Great Britain and the United States*, Cornell University Press, Ithaca and London

Walker, John (1995), Estimates of the Extent of Money Laundering in and through Australia, Paper prepared for the Australian Transaction Reports and Analysis Center, September 1995, Queanbeyan: John Walker Consulting Services.

Walker, John 1999, 'How Big is Global Money Laundering?' *Journal of Money Laundering Control*, Vol. 3, No. 1, 1999;

Walker, John (2005), *Global Illicit Drugs Trades, study done for the UN*, see UNODC 2006.
Wang et al (2007)

Wilson, Graham K. (1985) *The Politics of Safety and Health*, Oxford (Clarendon Press)

Zini et al (2002), *Money Laundering Prevention in the US*, 17/09/2002,
<http://www.altassets.net/casefor/countries/2002/nz2627.php>