

*December 2002, Draft*

## **Governance in the Financial Sector: The Broader Context of Money Laundering and Terrorist Financing**

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Even though substantial amounts of work have been done in the money laundering field, the focus until recently has been on particular banking institutions and a few countries. Since last September 11, however, the work has broadened to become a global concern. Many challenges and issues are still being debated.

Yet the challenge of money laundering is still viewed within a rather narrow context, one that still tends to focus narrowly on the banking system, and divorced from the links of poor governance and corruption in the public and private sectors. Here we suggest that it is important to approach the diagnostic, analysis and actions in the Anti-Money Laundering (AML) challenge within a much broader governance context. To provide a brief synthesis of key aspects and linkages within such broader governance framework, we present the “laundromat” AML chart below (and in slide 2 of the attached presentation in annex).

The rows in the chart illustrate stages in the developmental and governance framework. The first row (stage 1) refers to the various types of activity and sources of profits and funds, which may be legal or illegal. The funds may or may not be channeled through money laundering transactions. The second row (stage 2) refers to the types of financial transactions and intermediaries. The third row (stage 3) shows the uses to which funds are put. The last row (stage 4) indicates the ultimate impact of the activity—does it favor development or discourage it?

A key hypothesis here is that concerted action must be based on a good understanding of the fundamental causes and sources behind money laundering. The illegal and extralegal activities that generate funds for laundering (stage 1 on the chart) vary from country to country and from region to region. The oval on the left represents the legal side; the rest of the ovals (those on the right) are types of illegal activity that include insider trading in the stock market, transfer pricing through multinationals, drug trafficking, arms trade, corruption in procurement, and corruption in government and in the political classes. The relative importance of these sources varies from country to country. It is therefore paramount to diagnose within a country what the main sources for funds to be laundered are, and within it, to study the various links between money laundering and different manifestations of misgovernance and corruption in the public and private sectors. This is particularly important since significant progress on AML may

derive from preventive activities that reduce the illegal source of the funds intended to be laundered in the first place.

The second row (stage 2) of the schematic chart illustrates the types of financial institutions that may be involved in money laundering activities. First, we note the distinction between banks and other formal financial institutions. While the bulk of money laundering in many countries still tend to use the formal banking system, money laundering through non-banking financial institutions (NBFIs) appears to be growing in importance—through real estate transactions, security brokers, derivatives, the exchange rate market, leasing insurance companies, and others.

Yet transactions through non-banking financial institutions in the formal financial sector is not the only alternative conduit mechanism to the banking system. In fact in many countries informal financial institutions, such as *hawalas* and other such informal financial institutions, play a very important role. As the focus on enforcement, supervision, and institutional development in the formal banking (and non-banking) takes place, it is important to consider that there are substitutes to the formal financial institutions for money laundering. Such substitutes vary from country to country as well, and need to be addressed in tandem with the more conventional approaches being taken for tighter supervision and enforcement of the banking sector.

Laundered money can be put to many uses (stage 3 in row 3 in the schematic chart)—among them one possible use, in some settings, is terrorist activity. Yet terrorist financing can also be generated by quasi-legal activities, from state-sponsorship, and from contributions from individuals that may or may not involve laundering ill-gotten funds in the first place. Conversely, the bulk of laundered funds is not utilized for terrorist financing. In many cases, the funds and profits from money laundering can have significant political and developmental costs through their relationship to legal, political, and campaign financing, luxury consumption, and other criminal activities. By contrast, when financial activity is legal it is quite likely to contribute to growth and development.

Part of the challenge in not being able to probe in more analytical depth on money laundering worldwide was due to the lack of empirical evidence on the problem. In part, this is being addressed through surveys that probe into this issue. Slide 3 in the attached presentation in annex depicts the regional averages of money laundering and terrorism based on 2002 surveys of enterprises in 80 countries. The chart measures the reported costs of terrorist threats to businesses. It also shows money laundering through the banking system and through the non-banking system. We see that there are very significant variations across regions, both in the average levels and in the relative importance of each dimension of the problem of money laundering through banks vs. non-banks, and relative to the cost of the perceived terrorist threat as reported by the enterprise sector. In particular, it is noteworthy the reported differences in the relative importance of money laundering through the banking system as compared with the non-

banking system. In some regions money laundering through the nonbanking system is reported to be much more significant, while in others the challenges are similar in both dimensions (slide 3). These are merely regional averages; the differences within specific countries can be even more pronounced.

The rest of the slide presentation suggests the empirical links between money laundering and a few related variables—depicted as plotgrams, where each ‘dot’ in the graphs represents the average rating for one of the 80 countries in the sample, as reported by the enterprises. We see for instance that money laundering through the banking system is closely related to the standards of accounting and auditing in the private and financial sectors, and with the quality of the overall regulatory and supervisory framework. As important, however, is the nexus between money laundering and the diversion (or ‘leakages’) of public funds from the national budget, as well as with other forms of corruption—including one particularly nefarious form of ‘grand corruption’, namely state capture, which refers to the tendency of elite firms and interests (including oligarchs) to shape the laws, regulations and policies of the state for their private interest through illicit payments to politicians.

This evidence illustrates the point that it is counterproductive to divorce the issues of public and private sector misgovernance from the problem of money laundering. The evidence presented in the presentational slides also suggests how complex the link between money laundering and terrorist threat is: there is no one-to-one link between money laundering and the reported terrorist threat. There is a positive correlation among the 80 countries in the sample between these two variables, yet it is a far lower correlation than for the corruption, state capture, and financial supervision and audit variables suggested above. Again, studying the country-specific reality appears to be of particular importance in this context as well, since the evidence is suggestive in that such link between money laundering and terrorism may be relevant in some countries more than in others.

The following key implications emerge from this presentation and the preliminary evidence depicted in the slide presentation:

- It is crucial to understand and diagnose the main manifestations of misgovernance and corruption in both the public and private sector in order to be able to develop an effective, comprehensive national program to fight money laundering. Country specificity is key.
- It is very important to diagnose what the main sources of laundered funds are. They will vary significantly from country to country—drug trade, drug cartels, arms trade, the political arena, political funding, grand scale procurement, budgetary corruption, tax evasion, insider trading. Understanding the key sources is an absolute priority.
- We must distinguish and understand the differences between money laundering through the official banking system and through the non-banking system, both official and informal. The informal institutions play a very important role in some countries.

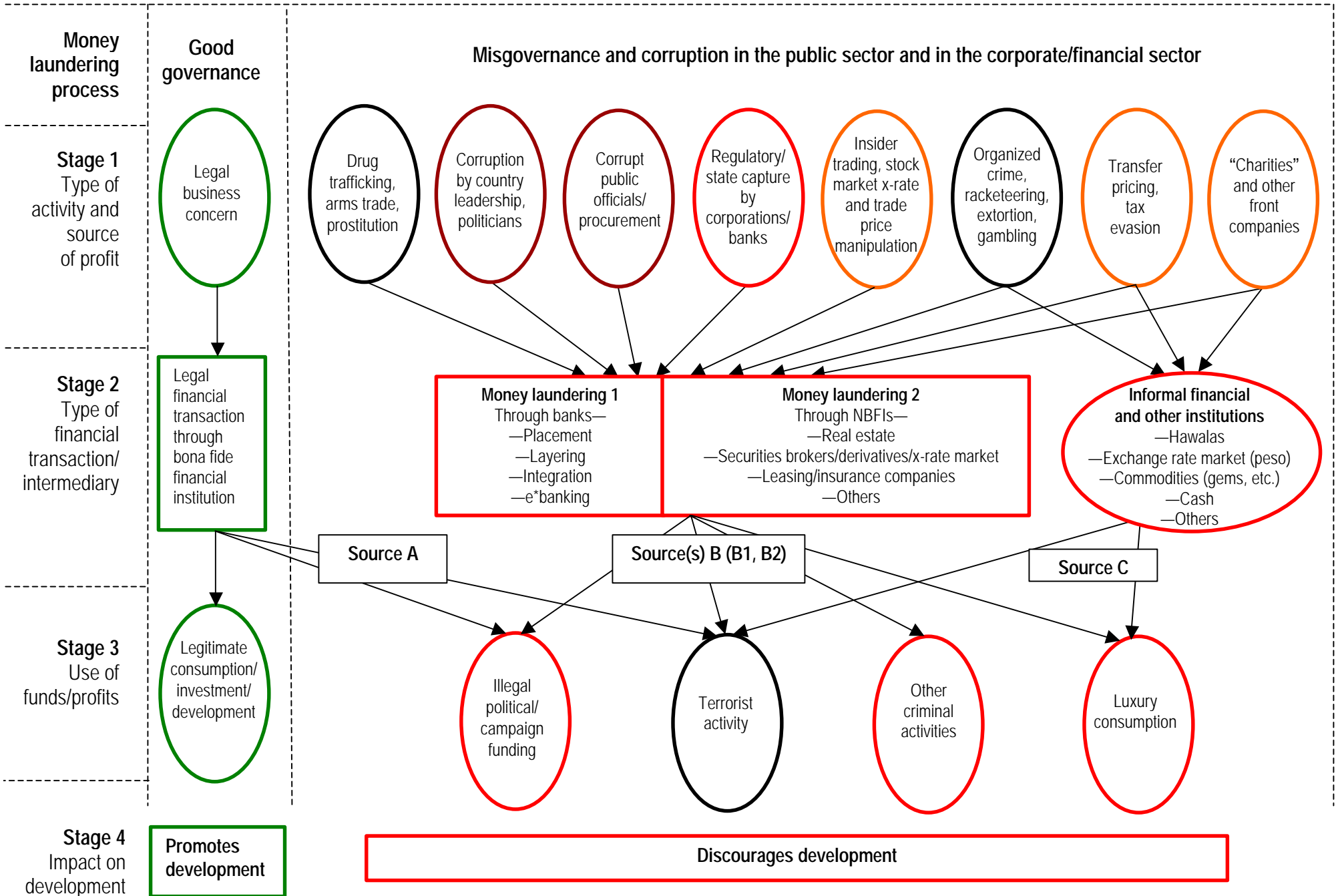
- A deeper understanding of the not-so-simple relationships between money laundering and terrorism financing is needed. It is very important in some countries; not as important in others. There are other crucial complexities. Terrorist activities can be financed by profits from so-called legal activities, and not just from illegal and laundered funds. To stop terrorism funding one has to go beyond merely looking at money laundering.
- We must move beyond narrow money laundering rules, laws, and regulations. Surely we will hear today how many new regulations are being passed in this area. Those are important, but on their own they are not going to make most of the difference. Politically, we have to tackle money laundering and terrorism financing as part of a commitment to improve governance in general and fight corruption within the public, private, and financial sectors.
- Finally, on the power of data: being informed through empirical evidence is a major challenge, which will continue to assist in addressing myths and misconceptions in this field, in monitoring progress in this area, as well as in prioritizing measures and actions, and placing AML within a rigorous and more comprehensive governance context. In this respect, further gathering of worldwide information on this issue through surveys and other such diagnostic methods of importance, as is the utilization of simple tools based on economic empiricism. For instance, an estimate of the ‘cut’ that had to be given to intermediaries to implement laundering of funds in the United States in the eighties was in the order of about a 6% fee; while nowadays such estimate exceeds 25%. The extent of the increase in this fee is a simple, powerful, and telling indicator of how much more costly it has become to launder funds (at least in the US), and thus it constitutes one monitoring indicator of progress.



In addition to his role as director for Global Governance, Daniel Kaufmann also directs the World Bank Institute's (WBI) capacity building efforts in Latin America. A recognized leading expert in the field of governance, he has pioneered new empirical and survey methodologies, and with his team he supports countries that request good governance and anticorruption assistance through a rigorous empirical, systemic, and strategy-driven approach. He frequently advises state leaders, governments and civil society. Before joining WBI in 1998 as manager, Dr. Kaufmann was lead economist in the Development Economics Group and also was the first chief of mission in Ukraine in the early nineties. He was a member of the team that produced the 1991 *World Development Report* on distilling the key lessons from development experience. Dr. Kaufmann has published extensively on issues of economic development, privatization, governance, the unofficial economy, industrial and trade restructuring, corruption, transparency, and urban and labor economics. A Chilean national, he

received bachelor degrees in economics and statistics from the Hebrew University of Jerusalem, and an M.A. and Ph.D. in economics from Harvard University, where he was also a visiting scholar in the late nineties.

Chart: 'Not a Simple "Laundromat"': Money Laundering in a Broader Framework



# Money Laundering and its Broader Context

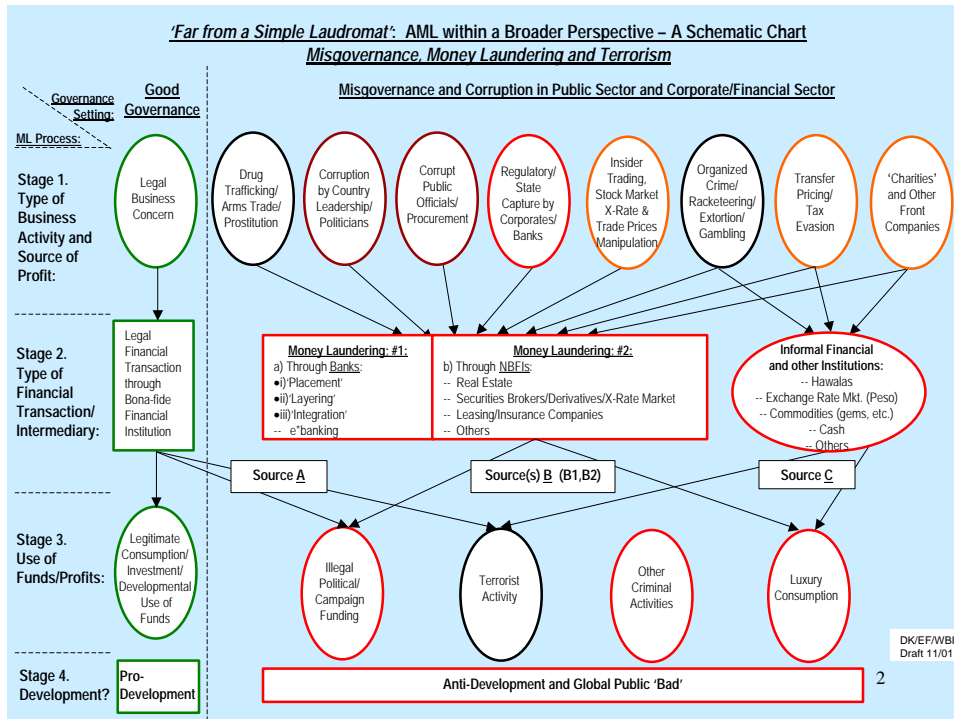
*Public, Private, and Financial Sector Governance Matters Enormously to a Diagnosis and Understanding of the Causes and Consequences of Money Laundering*

**Daniel Kaufmann, World Bank Institute**

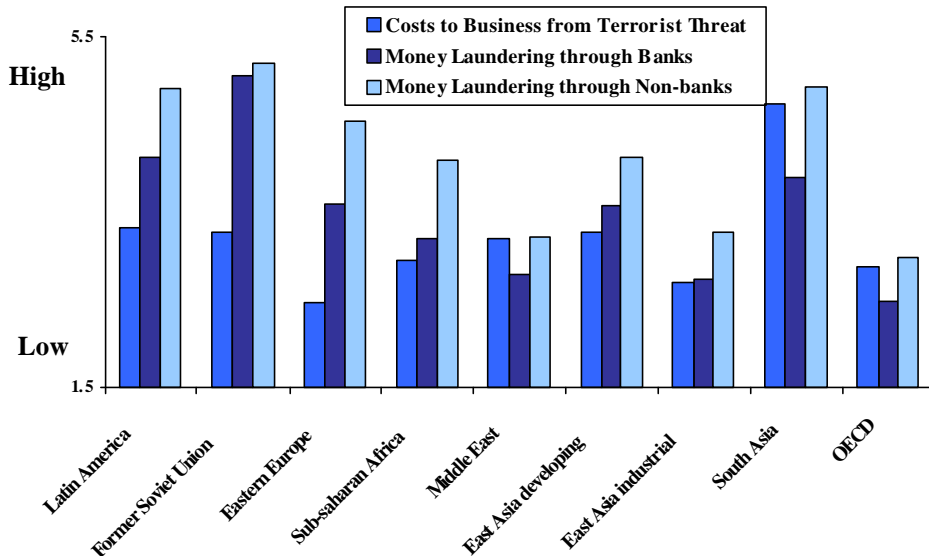
<http://www.worldbank.org/wbi/governance/>

*Background Empirical Materials for Discussion*

*Note: All data contained here is preliminary and for discussion only, reflecting research-in-progress.*

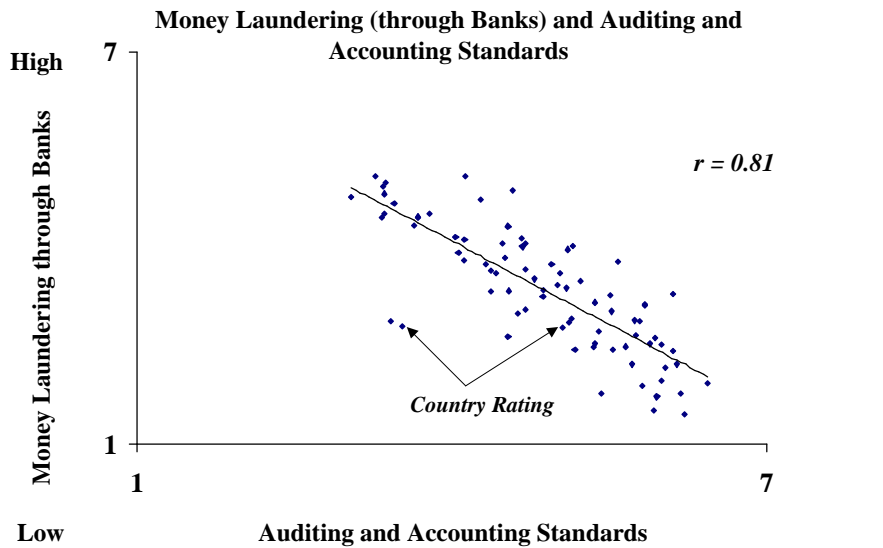


**Money Laundering and Terrorism – 2002 Preliminary  
Regional Averages Based on Reports from Firms in 80 countries**



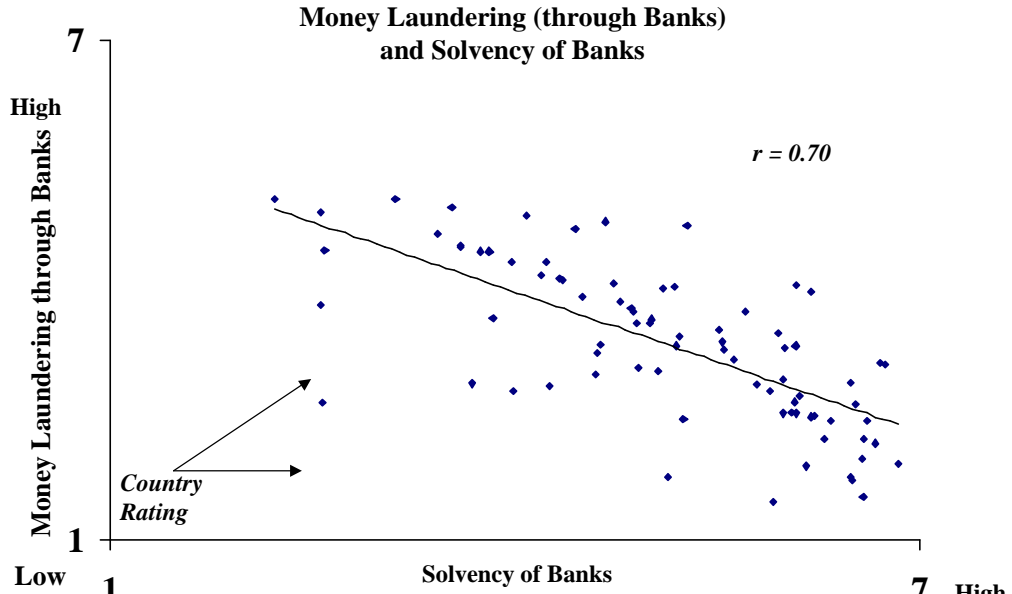
The costs of business from terrorist threat are on the scale from 1 to 7 with possible responses from executives of 1, 2, 3, 4, 5, 6, 7. 1 is "The threat does not impose significant costs on business" and 7 is "It imposes significant costs". Money laundering through the banking system and money laundering through non-bank channels are on the same scale, with 1 being "extremely rare" and 7 "pervasive".

Source: Global Competitiveness Survey 2002.



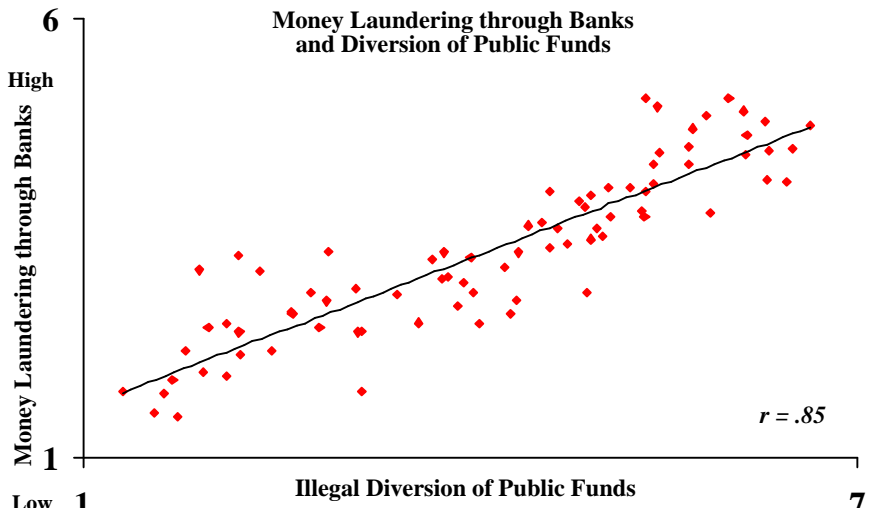
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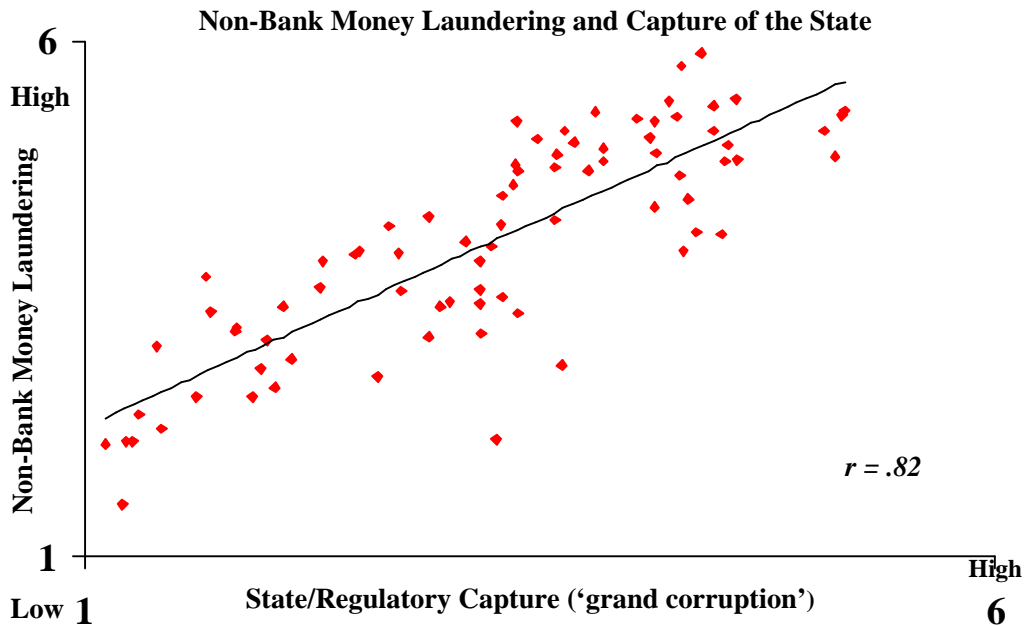
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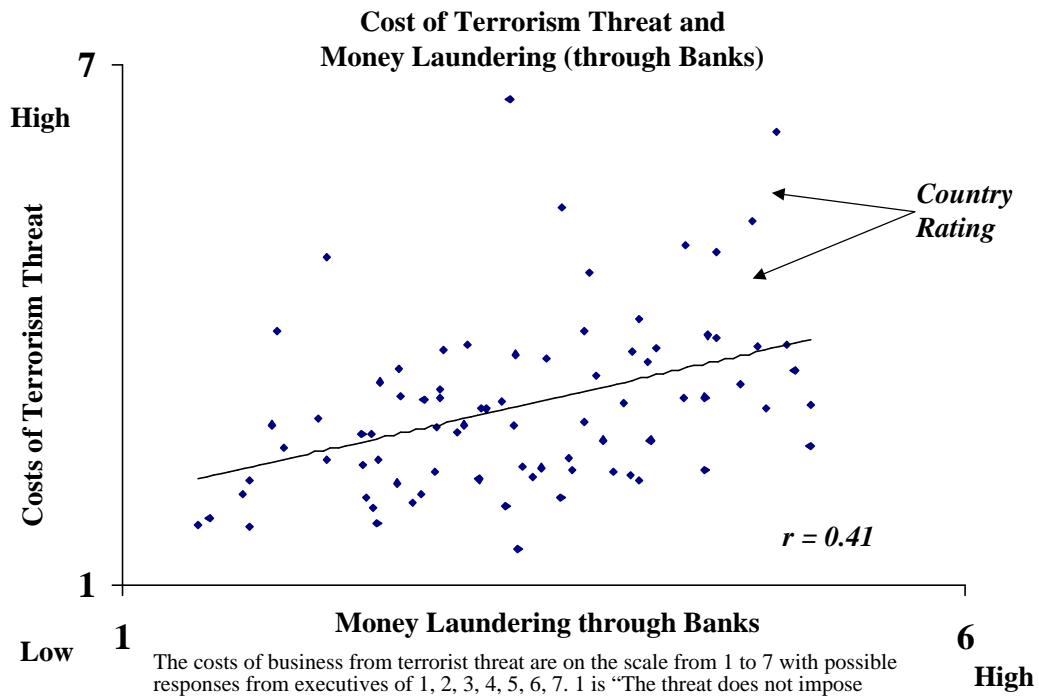
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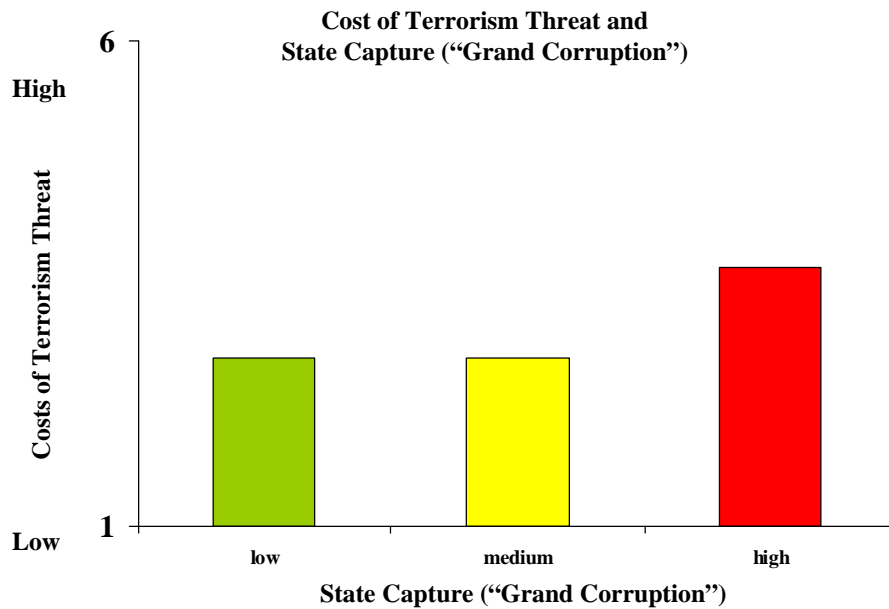
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## Implications of Broadening the AML Framework

- **Understanding/Diagnosing main manifestations of misgovernance and corruption in public and private sector in the country is key for AML – and it varies from country to country**
- **Addressing main sources of laundered funds: is it narco-traffic, organized crime; public sector corruption from the budget or procurement; tax evasion; arms trade, or other source?**
- **Bank vs. Non-Banking Money Laundering: country specifics matter -- non-banking sector may be important in some countries; & within non-banking: *formal vs. informal institutions***
- **Money Laundering and Terrorism Financing: complex link, more important in *some* countries – but terrorism activities can also be financed by profits from ‘quasi-legal’ activities**
- **Actions: Beyond narrow AML rules, laws and regulations alone**
- **The Power of Data & Diagnostics: Measure, Monitor, Control**