A PRIMER ON MONEY LAUNDERING: THE DARK SIDE OF CAPITAL ACCOUNT LIBERALIZATION

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Abstract

As a result of rapid technological advances, widespread regulatory change and continuing globalization of the world economy over the last twenty years, we have witnessed a resumption in the growth in living standards in most countries from their stalled levels in the 1970s. Unfortunately, these changes have also spawned a new growth industry, increased financial crime that has been referred to as “the dark side of capital mobility”. This paper begins with an overview of financial crime – conventionally defined as money laundering, tax evasion, and a relatively new component, financing terrorism. The paper presents some very rough estimates of the magnitude of financial crime, as well as its relative position with respect to GDP, investment and aid flows. After describing some of the principal actors in this new “field”, the paper provides a short review of the major national and international initiatives in place and those planned to arrest the growth of financial crime in the next decade. This paper was presented at the 12th international conference in Bangkok, Thailand, May 2002.
INTRODUCTION

Since the mid-1980s, in the wake of the stalled growth in living standards during the 1970s, most people in the developed countries and many in the developing countries are enjoying ever greater levels of material well-being that includes not only higher real per capita income but also more choices, lower prices and/or better quality of most consumer goods and services (Mandel, 2002). This improvement in living standards ranges from the increasing availability (at affordable prices) of summer fruits in the middle of winter – even in remote rural areas - or new, less costly and/or higher quality consumer audio-visual and communications products – once the privilege of the very wealthy – to virtually unbounded choices in clothing, personal care and home furnishing products.

Turning to services – the major component of consumer spending in developed countries – even in spite of occasional (and temporary) reversals, for example, those stemming from the September 11, 2001 attacks on New York and Washington, the flying public enjoys a safer, less costly and more efficient air transport system than was the case twenty years ago. The improvement in the provision and delivery of leisure-time products and services ranging from high-definition, direct satellite and cable television to more non-standard “open hours” for museums, concert halls, sporting events and shopping – of both the “bricks and mortar” and “on-line” varieties – provide much-needed flexibility and convenience towards relaxing time constraints for an increasingly harried workforce. Even in the education, health care and pension systems – often considered to be the “Achilles heels” of the American economy (and, for that matter, most of the other developed economies) – new technologies and regulatory changes, as well as greater political pressures, are forcing changes and, hopefully, improvements in the delivery of these essential services, if not yet in the financing of these programs.

To be sure, improved living standards for most in the developed countries and for many in the developing countries since the mid-1980s are the result of a “cocktail” that has sparked economic and financial change in most countries. This “trinity of catalysts” is the subject of Part I of this paper. Alongside the plethora of material benefits introduced over the last two decades as a result of this “trinity of catalysts”, our economic system also generates “economic bards” (or negative externalities in the jargon of economists) such as environmental degradation and other economic blemishes such as high levels of traffic congestion and excessive noise levels. This “trinity of catalysts” has spawned increased growth in another negative “by-product” of the system – international financial crime. In addition to developing the links between these catalysts and international financial crime, Part II describes the principal constituent parts of this new “growth industry” --
money laundering, tax evasion, and, as a result of the 9/11 attacks on the US, financing terrorist activities.

Part III of the paper provides some “ballpark” monetary estimates of the scope of this “industry” and Part IV serves as a “who’s who” and “what’s what” in the “field” of international financial crime, defining, classifying, and analyzing some of the leading institutions, key instruments, and principal “actors” that play a role in these activities. This part of the paper also describes and analyzes the major existing and planned international initiatives and some of the national efforts already established to combat financial crime, which, in the wake of the 9/11 attacks, also incorporates financing terrorist organizations. The paper concludes with some remarks concerning the prospects for mobilizing the stocks of assets accumulated from international financial crime for the purposes of large-scale worldwide poverty reduction, a topic that, in light of the recent United Nations Conference on Financing Development held in Monterrey, Mexico in March 2002, is unmistakably visible on the “radar screens” of top policymakers in the developed countries and the leading international development institutions. It is important to state at the outset that this paper serves as a “primer” on the subject – some “exploratory” remarks - that I expect will be “developed”, “processed”, and “refined”, like a newly discovered lode of minerals, over the next few years. Therefore, it is hoped that this paper will raise more questions than it answers on a subject that is certain to assume a key role on the stage of international finance in this decade and beyond.

PART I: THE ROOTS OF FINANCIAL INNOVATION

One of the themes developed in this paper is that the underlying causes for the growth of international financial crime over the last two decades are the same that are responsible for the plethora of financial innovations that have been introduced in the US and throughout the increasingly globalized world economy over the same time period (Chancellor, 1999; Morris, 1999). Consequently, before examining the subject of international financial crime it would be useful to enumerate these underlying causes of financial innovation along with examples that demonstrate the contribution these innovations have made towards increasing living standards.

In addition to the broad-based field of economics, the more narrowly circumscribed sub-field of finance has also benefited from powerful and widespread technological advances introduced into the information technology and communications sectors over the last two decades. Advances in both computer hardware and software enable investors, bankers, corporate management teams, financial analysts and government officials to describe and analyze complex financial projects more easily and permit them to make more
informed and faster decisions than was the case twenty years ago. For example, because of technological changes introduced in the financial services sector, more and more of the dissemination of financial information is accessed online. In addition, the steady increase in the sale and purchase of financial products, in turn, provides more transparency, better prices for both buyers and sellers, more liquidity for the investing public, and lower transactions costs.

A second major source of financial innovation during the last two decades is financial liberalization that is often associated with deregulation or, more generally, regulatory and/or institutional change, that also incorporates tax reform. Examples of these include: important institutional changes that are being planned in the developed countries in response to a much-needed over-haul of state-financed and directed pension systems, global accords on risk-adjusted capital adequacy requirements for international banks are being revised to accommodate the new financial environment, and the new initiatives to standardize (and, in the wake of the Enron and WorldCom debacles, to accelerate the reform of) accounting standards and corporate governance structures in the US and throughout the world.

In the US, a once-in-a-generation bank regulatory overhaul that repealed the depression era Glass-Steagall Act with the passage of the 1999 Financial Modernization Act – legislation that required 15 years of negotiations to win approval – now provides the US financial system with an appropriate regulatory regime for the financial environment of the 21st century. As a result of this new banking framework, numerous mergers of commercial banks with other commercial banks, investment banks and insurance companies is, as predicted, providing consumers with “one-stop shopping” for financial services, and reducing costs and increasing the efficiency of financial services firms. The adoption, after a decade of meticulous preparation, of a single-currency in 12 of the 15 EU member countries, along with need to attend to some “unfinished business” such as a community-wide policy on mergers and acquisitions, the creation of a single market for financial services, deregulation of the EU’s energy sector, and reform of its labor market, are sure to enhance the EU’s competitiveness in the world economy and, ultimately, to an improvement in future European living standards.

The third “tectonic plate” on which the field of finances rests is globalization: the adoption of harmonized rules and conventions governing trade, capital flows and foreign investment. Transition and emerging-market economies need to improve their business environments by implementing far-reaching (and often painful) economic and reform programs that include – but are not limited to – providing fiscal and monetary discipline, improving the efficiency of their public sectors, implementing privatization programs to increase the efficiency of state-owned and –operated assets, modernizing regulatory codes, reforming and
liberalizing their financial systems, reducing the level of public and private sector corruption, strengthening their legal systems, promoting trade liberalization and regional integration and eliminating barriers to direct foreign investment, and adopting unified and competitive exchange rate regimes. Needless to say, without the proper business environment, transition and emerging-market countries will be unable to attract and retain financial capital from both domestic and foreign sources that can be used to introduce new technology to the end of increasing productivity and reducing borrowing costs by accessing the international capital markets.

It is important to state that globalizing a national economy is not a one-way bet. We have witnessed, with too much regularity since the mid-1990s, the downside risk of a stalled reform program and/or the failure to modernize antiquated institutions with new structures that are appropriate to meet the needs of the global economy in the 21st century. Financial tremors rattled the world economy almost every year since 1995 as Mexico, some Asian countries, Russia, Brazil, Turkey, Ecuador and, most recently, Argentina all experienced major economic and financial crises. Despite these tremors, membership in the World Trade Organization continues to grow—with the accession of China in 2001 after 15 years of tortuous negotiations—and capital account and exchange rate liberalization continue to be objectives that many, if not most, developing countries are committed to achieve. Almost all countries perceive that globalizing their national economies is in their interest despite the very vocal (and often violent) anti-globalization protests—not all of which are entirely frivolous—witnessed over the last three years.

In conclusion, these powerful “catalysts”—technological advance, regulatory change and globalization—are the main sources of economic and financial progress that have restored the growth in living standards in almost all developed and many developing countries over the last two decades.

PART II: INTERNATIONAL FINANCIAL CRIME: A BY-PRODUCT SPAWNED BY THE “TRINITY OF CATALYSTS”.

Not all the “products” spawned by technological change, deregulation and globalization can be considered to enhance material well being. For example, the ever-increasing world-wide use of fossil fuels to power economic growth has generated a heated debate in the scientific and environmental communities—and, to be sure, among politicians and economists—on the most appropriate mechanism for reducing, if not the absolute level, at least the growth rate in the emission of these “greenhouse” substances. Even though the Bush administration has rejected the 1997 Kyoto protocol as fatally flawed because it fails to include developing countries as participants in the required actions to correct the
“emissions problem”, adopting a global mechanism continues to be in the forefront of policy debate between and among developed and developing countries, even into seemingly unrelated global initiatives such as the launch of a new global trade round, and is sure to figure prominently at the UN World Summit on Sustainable Development in Johannesburg in August 2002. While the controversy continues over the appropriate solution to the problem, there is increasing evidence that the powerful forces exerted by technological change, regulatory and institutional change, and globalization on promoting world-wide economic growth and development are responsible for the increasing amounts of “greenhouse” gases in the atmosphere.

Similarly in the financial services sector, technological advances along with domestic and international regulatory changes, for example, exchange rate and capital account liberalization, have combined to reduce the cost and enhance the efficiency for “ordinary” people to transfer financial assets throughout the international financial system seamlessly and with high degrees of anonymity, even as these funds navigate through different (and, possibly more friendly) legal and tax jurisdictions (Winer, 2002). Some of these financial assets (and/or the income derived from them) are associated with the three main categories of international financial crime: money laundering, tax evasion, and, in the wake of the 9/11 attacks on the US, financing terrorism.

Money laundering is defined as the processing of funds that are generated by criminal acts in order to disguise their illegal origin. Money laundering, according to Stuart Eisenstadt, deputy Secretary of the Treasury in the Clinton administration, is becoming a serious issue for policy-makers because it has “the potential to cause serious macro-economic distortions, misallocate capital and resources, increase the risks to a country’s financial sector, and hurt the credibility of the international monetary system” (Dunne, 2000). If carried out “properly”, money laundering enables criminals to enjoy the profits from criminal acts without jeopardizing their source. Profits from illegal arms sales, drug trafficking, illegal prostitution, embezzlement, insider trading, bribery, computer fraud, trafficking in stolen and smuggled art and antiquities, and the theft of national assets by corrupt political or military leaders are the typical sources of funds that are being laundered so these resources can re-enter the global financial markets and be “legitimized”. Needless to say, some of these activities do have their legitimate counter-parts. For example, there is, and has been, a flourishing international market for art and antiquities, and there is a large and vibrant international market for authorized arms sales.

In addition, as international norms evolve and national legal codes change over time, economic activities that were once considered to be legal can and do become illegal and vice versa, and activities that are considered to be criminal in one country are not necessarily considered to be criminal in others. For example,
it is well known that in the US from 1920-33 it was illegal to manufacture, sell or transport (though, curiously, not to consume!) intoxicating liquors. It is important to note that the legendary Al Capone was never convicted of murder but was prosecuted for and convicted of tax evasion on his illegal income from smuggling and selling legally-produced Canadian liquor! And today, a modern-day legal asymmetry between the US and Switzerland with regard to tax evasion is at the heart of an ongoing and heated international dispute.

Another example that serves to highlight the role of “legal arbitrage” concerns asymmetric legislation regarding bribery in different countries. In 1977, the US Congress passed the Foreign Corrupt Practices Act (FCPA) that outlaws the payment of bribes by American firms to foreign officials, political parties, party officials and candidates. In some European countries, until the 1997 Convention on Bribery was signed, bribes paid by European companies to advance their business interests abroad was not only legal, but, quite logically, a legitimate business expense, and, therefore, tax deductible! Another interesting example to frustrate anti-bribery legislation occurs when laws are enacted to prohibit accepting bribes but do not outlaw paying bribes and vice versa! The recent trial of Alfred Taubman, the former chairman of the auction house Sotheby’s, who was accused of price-fixing along with his counterpart at Christie’s, Sir Anthony Tenant, offers another example. Mr. Taubman was tried, convicted and sentenced to a year in jail, while, his colleague, who was also indicted, remains free in England, because price-fixing in Britain, as in most countries, is not yet considered a crime. Therefore, Sir Anthony’s extradition to the US to face trial for his alleged crimes would be illegal under British law.

In 2000, tax evasion in the US was estimated at $200bn (www.nationalissues.com). US citizens, whose tax liability is assessed on global income, have powerful tax incentives to move money to offshore banking jurisdictions that offer bank secrecy. While the original source of these offshore funds may not be of an illegal nature, the income earned by these funds, if undeclared by the owner, would escape the reach of US tax authorities. It is important to distinguish between tax evasion, which is a criminal offense in the US -- though not in Switzerland -- and tax avoidance, an activity that is not only legal, but is often encouraged in the quest to maximize shareholder wealth and investors’ returns. For example, when US corporations are registered, as is increasingly being done, in one of the off-shore financial centers, one motive among possible others, is not only to avoid paying taxes on income generated outside the United States, but also to reduce taxes on profits earned in the US by exploiting legal loopholes in accounting regulations (Johnston, 2002).

Finally, since the September 11 terrorist attacks on the US a major global effort (under the leadership of the Paris-based Financial Action Task Force, see below) is being forged to starve terrorists of their financial sustenance, that is, to
freeze assets that are suspected of belonging to terrorists, and of organizations that are suspected of being “fronts” to collect funds destined to finance terrorist activities. This would constitute a reversal of the classic money laundering problem: identifying and seizing assets suspected of being directed to finance illegal activities which may have as their source entirely legal activities. Money laundering, on the other hand, is conventionally defined as money originating from illegal activities, that, by the use of international financial system, is being “cleansed” so these resources can re-enter the global financial markets and be “legitimized”.

Needless to say, without these necessary ingredients in place – globalization, deregulation, and advanced technology (at affordable cost) – the levels of these financial crimes would be appreciably lower. Regrettably, the ongoing democratization of finance that we have enjoyed over the last two decades has also been accompanied by an increase in financial crime that prompted Stuart Eisenstadt, former deputy Secretary of the Treasury in the Clinton administration, to refer to money laundering in particular, as “the dark side of capital mobility” (Dunne, 2000).

PART III: FINANCIAL CRIME: AN OVERVIEW AND SOME ROUGH ESTIMATES.

Before examining the principal actors and conventions in the field of international financial crime it would be useful to provide some estimates – admittedly “soft” and highly unreliable – of the magnitude of “shadow” global economic activity, which is the source of the profits, that, over time, generates the financial assets that are eventually recycled into the “formal” world economy. “Formal” global gross domestic product (GDP) has been estimated at $40tr (Burki, 2001), and the global “shadow” economy has been estimated at approximately 25% of global GDP, a dollar magnitude that approaches annual US GDP (The Economist, 1999). As far as the breakdown of this sum of annual “shadow” GDP between developed and developing countries is concerned, about $3.6tr, an amount equal to around 15% of the annual GDP of all developed countries, has its source in developed countries, and $5.9tr, or around 33% of annual GDP in all developing countries, originates in developing countries (The Economist, 1999).

For the purposes of appreciating the scale of “illegal” economic activities, annual global cross-border investment flows range from $1-1.25tr, of which approximately $200 – 250bn flows to developing countries (Williams, 2000; Quinlan, 2001). The total amount of official development aid granted by developed countries in 2000 was approximately $50bn (Hoyas and Beattie, 2002). The International Monetary Fund (IMF) reckons that between $600-1,500bn of profits from illegal drugs and other crimes are laundered every year, i.e., from 1.5

Some of the most publicized cases of money laundering concern corrupt national leaders and their subordinates – known as kleptocrats-- who have transferred enormous amounts of state funds to private accounts in financial centers outside their countries. For example, the former Nigerian dictator, General Sani Abacha and his associates, reportedly stole approximately $4bn of state-owned funds, the equivalent of 10% of Nigeria’s GDP in 2000, most of which was deposited into Swiss and UK banks (Willman et al, 2000). During the 1980s, Philippine president, Ferdinand Marcos, along with family members and associates, allegedly transferred more than $500m of state-owned funds to Switzerland (Olson, 2000). Other national leaders and high-level officials accused of diverting state funds to “off-shore” financial centers include Joseph Estrada, the ousted president of the Philippines, deposed Haitian dictator Francois “Papa Doc” Duvalier, Mobutu Sese Seko of Zaire, Raul Salinas, the disgraced brother of former Mexican president Carlos Salinas, Slobodan Milosevic, the former president of Yugoslavia, and Suharto, the former president of Indonesia (Truman, 2001).

In 1999, the Bank of New York was used by Russian criminals to launder an estimated $7-10bn (O’Brien, 2000; Alden, 2001) and the Russian government estimated that, in the late 1990s, money laundering accounted for the movement of $20bn every year (Wines, 2001). It is estimated that a third of all private “off-shore” wealth is managed in Switzerland, with much of it avoiding taxes in customers’ home countries. (Hall, 2001). The Cayman Islands, in the Caribbean, with more than 500 banks and 47,000 registered and licensed partnerships, has an estimated $500-800 bn of bank deposits, equal to roughly one-third of all US bank deposits (Allen, 2000; Gonzalez, 2002). Finally, the Enron Corporation, which has been in the news a few times these last few months, among everything else, had established almost 1000 subsidiaries in “off-shore” jurisdictions thereby avoiding to pay US corporate income taxes for the last four years (James, 2002).

On the subject of foregone tax revenues, the US Internal Revenue Service (IRS) estimates that more than $70bn in personal tax revenue is lost each year because of Caribbean tax havens (Johnston, 2000; Sullivan, 2002), and the Citizens for Tax Justice, a non-partisan Washington research group, estimates that the US Treasury loses tens of billions of dollars a year in revenue when US corporations report profits from activities that were allegedly undertaken in lower tax jurisdictions (Phillips, 2001). World-wide, annual tax revenue losses resulting from funds deposited in “off-shore” tax havens has been estimated in the hundreds of billions of dollars (Johnston, 2000), and even the treasuries of developing countries are not spared. Oxfam, the international aid agency, estimates that developing countries lose at least $50bn a year in tax revenue to
“off-shore” tax havens, a sum equal to the total amount of annual official development aid provided to poor countries by developed economies (Horner, 2001).

PART IV: DRAMATIS PERSONNE: WHO’S WHO IN THE INDUSTRY?
OFF-SHORE FINANCIAL CENTERS

Offshore financial centers are generally assumed to be island nations or territories in the Caribbean or in the Pacific, such as the Bahamas, the Cayman Islands, Nauru, and Vanuatu. In fact, some of the largest are in Europe – Liechtenstein, Monaco, Gibraltar, and Jersey, to name a few. Their “off-shore” status is earned by serving as a banking center for non-resident funds leading to suspicions that some centers are attracting funds that are escaping taxation in the depositor’s home country and/or these funds are the result of ill-gotten profits and are being “laundered”. Worldwide, at the end of 2000, offshore banks controlled an estimated $5-6tr in assets (The Economist, 2001a; Peel, 2000).

In 1998, there were nearly 4,000 off-shore banks licensed by some 60 off-shore jurisdictions: 44% of the banks were in the Caribbean and Latin America, 28% in Europe, 18% in the Asia/Pacific region, and 10% in the Middle East and Africa. The Pacific atoll of Nauru, whose population is 12,000, has 450 banks registered to a single government post-office box. The Bahamas, which has no income tax, and, therefore, has no tax treaty with any country, has 400 banks and trust companies and 600 mutual funds which together manage $600bn in assets (Pascual, 2000). Often, these offshore centers are referred to as SDEs (small and developing economies) or “no-oil-no soil economies” — economies lacking natural resources and overly dependent on tourism and commodities for their material well being. Officials from these offshore centers contend that they were encouraged by the World Bank to diversify their economies towards higher valued financial services. Offshore finance accounts for approximately 30% of the GDP of the jurisdictions that were accused of engaging in harmful tax practices (see below). One former owner of a Caribbean offshore bank, testifying before a US Senate subcommittee said, “that about 95% of his clients were US citizens looking to evade taxes” (Alden, 2001).

HARMFUL TAX HAVENS AND HARMFUL TAX PRACTICES

According to the Organization for Economic Cooperation and Development (OECD), a tax haven is “a regime that imposes no more than nominal taxes; allows non-residents to escape taxation in their country of residence; and engages in harmful tax practices, characterized by either a refusal to exchange information, ‘a lack of transparency’ or a desire to attract ‘businesses with no substantial activities’”(The Economist, 2000). However, critics contend that one
country’s tax evasion is another’s tax avoidance, and one’s “lack of transparency” is another’s “respect for privacy”. In June, 2000, the Paris-based organization of 30 rich-countries, published a list of offshore financial centers that face economic sanctions – such as scrapping favorable tax treaties with OECD members -- unless they take remedial actions on improving the transparency and supervision of their financial sectors to the end of curbing tax evasion by non-resident depositors.

According to the OECD, in addition to low taxation, the criteria that have earned off-shore financial centers the designation of a “harmful tax haven” are insufficient transparency of their corporations that includes no requirements to publish accounts or lists of directors and shareholders and the absence of rules on the exchange of information with other tax authorities. (Peel and Adams, 2000). OECD members are supposed to abolish any harmful tax practices by April 2003, and tax havens outside the organization have until 2005.

Below is the original list of 35 jurisdictions identified as tax havens by the OECD in June 2000.

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The efforts to persuade the jurisdictions accused of being tax havens to cooperate with the OECD’s global initiative to improve the regulation and transparency of their financial sectors can be measured by the success to date. As of April 2002, only 7 of the original 35 jurisdictions designated by the OECD as Harmful Tax Havens in June 2000 remain on the list that carries a threat of economic sanctions. These 7 jurisdictions are: Andorra, Liberia, Liechtenstein, Liberia, Monaco, Nauru, and Vanuatu. The other 28 have either given commitments “to lift the veil of secrecy surrounding their tax and regulatory systems” or have already done so (Rhoads, 2002).

None of the 35 jurisdictions on the original OECD “blacklist” are member OECD countries. Some of these countries have criticized the OECD initiative...
because both Switzerland and Luxembourg, which are members of the OECD, have been cited as practicing harmful tax competition by the OECD, and both remain “permanent abstainers” from the initiative against harmful tax practices (Parker and Guerrera, 2002). As a result, Switzerland and Luxembourg could face financial sanctions if they continue to refuse to commit themselves to the OECD initiative against harmful tax practices.

In addition to the OECD’s international initiative to eliminate harmful tax practices, tracking down suspected income tax evasion is also proceeding in both the US and the EU through bilateral agreements with alleged “off-shore” financial centers. For example, in December 2001, an agreement between the US and the Cayman Islands was signed that calls for the Cayman Islands to cooperate with American tax investigators, starting in 2004, by sharing information that would help the US track down suspected income tax evaders. Since the Cayman Islands is the most important financial center in the Caribbean, the agreement, despite the two year lag before it is implemented, does serve as an early warning to tax cheats that the era of secret offshore bank accounts will eventually end (Johnston, 2001).

Critics of the OECD program to eliminate harmful tax practices in offshore financial jurisdictions contend that the OECD – comprised of countries with high tax-regimes -- is simply an attack on governments’ sovereign right to determine their own tax rates and systems, and attempts to extinguish healthy tax competition that would encourage capital to be employed in the most productive way. Furthermore, encouraging tax competition would force high tax countries to lower tax rates and government expenditures, thereby enhancing growth prospects. Until the September 11 attacks on the US, the Bush administration provided only tepid support for the OECD initiative, but has now fully endorsed the threat of sanctions against non-complying jurisdictions as G7 governments have engaged the OECD task force on money laundering (see below) to play a major role in the fight against financing terrorism.

CORRESPONDENT BANKS AND SHELL BANKS

“Correspondent banks”, which play a prominent role in laundering money, are defined as banks that have their own account at another bank which they make available to their customers. The billions of dollars laundered by Russians through the Bank of New York (see page 13, above) made use of correspondent banks. In a recent report undertaken by the U.S Senate, three quarters of the big banks surveyed had over 1,000 correspondent relationships apiece that were used to launder millions of dollars gained by illegal activities (Alden, 2001). Often, funds being laundered are wired to a bank outside the country, but these funds could actually still reside in the original country if the foreign bank has a correspondent account in a bank in the original country.
The worst offenders are “shell” or “brass plate” banks, which have no legitimate business purpose. Shell banks are usually registered in jurisdictions with tight banking secrecy laws. Most new shell banks are created by fringe jurisdictions, such as Nauru and Vanuatu, since some of the major offshore centers such as the Cayman Islands and the Bahamas no longer issue shell bank licenses. A new US law, passed in October 2001, requires US banks and securities firms to cut off correspondent accounts with foreign banks that maintain no physical presence in any country, i.e., “shell banks”. Clearly, regulatory clarification will be needed to accommodate Internet banks, which have legitimate business activities, yet because of technological advances, might have no physical presence, anywhere.

COMBATING MONEY LAUNDERING

The US passed the world’s first law explicitly directed at money laundering in 1986. The Money Laundering Control Act “made it a crime for a person knowingly to engage in a financial transaction involving the proceeds of a ‘specified unlawful activity’” (The Economist, 2001a). As might be expected, the battle to combat money laundering is increasingly global because of globalization, technological advance and regulatory change. As a result, a multilateral effort is required that will have to incorporate not only banks, but the entire financial services sector that includes mutual funds, brokerage firms, check-cashing and foreign currency exchange services, commodities dealers and credit card companies. As a part of the anti-terrorist legislation, known as the USA Patriot Act, that was signed into law in October 2001, all of the above financial services companies -- not only banks which are already complying with these regulations – are required to have a formal policy on combating money laundering, put an executive in charge of carrying it out, train employees to know what to look for and undergo independent audits to evaluate their compliance with the new regulations. Other financial institutions and industries, such as insurance companies, venture capital firms, hedge funds, travel agents and automobile dealers, -- all of whom might handle large sums of money -- will eventually also have to comply with similar rules, according to the Treasury Department (Stevenson and Wayne, 2002).

The most important inter-governmental body that is responsible for developing and promoting policies, both nationally and internationally, to combat money laundering is the Financial Action Task Force (FATF), which was established at the G-7 summit in Paris in 1989, and is based in the OECD in Paris. One of the first tasks of the FATF was to develop a set of Forty Recommendations, which provides a comprehensive blueprint of the action
needed to fight against money laundering. The basic obligations contained in the Recommendations are:

1. The criminalization of the laundering of the proceeds of serious crimes (Recommendation 4) and the enactment of laws to seize and confiscate the proceeds of crime (Recommendation 7).

2. Obligations for financial institutions to identify all clients, including any beneficial owners of property, and to keep appropriate records (Recommendations 10 to 12).

3. A requirement for financial institutions to report suspicious transactions to the competent national authorities (Recommendation 15), and to implement a comprehensive range of internal control measures (Recommendation 19).

4. Adequate systems for the control and supervision of financial institutions (Recommendations 26 to 29).

5. The need to enter into international treaties or agreements and to pass national legislation which will allow countries to provide prompt and effective international co-operation at all levels (Recommendations 32 to 40).

A complete list of the Forty Recommendations, which were revised in 1996 and are in the process of being further updated to incorporate changes in money laundering trends, to anticipate potential future threats, and to account for the growing involvement of lawyers, security firms, accountants and real estate agents in money laundering activities, is available from the FATF (www.oecd.org/fatf).

In June 2000, the FATF published a blacklist of 15 jurisdictions -- not unlike the OECD’s list of 35 jurisdictions accused of engaging in harmful tax competition (see p.16, above),-- who were deemed to be “non-cooperative” with the task force’s anti-money laundering efforts. The jurisdictions are: The Bahamas, the Cayman Islands, Panama, Dominica, St. Kitts and Nevis, St. Vincent and The Grenadines, Russia, Liechtenstein, Lebanon, Israel, Philippines, Cook Islands, Marshall Islands, Nauru, and Niue.

Since the publication of the list, legal reforms introduced in the Bahamas, the Cayman Islands, Liechtenstein, and Panama have addressed the deficiencies identified by the FATF sufficiently to merit their withdrawal from the list. In seven other jurisdictions, the FATF noted that progress is being made to address
the deficiencies, and six new jurisdictions have been added: Egypt, Guatemala, Hungary, Indonesia, Myanmar and Nigeria.

Conclusions

The war against financial crime is clearly in its infancy. It will be fought with the same tools that financial criminals rely on to carry on their activities: a technological base that is being continually upgraded, and mastering legal, accounting and other regulatory asymmetries in an increasingly globalized and democratized financial arena. Giancarlo Caselli, an Italian magistrate, recently remarked that “organized crime is using methods from the 21st century, but police and magistrates in Europe are still operating with procedures from the 19th century” (Gumbel, 2001).

The multi-lateral efforts discussed above are being spearheaded by the OECD (on tax evasion) and its sister organization, the FATF (on money laundering and, more recently, on financing terrorism). They are putting in place comprehensive regulations that incorporate “on-shore” and “off-shore” financial centers that require similar guidelines for all members of the financial services sector, as well as other sectors of the economy that handle large amounts of money. Obviously, the role played by national governments in legislating, monitoring and enforcing the internationally agreed codes is critical for the success of this global initiative. Compliance costs imposed on the financial services sector must not be oppressive, and the delicate task of separating the “sheep from the goats”, that is, distinguishing between the movement of funds that are suspected of being involved in financial crime and those with legitimate business intent is central in the battle against financial crime.

As financial criminals engage savvy financial engineers to exploit regulatory loopholes and new technologies, there is a need for “smarter” government that will be willing and able to use “unconventional” methods to entrap alleged perpetrators of financial crime. For example, in the transportation sector, in order to prevent hijackings, increasingly, trucks, equipped with transponders, are being tracked by satellite, and, when necessary, the engine can be shut down by remote control, disabling the vehicle (Nieves and Revkin, 2001). Or, in the agricultural sector, in the United Kingdom, in order to improve food safety, all new-born calves are being fitted with microprocessors that act as “ passports”, tracking the movement of these animals from farm to farm throughout their lives (The Economist, 2001b).

Earlier this year the Securities and Exchange Commission, the regulator of US securities markets, in order to educate investors about the dangers of being swindled, created a website for a bogus company complete with financial reports and a statement by a stock analyst praising the company, along with an “invest now” section. In one weekend, the site drew more than 120,000 hits from curious investors (Labate, 2002). In yet another unconventional, though successful,
scheme some years ago, in order to capture a number of fugitives from justice, the FBI lured these individuals to a local school in suburban Washington, DC under the pretense of awarding them tickets to a Redskins game, the local football team. Once the group was assembled, the doors were locked, and an FBI agent dutifully announced that they were all under arrest!

Finally, to be sure one of the major issues confronting the world economy in the 21st century is the prospect for a large-scale reduction in the poverty rate. With aid budgets already strained, where will the resources come from? A future paper will explore the prospects for allocating seized assets from financial crime and redirecting them for the purposes of fighting worldwide poverty and promoting development.

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