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**GLOBAL SURVEILLANCE OF DIRTY MONEY:
ASSESSING ASSESSMENTS
OF REGIMES
TO CONTROL MONEY-LAUNDERING
AND
COMBAT THE FINANCING OF TERRORISM**

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The conclusions in this Report remain those of the Center team only.

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Executive Summary

The International Monetary Fund's (IMF, Fund) program on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) has been integrally involved in the global system for AML/CFT in coordination with other key players, particularly the Financial Action Task Force (FATF). AML/CFT assessments, whether by the Fund or other assessor bodies, contribute to the key Fund activities of surveillance, financial support and technical assistance in support of domestic and international financial stability. These evaluations are taken seriously by both assessors and assessed.

It is timely to evaluate the IMF's involvement in the AML/CFT system and to reconsider relevant aspects of the FATF standards, methodologies and practices more generally.

The Center on Law and Globalization (CLG) obtained agreement from the IMF to conduct an independent critical analysis of IMF Reports on the Observance of Standards and Codes (ROSCs)¹ during the 3rd round² with the intent that the appraisal of past practices might inform advances in IMF and FATF methodologies and practices. Findings of the study are based on extensive interviews at the IMF and the FATF, detailed analysis of documents, close examination of four IMF assessments, site visits to three countries, and review of related literatures.

This study finds that the IMF has contributed significantly to efforts that will improve the standards and methodology for assessing AML/CFT systems worldwide. The IMF has shown an openness to independent investigation of its practices; a willingness to ask baseline questions about the objectives and efficacy of AML/CFT regimes; a commitment to experimentation in assessment techniques; an impetus to clarify AML/CFT goals and objectives; leadership in the drive for assessments to appraise whether effective outcomes have resulted from implementation of standards; an investment in highly-qualified experienced assessment teams; undertaken initiatives to find new forms of valid and reliable data; intentions to forge tighter linkages between specific AML/CFT tools and targeted problems in financial systems, e.g., tax evasion, corruption; and effectiveness in raising donor moneys to invest in technical assistance to countries in need of reforms.

I. Objectives

Explicit objectives are necessary for effective implementation and assessment of regimes to combat money laundering and the financing of terrorism.

¹ See Box 1, p.11.

² The '3rd round' is a short-hand to refer to country assessments undertaken by FATF-related assessor bodies, including the IMF, from 2003 to 2012, under the 2003 FATF Standards and 2004 FATF Methodology. The '4th round' refers to prospective assessments to be undertaken under the revised 2012 Standards and 2013 Methodology.

This study found that in the 3rd round the FATF did not articulate its objectives sufficiently precisely for reliable evaluations. Neither did the FATF anywhere demonstrate that objectives, insofar as they can be specified, are more likely to be reached by compliance with FATF Standards. Instead reliance was placed on the prima facie plausibility of the claim that adherence to the Standards would help reduce money laundering and the financing of terrorism, and collaterally the reduction of serious crimes for gain and terrorism. The FATF and IMF assessments focused almost entirely on formal compliance with FATF standards and whether countries appeared to implement programs. Very little emphasis, if any, was given to program effectiveness and outcome effectiveness.

For the 4th round the IMF shared leadership in two major advances:

- (1) the 2013 FATF Methodology states more refined and precise objectives;
- (2) assessments of AML/CFT regimes in the future will incorporate judgments about outcome effectiveness.

Significant challenges remain if these advances are to be realized in practice.

(1) The FATF objectives are not yet specified sufficiently to undertake outcome assessments. IMF objectives are more expansive insofar as they embrace those of the FATF and in addition seek to use AML/CFT means to promote financial stability and financial integrity within countries and across the international financial system.

(2) No credible scientific evidence has yet been presented that there is a direct relationship between installation of effective AML/CFT regimes and the IMF mandates to produce domestic and international financial stability.

II. Assessment Methodologies and Assessment Practices

Assessments require the capacity to measure or to verify empirically technical and outcome effectiveness. Yet the state of the art for assessing AML/CFT regimes is poorly developed in general and this poses major difficulties for valid assessments that serve FATF and/or IMF objectives. For example, there are both major empirical and conceptual problems in measuring the proceeds of crime, a fundamental outcome for AML/CFT regimes.

Evidentiary Standards. In the 3rd round, efforts to gather valid and reliable evidence for compliance, beyond formal compliance and program implementation, fell below professional standards of evaluations. In the last several years, the IMF took several steps to integrate more data into its assessments. Those constructive steps do not as yet satisfy minimal standards of research on the extent and patterns of money laundering, in particular. The 2013 Methodology opens broad prospects for assessment innovations to produce more valid and reliable evidence salient to FATF and IMF objectives. Realizing these prospects will require considerable effort.

Risk-Based Analysis (RBA). The art and science of risk analysis are poorly developed with respect to money laundering. While the 3rd round introduced the possibility of RBA, it was not substantially integrated into AML/CFT reports. The IMF has actively advocated the stronger emphasis on risk-based approaches in the 2013 Methodology, a turn that has considerable potential. For it to succeed, several hurdles will need to be surmounted, including (a) a weak

scientific foundation on which to build, and (b) problems of conducting sophisticated crime and money laundering risk analysis with assessors most of whom have only modest training in such techniques.

Data. Systematic quantitative or qualitative data that would provide defensible bases for assessments and recommendations are not now available for most countries, nor likely to be available in the foreseeable future. In the 3rd round, this study finds major deficits in the quality of data brought to bear on formal compliance and program implementation. In the 4th round, both the FATF and the IMF will need to invest significantly in methods that produce adequate quantitative and, particularly, systematic qualitative data, to enable them better to evaluate outcome effectiveness.

Assessment Process. Although the Methodology in the 3rd round followed a standardized method for assessments of all countries by all twelve FATF-related assessor bodies, including the IMF, the assessment process had substantial gaps that will need to be filled if the goals and promise of the 4th round Methodology are to be attained.

Assessment Teams. The quality of ROSCs and Mutual Evaluation Reports (MERs) depends heavily on the capabilities of assessors. Serious problems were identified with assessors in the 3rd round, most notably the large proportion of assessors who conducted only one country assessment. For the FATF system to meet its ambitious evaluation objectives in the 4th round, and for the IMF to be confident that MERs reach IMF quality standards, the recruitment, training and professionalization of assessors will require serious attention, notwithstanding resource constraints.

III. Global Standards, National Differences

The AML/CFT system confronts the seemingly intractable problems of all international institutions that seek to promulgate global standards to be adopted by countries whose circumstances vary enormously. The IMF confronts this problem with its twelve ROSCs and their respective standards and assessments.

Country Fundamentals. In the 3rd round the FATF and IMF essentially sought to compel all countries to adopt the same AML/CFT regime. Many IMF staff concur with academic specialists in the view that without certain fundamental elements in place (e.g., rule of law, low levels of corruption), a country is very unlikely to attain the FATF objectives. While it might have been possible to paper over this problem with the 3rd round focus on technical compliance and program implementation, this problem is intensified with the stricter standard of outcome effectiveness in the 4th round. The prospect of widespread non-compliance by many countries that lack fundamentals will continue to present challenges for the FATF and IMF and may require fresh resources and strategies to meet those challenges.

Functional Equivalence. Unlike the 3rd round, the 4th round allows the possibility, if not expressly articulated, that countries will be able to produce their own creative alternative

means (“functional equivalents”) of attaining outcome effectiveness. This prospect can stimulate more country innovation, better adaptation of global standards to local circumstances, and a higher probability of effective outcomes.

Tailoring Recommendations. For outcomes to be effective, it will be necessary to get beyond either one-size-fits-all (the 3rd round) or individual tailoring for every country (an intent expressed by assessor bodies for the 4th round). The 2013 Methodology permits a parsimonious approach to adopting scientific methodologies for clustering countries with similar attributes and matching bundles of recommendations to those attributes. The IMF has a distinctive capacity to exercise leadership in this effort.

Assessment Reports. Third round assessment reports have been widely and properly criticized for their failure to effectively guide state and non-state stakeholders. Commitments by the FATF to revise substantially its presentation of reports and intention of the IMF to produce reports of added value for IMF activities presage constructive steps forward.

IV. Costs, Benefits, and Adverse Outcomes

To date there is no substantial effort by any international organization, including the IMF, to assess either the costs or benefits of an AML/CFT regime. The FATF system has proceeded as if it produces only public and private goods, not public or private “bads” or adverse by-products against which the “goods” have to be weighed.

The Fund staff itself has raised questions about whether its substantial investment in the 3rd round has yielded adequate returns. It is not known what value that investment produced for the FATF or the Fund’s core objectives.

There needs to be more open acknowledgement of actual and potential financial costs of AML/CFT controls, their potential misuse by authoritarian rulers, and possible adverse effects on populations that rely on remittances and the informal economy, as well as potential negative impacts on NGOs and parts of civil society. Likewise the benefits, including a more universally compatible mutual legal assistance scheme, laundering prevention and better proceeds of crime detection and recoveries, need to be articulated more clearly.

V. Levers and Mechanisms to Produce Compliance

At a time when the methodology underlying AML/CFT assessments and ROSCs is being re-designed and implemented, it is timely to make explicit and to critique the underlying behavioral assumptions about levers and mechanisms that will produce compliance.

Alternative models for producing effective outcomes, which are widely discussed in scientific circles, should be actively considered by the FATF and the Fund. These levers and mechanisms require particular attention to failures in both formal and substantive compliance by large financial institutions in advanced economies.

This Report is addressed primarily to the expert community, in particular the FATF and Fund and their national memberships, but also to the large range of commercial and civil society bodies professionally concerned with these issues. Later writings will address academic and other audiences.

I. Introduction and Background

Origins of Study

1. **This study emerged from a symposium organized by the Center on Law and Globalization (CLG), with the cooperation of the IMF and other international financial institutions, on “Measuring Law: How to do it Right in Real World Circumstances.”**³ In view of the extensive involvement of international financial institutions (IFIs) in the appraisal and reform of legal systems, officials from IFIs and leading scholars and methodologists discussed ways to produce valid and rigorous assessments and evaluations of legal systems and to craft defensible reform programs.
2. **The CLG approached the IMF with a request to study its assessments of AML/CFT ROSCs.** The CLG proposed that it undertake a critical analysis of the process of IMF assessments during the 3rd round of FATF country assessments with the intent that the appraisal of past practices might inform advances in IMF assessment practices that draw on advanced social science research techniques and scholarship. The IMF approved this request and cooperated in the extensive collection of data from within the IMF, from several countries which agreed to participate in the study, and from other bodies (see Annex 1, Design of the Study).
3. Because the IMF is embedded within a global system of standard-setting and assessments, the scope was broadened to examine aspects of the Financial Action Task Force (FATF). As the standard-setter for AML/CFT, and the coordinator of assessments worldwide, the FATF simultaneously enables and constrains global policy-making and assessments in which the IMF is a significant institutional player.
4. And because the CLG study of IMF assessment practices occurred during a period when the IMF was heavily involved in reforms of the FATF system, this study was extended to analyze debates and outcomes of policy decisions about the FATF system for a 4th round of assessments between 2012 and 2020.
5. The CLG received no funds from the IMF. The analysis and recommendations in this Report are entirely those of the CLG. The American Bar Foundation⁴ and the British Academy provided funding for research and travel. The IMF retained rights to review the Report to ensure it contained no information that was protected by confidentiality agreements between the Fund and Member States. At the request of the CLG, the IMF and FATF Secretariat also responded to earlier drafts of this Report.

³ Held in Washington, D.C., 23 March 2010.

⁴ The American Bar Foundation is an independent institute of advanced empirical research on law and legal institutions. <http://www.americanbarfoundation.org/index.html>

6. A Technical Paper is in preparation that provides extended analysis, supporting empirical materials, and more detailed academic perspectives on this Report. Later academic writings will address broader issues and audiences.

Money Laundering and the Financing of Terrorism

7. **There is substantial skepticism about the efficacy of global systems and national regimes to control money laundering and the financing of terrorism.** It is widely accepted that it is desirable to reduce crime by making it more difficult for criminals to finance crimes and to enjoy the proceeds thereof, as it is also desirable to inhibit the capacity for harms by terrorists. Yet consider three sets of recent revelations:

- Several of the world's most prominent international banks have been caught in flagrant and enormous repeat violations of AML/CFT regimes in countries where those regimes might have been thought to be most effective.⁵
- Reports indicate that money laundering was implicated in the financial crisis in Cyprus even though AML/CFT assessments failed to signal the magnitude of a problem about illegal flows of money, which had apparently been an open secret for many years.⁶
- AML/CFT assessment reports have given countries with high levels of corruption and huge flows of illicit moneys ratings on core recommendations that are similar to those of countries with low corruption and lower flows of illicit moneys.

Unless bank behavior can be convincingly shown to have changed, the first of these revelations undermines the credibility of the entire AML/CFT system.

8. **These jointly raise difficult questions for the IMF:**

- **Can the Fund rely on the quality of AML/CFT assessments?** If the AML/CFT assessments and ROSCs cannot provide accurate and valid reports on countries where risks are high, or cannot reliably distinguish between countries where risks are high versus those where they are low, then confidence of the Fund in the value of those reports in reaching its own objectives is likely to be undermined.
- **Does the AML/CFT system have the capacity to regulate and influence the behavior of the largest financial institutions salient to money laundering, the financing of terrorism, and proliferation financing?** Of all institutions these are most likely to affect domestic and international financial stability.

9. **It is also timely to evaluate AML/CFT assessments because the global regime is currently undergoing potentially wide-ranging reforms.** The IMF has been actively involved in developing the newly revised 2012 Standards and newly revised 2013 Methodology. This Report examines prospects for more defensible assessments that might resolve problems that

⁵ See, for example, "How a big US bank laundered billions from Mexico's murderous drug gangs" <http://www.theguardian.com/world/2011/apr/03/us-bank-mexico-drug-gangs> ; and "HSBC boss quits for failing to stop money laundering," The Telegraph, 18 July 2012.

⁶ A confidential document (not from the IMF) on file at the Center on Law and Globalization.

we have identified in the 3rd round of assessments under the 2003 Standard and 2004 Methodology.

The Financial Action Task Force

10. **The FATF has accomplished a remarkable feat of global standard-setting since its founding in 1989.** From a world in which there were no global standards on anti-money laundering and few national standards, FATF has forged a single global standard for AML, then CFT, and now financing of proliferation of weapons of mass destruction. The Standard comprises a set of Recommendations which were first issued by the FATF in 1990 and revised in 1996, 2001 (where eight provisions were added on terrorism), 2003, 2004 (where a 9th recommendation was added on terrorism) and 2012. To guide assessments of countries, the FATF created an assessment Methodology in 2013 for all AML/CFT assessor bodies, namely the FATF, the eight FATF-Style Regional Bodies (FSRBs),⁷ the Fund and the World Bank.

11. **Since its founding, the FATF has forged a global network of states and non-state bodies.** It has created an amalgam of thirty-four member jurisdictions and two regional organizations⁸, nine regional bodies, and 22 observer bodies, including the International Monetary Fund and World Bank. The FATF-led standard setting and assessment program has produced substantial convergence on core elements of a universal AML/CFT regime which in turn has facilitated international communication and cooperation in the efforts to prevent money laundering and terrorism, to freeze and recover proceeds of crime, and ease financial investigation and prosecution of offenders. This is a significant political achievement.

International Monetary Fund

12. **The IMF participates as an observer in the setting of FATF standards and as an assessor body applying those standards.** The Fund states: “For the purposes of integrating AML/CFT issues into the FSAP (Financial Sector Assessment Program) and ROSC programs, the Fund and the World Bank make use of assessment reports and ROSCs prepared, not only by Fund and Bank staff, but also by the FATF and FATF-style regional bodies (FSRBs). For the purposes of their own mutual or peer evaluation exercises, the FATF and the FSRBs make use of AML/CFT assessments prepared by the Fund and the Bank” (see Box 1 below). The Fund further describes the relationships among the FATF and Fund with respect to their respective responsibilities in Box 1.

13. **Increasingly information gathered from AML/CFT assessments and MERs is being incorporated into the fundamental mechanisms at the IMF for ensuring financial stability and financial integrity, including surveillance, lending, and technical assistance programs.** AML/CFT assessments of compliance with the standard is currently a mandatory component of the IMF’s FSAP, which provides periodic comprehensive analyses of the financial stability of a

⁷ See <http://www.fatf-gafi.org/pages/aboutus/membersandobservers/> for details about the FSRBs.

⁸ Financial Task Force Mandate (2012-2020), 20 April 2012, Washington, D.C., Annex A.

country's financial sector. Information on money laundering, terrorism financing, and predicate crimes is increasingly incorporated into informing IMF Article IV reports⁹, and to IMF teams invited to assess the prospect of interventions in program and "near-crisis" countries.

Box 1: IMF AML/CFT ROSCs and the FATF Standards

The IMF and the World Bank established the Reports on the Observance of Standards and Codes (ROSCs) program in 1999 as part of the broader effort to strengthen the international financial architecture following the Asian financial crisis. The ROSC program is designed to promote greater financial stability, at both the domestic and international levels, through the development, dissemination, adoption, and implementation of international standards and codes.

The IMF and World Bank have endorsed internationally recognized standards and codes in 12 areas which are important for their work. These standards relate to policy transparency, financial sector regulation and supervision, and market and financial integrity. Standards in the areas of data, fiscal transparency, and monetary and financial policy transparency have been developed by the Fund while others have been developed by other standard setting bodies, including the World Bank, the Basel Committee on Banking Supervision, and the Financial Action Task Force (FATF). Assessment of the degree of implementation of these standards by countries results in Reports on the Observance of Standards and Codes (ROSCs).

ROSCs are prepared and published at the request of the member country by the IMF and/or World Bank in each of the 12 areas. ROSCs covering financial sector standards are usually prepared in the context of the Financial Sector Assessment Program (FSAP) and are derived from detailed assessments of countries' observance of standards.

For the purposes of integrating AML/CFT issues into the FSAP and ROSC programs, the Fund and the World Bank make use of assessment reports and ROSCs prepared, not only by Fund and Bank staff, but also by the FATF and FATF-Style regional bodies (FSRBs). For the purposes of their own mutual or peer evaluation exercises, the FATF and the FSRBs make use of AML/CFT assessments prepared by the Fund and the Bank.

Since 2004, the Fund has conducted more than 35 AML/CFT assessments (which have generated a number of ROSCs) against the 2003 standard. These assessments were conducted by staff of the Financial Integrity Group (FIG) of the Legal Department of the IMF. FIG is a unit comprising a multidisciplinary group of staff (lawyers, financial sector experts, economists) within the Legal Department which focuses on financial integrity. In addition to its active involvement in AML/CFT assessments, FIG also conducts a range of other functions, such as integrating financial integrity issues in Fund surveillance and programs, and assisting the Fund's member countries in capacity building.

Source: IMF, 12 November 2012.

⁹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year.

Design of the Study¹⁰

14. **The CLG panel collected extensive data:**

- Within the IMF Legal Department, the team conducted more than 65 extended interviews and examined public and internal memoranda and reports.
- Within the FATF Secretariat, the team conducted numerous interviews with senior FATF officials and reviewed FATF published materials.
- For four countries (Armenia, Germany, Mauritius, and The Netherlands), the team undertook a more intensive study, including field visits to Germany, The Netherlands, and Mauritius.

15. **There are limitations to the design which may qualify findings and recommendations of this report.**

The CLG did not have the resources to undertake a fully representative sample of IMF ROSCs undertaken between 2007 and 2012. The study did not include a comparative analysis of AML/CFT ROSCs with other IMF ROSCs, nor a comparison of IMF assessments with those produced by other assessor bodies, nor a comparison of IMF ROSCs over time in the 3rd round.

16. **Despite these limitations, the data collected and analyzed for this report are extensive and evocative.**

Even in cases where there is significant bias in the sample—for example, an intensive analysis of Germany and The Netherlands, which are not typical of countries worldwide and are among the world’s most affluent economies and financial systems—the bias itself can produce a methodological benefit.

17. On five main sets of issues concerning AML/CFT assessments, the Report will:
- (1) Assess and critique practices and limitations of the Standards and Methodology in the 3rd round as they relate to the FATF and IMF respectively;
 - (2) Appraise the prospects for the FATF and IMF that the 2012 Standards/2013 Methodology will mitigate the problems identified in (1);
 - (3) Identify challenges, offer recommendations, and present potential markers by which it will be possible for stakeholders and observers to judge developments in the 4th round.

Definitions

18. **For consistency and clarity, this report distinguishes among four outcomes of an AML/CFT regime and possible types of evaluation.** It draws upon the U.S. General Accounting Office definitions for evaluations generally¹¹ and seeks, where possible, to find correspondences between these definitions and the usages in the 2013 Methodology.

¹⁰ For a detailed description, see Annex 2 of this Report.

¹¹ GAO: Performance Measurement and Evaluation: Definitions and Relationships, May 2011 (GAO-11-646SP).

Formal compliance refers to legal authorizations for a country to comply with FATF standards by placing substantive and procedural laws on the books, issuing regulations, and passing enabling law that authorizes the setting up or reform of agencies.

Program implementation refers to practices that put into effect the authorizations of formal compliance. There are two aspects of program implementation:

- (a) the setting up, funding and staffing of agencies, creating educational and reporting obligations for state and non-state bodies, designing reporting protocols and procedures, among others;
- (b) the operation of these agencies and programs in the public and private sectors through activities such as obtaining and analyzing STRs (Suspicious Transaction Reports) and/or SARs (Suspicious Activity Reports),¹² investigating and prosecuting crimes, freezing and confiscating proceeds of crime/terrorist finance, sanctioning criminals, exchanging information between countries on money laundering and terrorist financing and predicate crimes, as well as instituting actions by the private sector.

Program effectiveness refers to the extent of actual attainment of the goals and objectives of a particular AML/CFT regime as indicated by activities and behaviors that display a *net* effect of formal compliance and program implementation.¹³ That is, these are effects of formal and program compliance whose impact would not have occurred without the AML/CFT interventions.

Outcome effectiveness refers to a country's attainment of ultimate AML/CFT objectives *whether or not* those objectives were met through the FATF AML/CFT tools and regime.

II. Objectives

General

19. As for any policy, clear and specific objectives are necessary for effective implementation and assessment of regimes to combat money laundering and the financing of terrorism. If objectives and goals are not clearly stated, and relationships among the implicit goals are not articulated, then evaluations to assess effectiveness become difficult, if not impossible.

20. Yet it is very difficult to articulate clear objectives for an AML/CFT regime. The purposes of the regime may differ and conflict as international organizations and states themselves seek to use AML/CFT regimes to solve different problems. The FATF and IMF have generated a large

¹² Henceforth the term "STRs" will be used as a shorthand to cover these terminological variations.

¹³ This usage corresponds to the GAO definition of an "impact evaluation," which it specifies as "a form of outcome evaluation that assesses the *net* effect of a program by comparing program outcomes with an estimate of what would have happened in the absence of the program." (<http://www.gao.gov/new.items/d05739sp.pdf>).

number of potential objectives at varying degrees of specificity,¹⁴ and sometimes with no specification at all.

21. It is even more difficult to formulate the theory that links interventions to objectives and both to assessments. Without underlying theory, then no logic of action can be used to focus interventions in an effective manner.¹⁵ Without knowing the logic of action, then assessments become detached from understandings of what elements of the AML/CFT regime are intended to produce what outcomes.

22. **The FATF did not articulate precise objectives in the 2003 Standards and 2004 Methodology.** The FATF membership and Secretariat, together with Fund, World Bank, and other global AML/CFT policymakers, came increasingly in the 3rd round to acknowledge that they were struggling with how effective were AML systems, and that raised the related question—what were the objectives and ultimate outcomes to which AML regimes were directed?

23. **Neither did the FATF anywhere demonstrate that objectives, insofar as they can be specified, are more likely to be reached by compliance with FATF Standards.** No serious research has shown that countries with better compliance scores have smaller money-laundering problems than they had before and/or than countries with lower compliance scores. The 2003 FATF Recommendations were taken to be both necessary and thought by some to be sufficient to achieve core objectives.

24. **This study finds that assessments by FATF-related assessor bodies of compliance with objectives were narrowly focused, as the methodology of the time prescribed.** FATF evaluations in the 3rd round were directed entirely to formal compliance (i.e., legal authorizations in place to set up an AML/CFT regulatory regime) and program implementation (i.e., the existence and minimal operation of AML/CFT programs under the terms of legal authorization). A country was rated more or less compliant, for instance, depending on whether it had criminalized certain behaviors or established an FIU, on whether STRs were flowing into FIUs or criminals were convicted and assets seized, or whether regulatory agencies had specific authority over particular sectors of businesses.¹⁶ Assessments under the 2003 Methodology thereby failed either to evaluate program effectiveness (i.e., did this AML/CFT regime make a

¹⁴ See, for example, IMF, *Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)—Report on the Review of the Effectiveness of the Program, Annex3, The Fund Staff's Approach to Conducting National Money Laundering of Financing of Terrorism Risk Assessment*, Prepared by the Legal Department, May 11, 2011 (hereafter 2011 LEG Report). That Report identified many different and potentially conflicting objectives.

¹⁵ Matthew Andrews (2013), *The Limits of Institutional Reform in Development: Changing Rules for Realistic Solutions*. New York: Cambridge University Press.

¹⁶ For example, in the 2008 Mauritius evaluation, the country was rated as only Partially Compliant on R23 (Regulation, supervision and monitoring) because of highly technical issues such as the lack of explicitness in regulations of money transfer services and money or currency-changing services. This application of the Methodology did not involve an assessment of whether these kinds of businesses presented a high-risk activity or whether large sums were actually or plausibly being laundered through them.

difference?) or outcome effectiveness (i.e., did any interventions enable a country to narrow the gap between FATF standards and national practices?).

25. **Essentially, assessments in the 3rd round substituted *process evaluations for impact evaluations*.** Process evaluations appraise “the extent to which a program is operating as it was intended. They typically assess program activities’ conformance to statutory and regulatory requirements, program design, and professional standards or customer expectations.”¹⁷ A *process* evaluation does not itself determine whether an intervention made an appropriate impact on its target populations or whether underlying objectives were met in another way. In this respect, the 3rd round assessments shared a deficit widely observed in policy evaluations, which some see to be common in monitoring and surveillance by international organizations.

26. **The net result of the FATF focus on formal compliance and program implementation, and their appraisal through process evaluations, is that extensive efforts were expended with no demonstrable impact on money laundering or the financing of terrorism.** The FATF global network of standard-setting and assessment bodies, the law reforms and institution-building by governments, the efforts by for-profit and non-profit entities to comply with national laws and regulations, and the financial costs to the IMF and all other assessing and implementing bodies have proceeded without more than impressionistic evidence that fundamental objectives, so far as they could be understood, were being attained by any efforts at compliance.

27. **In response to intensifying concerns about the clarity and scope of AML/CFT objectives in the 3rd round, the FATF and related bodies have produced a new formulation of objectives and outcomes in the 2013 Methodology.** There is now a High Level Objective, under which are three Intermediate Outcomes; they in turn generate 11 Immediate Outcomes.

28. **The IMF contributed significantly to the crafting of objectives in the 2013 Methodology.** In association with the World Bank, the IMF contributed extensively to rounds of discussion and negotiation with the FATF on objectives, including drafting, commentary on other drafts, and participation in FATF Working Groups charged with developing proposals for approval by the FATF plenary.

29. **Organizing the AML/CFT objectives in the 2013 Methodology in a three-level hierarchy of generality or specificity is a significant advance.**

The “High Level Objective” states “Financial systems and the broader economy are protected from the threats of money laundering and the financing of terrorism and proliferation, thereby strengthening financial sector integrity and contributing to safety and security.”¹⁸

¹⁷ <http://www.gao.gov/new.items/d05739sp.pdf>

¹⁸ FATF, *Methodology for Assessing Compliance with the FATF Recommendations and the Effectiveness of AML/CFT Systems*. FATF/OECD. February, 2013 (hereafter 2013 Methodology). p.15, para 43.

At the Intermediate level,¹⁹ the AML/CFT system aims at:

- Lessening ML and FT (risks) [Intermediate Outcome 1].
- Detecting proceeds of crime [Intermediate Outcome 2]
- Keeping proceeds of crime from entering financial and other sectors [Intermediate Outcome 2]
- Detecting and disrupting money-laundering threats [Intermediate Outcome 3]
- Depriving criminals of illicit moneys and otherwise sanctioning criminals [Intermediate Outcome 3]
- Depriving terrorists of illicit moneys and otherwise sanctioning terrorists [Intermediate Outcome 3]
- Preventing terrorist acts [Intermediate Outcome 3]²⁰

The Intermediate Outcomes are supported by 11 Immediate Outcomes.²¹ The Immediate Outcomes, which constitute the operationally relevant part of the objectives for evaluation, are further expanded.

30. An even more significant advance is the shift in emphasis in the 2013 Methodology from program compliance and program implementation to assessments of effectiveness and outcomes.

The importance of the distinction between technical compliance and effectiveness in the 2013 Methodology can scarcely be overstated because it now brings firmly into the public square and onto the international policy agenda the question of whether a fully defined AML/CFT system in a country that obtains high ratings for compliance actually makes a difference to outcomes. Now, in principle, it might be possible to question both (a) the logic of causality or theory that links certain preventive and regulatory actions to specified outcomes, and (b) the possibility that alternative means beyond or in place of FATF's technical requirements might comply with the FATF's higher level objectives and outcomes.

31. The FATF now explicitly acknowledges the possibilities that a country low on technical compliance might be effective and that a technically compliant country might not be effective.²²

This de-linking of the assumed invariant positive relationship between technical compliance and outcome effectiveness potentially recognizes and can respond to the ubiquitous difficulty in global governance and regulation, namely, of countries that comply symbolically (i.e., technically) with global standards but fail to achieve the outcome objectives in global norms.

32. Three problems remain to be resolved by the FATF and its policy-making partners and assessor bodies with respect to AML/CFT objectives and outcomes.

¹⁹ Id., p.15.

²⁰ Id., p.114.

²¹ These are grouped under individual Intermediate Outcomes: 2 under Intermediate Outcome 1, 3 under Intermediate Outcome 2, and 6 under Intermediate Outcome 3.

²² 2013 Methodology, para 45.

(1) Some key concepts remain undefined and underspecified. Each of the objectives and outcomes requires further specification, both of what will be measured and what are satisfactory levels of compliance or performance. For example in the detailing of “Specific Factors that could support the Conclusions on Core Issues” under Immediate Outcome 1 is “To what extent is the assessment(s) of risks reasonable and consistent with the ML/TF threats, vulnerabilities and specificities faced by the country? Where appropriate, does it take into account risks identified by other credible sources?” This may well be a reasonable factor but there are multiple methods for assessing the fit between risk assessment on the one hand and the threats and vulnerabilities on the other. Having chosen a specific method, the choice of what constitutes a fully effective performance is a matter of judgment rather than science and is clearly open to dispute.

(2) Underlying logics that connect the three levels are not yet well articulated. The three levels of Objective/Outcomes should have a clear relationship, so that Intermediate Outcomes more clearly specify the components of the Highest Objective and the Immediate Outcomes then specify more precisely the Intermediate Outcomes. There are two potential problems: one is that the lower level Outcomes do not include all of the elements that together constitute higher level Outcomes; the other is that lower level Outcomes introduce dimensions that are not included in those above them.

(3) FATF and its assessor bodies face a challenge. They must specify ultimate objectives or outcomes, then identify what evidence will be considered sufficient to support judgments about effectiveness, and then seek evidence which may not be practically discoverable. There is a danger that this task may be so daunting that it leads the FATF back to what we call program implementation measures. That is, processes will become proxies for outcome measures.

33. Consistent with its Executive Board Mandate (2011),²³ the Fund has a mandate to facilitate domestic financial stability and external financial stability.

34. Consistent with the activities of the Fund as a whole, the Legal Department and Financial Integrity Group contribute to Fund mandates through three sets of activities (see Annex 2):

(1) Surveillance: The Legal Department (LEG) uses its expertise in AML/CFT assessments to contribute to Fund surveillance activities, including Article IV Reviews of all countries and Financial Stability Assessments which are compulsory for twenty-five countries and are voluntarily undertaken by some other countries.

(2) Financial support: Country appraisals by LEG may inform conditions for lending in countries where AML/CFT regimes are deemed to be weak.

(3) Technical assistance: The Legal Department has developed an extensive capacity, funded significantly by a Topical Trust Fund,²⁴ for technical assistance in support of AML/CFT reforms.

²³ See <http://www.imf.org/external/np/spr/triennial/index.htm>

35. **The Fund places a stronger emphasis on suppression of predicate crimes than the FATF has done in the past.**²⁵ The FATF Immediate Outcomes encourage this emphasis. For example, Immediate Outcome 2 includes the goal of making “the country an unattractive location for criminals.”²⁶ Immediate Outcome 3 has the goal of “discouraging attempts by criminals to abuse the financial and DNFBP sectors.”²⁷ Immediate Outcome 7 seeks sanctions sufficient to “dissuade potential criminals from carrying out proceeds generating crimes”²⁸

36. **The Fund has been intensifying its efforts to specify, link and measure its objectives.** These efforts are necessary in view of the limited scientific evidence to support the claim that AML/CFT measures contribute to macro-economic performance or to protection of financial sector stability and external stability. A fair reading of that literature suggests that scientific research to date on the relationship between proceeds of crime, money laundering and macro-economic financial stability is narrowly targeted and that well-evidenced impact mostly involves tiny economies, such as those of Caribbean and South Pacific states.²⁹ Predicate crimes involving weak banking controls themselves may have large impacts on more significant economies such as Greece and Afghanistan, but money laundering issues in those economies are closely related to the domestic crimes such as corruption, fraud and drugs trafficking.

37. **Scientific data would strengthen claims that link AML/CFT to Fund mandates.** Although plausible arguments and apparent cases can be offered to support Fund AML/CFT activities in support of Fund core objectives, the Fund has not invested sufficiently in research that would show legal interventions have tangible effects on outcomes the Fund advocates.

38. The Fund’s sharper focus on AML/CFT impacts on predicate crimes and their impacts on the macro-economy could open up a targeted research more feasible than impact assessments of entire AML/CFT regimes. Even if that investment were made, it would take time to achieve the desired understanding.

RECOMMENDATIONS

It is recommended that the FATF global network continue efforts to further:

- Specify meanings of objectives and outcomes (High Level Objective, Intermediate Objectives, or Immediate Outcomes).
- Clarify the logic of relationships between the High Level Objective, Intermediate and Immediate Outcomes.

²⁴ See 2011 LEG Report; IMF, *Anti-Money Laundering and Combating the Financing of Terrorism Inclusion in Surveillance and Financial Stability Assessments—Guidance Note*, 14 December 2012 (hereafter, 2012 Guidance Note). pp. 13-16.

²⁵ Id.

²⁶ 2013 Methodology, p.93.

²⁷ Id., p.96.

²⁸ Id., p. 108.

²⁹ Cf. 2012 Guidance Note, pp. 5-6.

- Make explicit the logic and the assumptions that connect certain aspects of technical compliance to independently measured outcomes.
- Provide transparent behavioral criteria that will enable countries, assessors, and observers to know when their outcomes have been effective.

It is recommended that the Fund:

- Make explicit for testing the logic of relationships between interventions achieved through AML/CFT regimes and Fund objectives.
- Analyze whether a tight link between a particular AML/CFT tool and a particular crime (e.g., tax evasion) might achieve particular Fund objectives.
- Produce and gather scientific evidence that will support, qualify, or rebut theories and logics of links between AML/CFT interventions and Fund objectives.

III. Assessment Methodologies and Assessment Practices

39. Assessments in the 3rd Round faced formidable problems, which will continue to present challenges in the 4th round under the 2013 Methodology.

Evidentiary Standards

40. **Assessors in the 3rd round confronted significant evidentiary difficulties.** These can be illustrated by treatment of three issues in several IMF Detailed Assessment Reports (DARs) for individual countries. These difficulties may extend to issues of evidence in FATF assessments as a whole.³⁰ Dealing with the problems of crime data will be a critical concern for the efficacy of future assessments.

(1) **The General Situation.** Each assessment report under the 2003 Standard included a section entitled “General Situation of Money Laundering and Financing of Terrorism” (Section 1.2). It provided a set of statistics and brief narrative comments about crime, criminal justice, and the risks faced by the nation with respect to specific crimes. It described the problem with which AML/CTF efforts must deal and/or the success of AML/CTF efforts to date. The difficulties it confronted illustrate the challenges posed by analysis of the “General Situation.” This section played a very limited role in the assessment of a nation’s AML/CTF system. The choice of indicators to describe a nation’s crime problem revealed difficulties. The cross-national comparisons were also of questionable relevance.

(2) **The Proceeds of Crime (POC)** is a plausible starting point for assessing the money-laundering problem in a country. Several DARs attempted to provide an estimate of POC, both

³⁰ As the CLG Report focuses here on four assessments undertaken by the IMF late in the 3rd round, it should be emphasized that these are likely to be more sophisticated than assessments earlier in the round.

in absolute terms and as a percentage of GDP. However, the state of the art is weak. Estimates of domestic POC are exceedingly difficult to establish and were not persuasive in the DARs reviewed by the CLG team. Efforts at estimating the POC raise the difficult question of whether any estimates are better than no estimates. It is not clear how to move forward.

(3) Suspicious Transaction Reports illustrate the problems of drawing conclusions from seemingly hard data. Nations differ in their approach to reporting by financial institutions. Some use a low threshold: a report should be filed if there is any concern at all. Others favor a high threshold, placing the burden on the reporting institution of an initial assessment of the credibility of the claim. There is currently no empirical basis in outputs or outcomes for choosing between these approaches, not least because investigative and prosecution inputs into the STRs are highly constrained whatever the system.³¹

There was no careful analysis to show that STRs in one country (e.g., Germany or The Netherlands) were comparable to STRs in another (e.g., U.K.). Country officials asserted they are not and further stated, rightly or wrongly, that the IMF assessors failed to grapple adequately with this lack of comparability. In fact, the DARs elevated the average to the status of “best practice.”

41. The 2013 Methodology and extensive comments by IMF and the FATF Secretariat and senior assessors indicate that there is an acute awareness of many of the evidentiary issues identified above. Several constructive steps create opportunities for advances:

- The four-fold framing of risks, structural elements, materiality, and other structural factors in the “risks and context” section of the 2013 Methodology (paras 5-12) offers an important step towards a much more context-dependent and context-sensitive treatment of evidence as it is used as a basis for inferences and recommendations.
- The major advance in the review process via the stress on “effectiveness outcomes” explicitly acknowledges the limitations of data, and particularly quantitative data, both for inferences that can be drawn within countries and for comparisons that can be made across countries.
- There is openness to varieties of data. For instance, sections on “Examples of Information” and “Examples of Specific Factors” in the elaboration of Immediate

³¹ Michael Gold and Michael Levi (1994), *Money-Laundering in the UK: an Appraisal of Suspicion-Based Reporting*, London: Police Foundation, confirmed later by KPMG, “Money Laundering: Review of the Reporting System”, London, 2003, which showed that even in an era when the number of STRs was comparatively low, most received very little investigative attention because of resource constraints. This is likely to be a universal finding unless STRs are quite few or entail automatic freezing, as in Liechtenstein and Switzerland. Thus in most countries, only a very modest proportion of STRs receive serious investigation by the relevant police, the FIU, and/or the investigating judge/prosecutor. The pressure by assessors and national regulators on firms to make more reports can result in fewer that are acted upon by those constrained resources, and therefore in *less* effective outputs and outcomes.

Outcomes³² indicate a readiness to rethink the interplay of varieties of data upon which country assessments are built.

MARKERS

Evidentiary foundations of assessments will be strengthened to the degree that the FATF:

- Develops, publishes, and publicizes a systematic methodology for undertaking analysis of country fundamentals, its risks and context. Assessments will make the factual description of the problem in the general diagnostic section integral to proposed solutions throughout the assessment report.
- Develops analytically defensible and transparent methods for assessing contextual and structural elements, including: political stability, political will, rule of law, effective judiciary, supervisory effectiveness, level of corruption, levels of financial exclusion.
- Operationalizes directly, or through use of defensible proxies, the key terms for “Characteristics of an effective system” in each of the Immediate Outcomes. These would include: “makes the country an unattractive location for criminals” (IO2); “discourages attempts by criminals to abuse the financial and DNFBP sectors” (IO3); “leads to a reduction in money laundering and terrorist financing activity” (IO4); “dissuades potential criminals” (IO7); “mitigate terrorist financing risks” (IO9); “reduces terrorist financing flows, which would prevent terrorist acts.”³³ (IO10)
- Develops methods for defensible cross-national comparisons and time-series analysis.

³² See, for example, 2013 Methodology, pp. 90-91, and thereafter.

³³ This Report recognizes that it is highly implausible that this would prevent *all* terrorist attacks, since self-starter individuals and small groups require so few funds that they are not vulnerable to financial controls. However, by increasing risks for donors and intermediaries, they might have an impact on *some* terrorist acts.

Risk-Based Analysis

42. **Risk-based approaches are a staple of financial regulation in many aspects of financial systems.** For example, bank regulators will focus on those parts of a loan portfolio which are known to have the greatest risk associated with them and give less attention to other parts that are known, from long experience with similar customers, products and regions, to have little risk of default. RBA is becoming common in the regulation of AML, as reflected in a 2012 statement from the Wolfsberg Group of major international banks.³⁴

43. Although the potentiality for development of risk-based analysis emerged in the course of the 3rd round, its systematic application and integration into assessments remained under-developed.

44. **The 2013 Methodology has adopted whole-heartedly an approach that requires identifying and assaying a country's risks.**³⁵ Countries are required first to identify, assess, and understand their ML/TF risks. They should then apply an RBA to prevent or mitigate those risks, prioritizing the more serious ones. Countries should also require their financial institutions and DNFBs to identify, assess and take action to mitigate their risks. External assessors will appraise the validity/plausibility of a country's risk assessment; and the adequacy of policy interventions intended to mitigate those risks and whether or not they result in effective outcomes.

45. **Risk-based analysis promises many benefits for AML/CFT regimes.** By tailoring requirements to risk so that resources will be allocated where the risk is higher, RBA allows for a more efficient allocation of scarce assessment resources. RBA would seem to increase flexibility in the tailoring of recommendations and programs to sectors and countries where the risk profile warrants particular interventions. RBA opens up a major channel of escape from "one-size-fits-all" applications of AML/CFT regimes to all situations, regardless of their variations in risk profiles.

46. **Nevertheless, RBA poses major challenges for AML/CFT regulation.** For example, the requirement in Immediate Outcome 1 that money laundering and terrorist financing "risks are understood,"³⁶ in fact, presents a formidable problem for all parties in AML/CFT assessments.

- RBA may have its origin in science but for AML it is very little studied in any formal sense, and its measurement and modeling building blocks are still very undeveloped.
- RBA rests on the premise of evidence sufficient to weigh risk. Yet, evidence is scarce, patchy, and variable on even the most basic indicators of crime, proceeds of crime, money laundering, and its consequences.
- Estimations of risk will therefore rest heavily on judgments of assessors. Justifying those judgments by assessors will be no easy task. And challenging those judgments by country officials or plenary participants will be daunting.

³⁴ *Wolfsberg Statement-Guidance on a Risk Based Approach for Managing Money Laundering Risks* (2012).

³⁵ 2013 Methodology, p.5, para 5.

³⁶ 2013 Methodology, p.90.

47. **Hence the FATF move towards RBA will involve building on a primitive foundation** where lacunae in evidence, conflicts of evidence, and widespread use of proxies (e.g., such as extent of moneys passing through a system) and impressionistic data will make valid estimations of risk exceedingly difficult.

48. **In order to leverage the assessment possibilities of a systematic RBA, the Fund devoted substantial resources in the last several years to explorations of alternative ways forward.**

- The Fund examined use of risk-management principles developed by the International Standards Organization and other bodies.
- Fund staff conducted an important survey of a sample of 48 member states (including many high-income countries) on what data they had available relevant to RBA. It established that such data were rare; e.g., only 21% had estimates of aggregate POC, and only 31% had figures on the number of suspected ML cases. The paper indicated that little effort had been made at developing the concepts of risk to be applied to ML and FT.
- The Fund explored prospects of ways that countries could conduct self-assessments on ML and FT risks.
- The Fund conducted some exploratory country studies to test feasibility of these methods.

49. **Risk has become a shorthand for moving away from the checklist of formal compliance that constituted the heart of evaluations in the 3rd round.** In this sense, it offers a major new opportunity to get beyond technical compliance. Nevertheless, sustained effort will be required to adapt RBA defensibly to AML/CFT regime assessments, compliance, and outcome effectiveness.

MARKERS

Risk-Based Analysis will be adapted for AML/CFT regimes by:

- Not emulating sophisticated models based on techniques with assumptions about data validity that cannot be met in AML/CFT regimes, but rather,
- Adopting a broad class of approaches that are suited to the infancy of RBA in the AML/CFT domain and the severe difficulties of measuring outcomes or even of obtaining valid and reliable data on the most basic of phenomena salient to AML/CFT.
- Justifying risk judgments in assessment reports so that they can be subject to independent critique.

Data

50. **FATF assessments in the 3rd round relied upon a combination of data sources to evaluate formal compliance and program implementation.** These included statistical data, where available; documents; interviews with government officials and representatives of those non-state occupations and organizations they invited to attend; responses to detailed questionnaires about operations of AML/CFT units; and on other incidental information, such as news reports.

51. **This study's review of IMF country Detailed Assessment Reports, if typical of FATF reports more generally, indicates that data collection and data analysis remained well behind the state of the art in the applied social sciences which specialize in behavioral observation and institutional analysis.** Deficiencies included:

- No systematic methodology for collecting data on country fundamentals.
- No sampling design for collecting information from non-state stakeholders.
- A degree of bias from primary reliance on government officials within the evaluated state to choose informants and sources on private compliance.
- No methodology for systematic analysis of media reports, including investigative journalist reports, on crime and laundering.
- No systematic methodology for qualitative analysis.
- No systematic methods for gathering and appraising scientific and academic research on ML/FT, crime or regulation in a given country.

52. **The emphasis on effectiveness in the 2013 Methodology will demand better data than were collected in the 3rd round.** Since the Methodology appears to be more open to varieties of data that complement each other, it moves in the direction of the social science methodological principle of "triangulation," in which varieties of data, with differences in validity and reliability, are brought to bear on a problem so that incorrect inferences will not be drawn from solitary measures or from biased or inadequate data.

53. **It should be emphasized that it is unrealistic for assessments to achieve advanced levels of scientific rigor in design and methods, data and analysis.** Nevertheless, very significant improvements in quality of data and methods would result from resource-appropriate efforts to meet minimal standards of evaluation.

54. **In the past several years, the Fund has exercised leadership in development of AML/CFT methodologies and varieties of data on which development of the 2013 Methodology can build.**

- The Fund designated a staff person to collect more systematic data on country fundamentals for any country which the IMF is assessing.
- The Fund experimented with online-perception surveys of country officials.
- An instrument was devised for a desk-based analysis of a country's situation, which was subsequently shown to country officials and revised to reflect their judgments.

The spirit of experimentation by the IMF in the last several years appears to have permeated the 2013 Methodology. These efforts advance the prospects of placing AML/CFT assessments on a more robust evidentiary foundation.

55. Threatening the 4th round promise of broad, deep, and variegated openness to data in all their forms, together with systematic methods for combining data, are five prospective difficulties:

- (1) If the FATF system puts pressure on countries to “improve” their collection of data, that pressure may lead to the production of numbers that have a surface appearance of validity and reliability but in fact conceal their limited value for assaying risk, effectiveness, and outcomes.
- (2) An emphasis in the 2013 Methodology on effectiveness and outcomes—and self-assessments by countries themselves—will likely press countries to rely more heavily on quantitative indicators because they appear, if mistakenly, to be more precise and defensible.
- (3) While the 2013 Methodology calls for the gathering of “qualitative information,”³⁷ it does not yet offer a systematic way for doing so.
- (4) The problem in (3) is compounded by what are likely to be systematic variations in what types of qualitative data can be collected in countries with differing fundamentals.
- (5) While the 2013 Methodology calls for analysis of political stability, political will, rule of law, an effective judiciary, supervisory effectiveness, levels of corruption, levels of financial exclusion, etc., little guidance yet is offered on how these fundamental attributes of a country are to be characterized.

56. Innovative, relatively low-cost methods have been developed in social science that can be applied to money laundering regulation. Quantitative methods include (a) audit analysis, (b) systematic ‘mystery shopping’ and experiments to examine rule-following in practice, and (c) profile analysis of bank customers.³⁸ Qualitative methods can include (a) email surveys, (b) focus groups, (c) lists for ranking and rating behaviors by a target audience, (d) structured interviews, (e) selective interviews of key informants, such as journalists and academics.

57. It is imperative that assessments establish country baselines of effectiveness at one point in time so that improvements or declines in AML/CFT effectiveness can be reliably

³⁷ 2013 Methodology, p.18, para 53.

³⁸ See Jason C. Sharman (2011), *The Money Laundry: Regulating Criminal Finance in the Global Economy* (Ithaca and London: Cornell University Press); Robert Harrison, Emile van der Does de Willebois, J.C. Sharman, and Ji Won Park, (2011), *The Puppet Masters: How the Corrupt Use Legal Structures to Hide Stolen Assets and What to Do About It* The World Bank; Michael G Findley, Brock Laney, Daniel L. Nielson, and J. C. Sharman (2013), "Deceptive Studies or Deceptive Answers? Competing Global Field and Survey Experiments on Anonymous Incorporation;" Michael G. Findley, Daniel L. Nielson, and Jason Sharman (2014), *Global Shell Games: Experiments in Transnational Relations, Crime, and Terrorism* (Cambridge: Cambridge University Press).

assessed at another point in time. The current alternative, of assessing countries against standards of perfection, can be discouraging and counter-productive.

MARKERS

Data collection and triangulation will be improved to the extent that:

- For every “Core issue” in Immediate Objectives, FATF were to specify which kinds of data provide what degree of probative value for each core issue (i.e., a matrix of core issues by type of data).
- For quantitative methodologies, FATF and other assessor bodies enter into a constructive relationship with researchers:
 - (i) To list each type of statistic
 - (ii) To analyze factors that affect its validity and reliability
 - (iii) To describe which inferences from that statistic can be justified.
- For qualitative methodologies, the FATF, the Fund and Bank develop a repertoire of qualitative methods, in consultation with specialists in cross-national comparative research, that include:
 - a. a sampling frame (e.g., weighted towards institutions where risk is thought to be greater)
 - b. design of systematic interview schedules
 - c. techniques for aggregation of qualitative data
 - d. content analysis, where possible and desirable, of interview, documentary, and media information
- For the FATF to develop “situational” or “stress” tests for assessors to experience first-hand whether basic procedures are in place.³⁹
- For the FATF, IMF and World Bank to investigate and deploy cost-effective innovative methodologies to improve the quality of data necessary to meet the higher evidentiary demands of the 2012 Standards and 2013 Methodology.

Assessment Process

58. This Report did not compare the process of assessment across different assessment bodies. Several persons reported that there were considerable variations in quality and style, although the quality gap narrowed as the 3rd round progressed.⁴⁰ The study can offer no

³⁹ For example, an assessor might seek to exchange money or open a personal or business account without meeting FATF-standard requirements. Or an assessor might observe inspections of vehicles at borders. In a widely publicized study, Sharman solicited offers to set up anonymous shell companies in a large number of OECD and non-OECD countries, including several tax havens, in direct contravention of FATF standards (Sharman, *The Money Laundry*, op.cit.)

⁴⁰ Early in the 3rd round the Fund commissioned a study of this matter. See *Anti-Money Laundering and Combating the Financing of Terrorism: Review of the Quality and Consistency of Assessment Reports and the Effectiveness of Coordination* (IMF, 2006)

independent judgment on that conclusion. Maintaining quality across assessor bodies in the 4th round is important for the Fund if it is to sustainably rely on these assessments to meet its Article IV and FSAP monitoring obligations.

59. In the 3rd round, the FATF's systematic approach to conducting assessments included some combination of the following steps, with some variations across assessor bodies:⁴¹

- A desk analysis of background aspects of a country's financial and legal system.
- A detailed assessment questionnaire in which countries provide extensive information to the assessment body on aspects of their legal and financial regulatory systems that relate to FATF Standards, and on AML/CFT laws, regulations, and agencies, in particular.
- A site visit by an assessment team, up to 2 ½ weeks, to meet with officials and non-state stakeholders.
- A face-to-face meeting between the assessment team and country officials onsite at the conclusion of the site visit.
- Several rounds of draft reports where comments and responses are provided by country officials and the assessing body until the assessment team comes to a final decision on text and ratings.
- On occasion, a face-to-face meeting of the assessment body and country officials in later stages of report drafting.
- A quality control and consistency round conducted by the FATF Secretariat.

OR

If assessments were conducted by the IMF or World Bank, an internal review process.

- If the assessment was undertaken by an FSRB, discussion and decisions on revisions of recommendations and ratings at a regional Plenary.

OR

- If the assessment was undertaken of a FATF member country, discussion and decisions on recommendations and rating by the FATF Plenary.⁴²
- Publication of the Report by FATF and relevant FSRBs.
- For FATF members, depending on the levels of compliance reported in an assessment, countries might go through several rounds of reforms, and reporting of reforms to the FATF, until such times as the FATF considered that compliance was satisfactory enough for countries to obtain approval to exit the reporting process

60. The study identified a number of problems in the 3rd round as they were refracted through our selective sample of IMF ROSCs. Several country stakeholders commented on assessments in general:

- It was often very difficult for outside assessors to comprehend how a country shaped its public policy choices to conform to global standards, and to understand how a country's history, constitution, and political order constrained the structure and process of an AML/CFT regime.

⁴¹ See 2011 LEG Report, Box 2, p.10.

⁴² Where there is a joint FATF/FSRB evaluation a country assessment will be discussed and approved by both a regional plenary and the FATF plenary.

- Both state and non-state officials expressed reservations about the sampling problems of reaching out to the people most appropriate to explain AML efforts on a country site visit.
- State and non-state officials expressed the perception that assessments were more about a country's score on a checklist than its performance or effectiveness in combating money laundering or the financing of terrorism.
- There were processual problems within states, both in communications among state agencies involved in assessments, and in the limited opportunities for non-state stakeholders to respond to conclusions in drafts of the DAR.

61. **Several assessors and country officials expressed concerns about the practices of regional and the FATF Plenaries.** Several assessors and officials expressed concerns about the practices of regional and the FATF Plenaries. Some assessors noted that in the course of FSRB and FATF plenaries their “professional” judgments on recommendations and ratings were sometimes pushed outside by what they regarded as “political” concerns.

62. **The FATF has taken the decision in the 2013 Methodology to undertake assessments in what amounts to three steps:**

- A country self-assessment.
- A desk review of technical compliance by an external assessor body.
- An assessment of outcome effectiveness by an external assessor body.

63. **The 2013 Methodology has the potential to mitigate some problems in the 3rd round, most notably with respect to the turn towards evaluation of outcome effectiveness.**

- A country's self-assessment of effectiveness might provide that country with the capacity and freedom to demonstrate how its adaptations to the AML/CFT regulatory regime reflects a country's own distinctive risk and contextual circumstances.
- Countries might better demonstrate that a checklist evaluation of technical compliance does not adequately reflect country effectiveness.
- The encounter of a country self-assessment with an external assessment could stimulate mutually constructive dialogues between states and FATF-body assessors in ways that approximate more a dialogic mode of regulation than command and control regulation.
- A dialogue between regulators and states opens up possibilities for infusion by states and non-state actors into FATF decision-making and regulatory practices with insights, innovations, and points of view that may not have had opportunities for expression in the 3rd round and in discussions of the 4th round Standards and Methodology.

64. **Yet the opportunities now opened up for a focus on effectiveness also present significant challenges.** Assessments of outcome effectiveness are likely to be the most challenging element of an assessment.

- A country self-analysis of effectiveness may turn into a purely defensive maneuver to rebut technical compliance ratings.
- The country self-analysis opens up a potential conflict with the review by the external assessor team. If the conflict turns into a policing exercise, then the evaluation process will become more politicized. If differences take the form of mutually respectful dialogues, then that potential conflict can be converted into constructive mutual adjustment.
- The constructive stress on risks and context, materiality, structural elements, and other contextual factors in the 2013 Methodology (paras 5-12) creates the difficulty that external teams must make judgments about such matters as political will, corruption, and rule of law, which frequently will be considered highly “political” by many actors. Unless a relatively neutral or technical way is found to minimize disputes between assessor bodies over what is “political,” there may be a retreat away from effectiveness assessments back towards technical compliance.
- Until the Methodology offers a more precise measure of outcome effectiveness with respect to specific objectives, the match of data with probative value to support claims about outcomes will remain problematic.

MARKERS

The Assessment Process will advance in the 4th round to the degree that:

- The FATF equips assessors with rigorous criteria to assess the quality and salience of all types of data, most especially statistics, and alerts assessors to the dangers of false inferences.
- The FATF develops methods that enable external assessors defensibly to justify appraisals of country circumstances that inhibit effective outcomes.
- Judgment devices⁴³ are developed to enable assessors to master a craft of making defensible sense of partial and weak data.
- The 2013 Methodology develops methods for establishing the progress of the country in achieving effective outcomes.
- Guidelines and training materials provide practical steps for country and external assessors to follow methodical and comparable risk-based analyses.
- FATF publishes a Handbook or equivalent and supplementary aids that provide tools for systematically appraising effectiveness, and which are sufficiently open to acknowledge alternative means to AML/CFT ends.
- The FATF accumulates (a) an inventory of optional regulatory paths and interventions towards effective outcomes, and (b) specifies some of the conditions in which these are possible.
- Models will be developed by assessor bodies to inform their own background views on assessments should be made public so they can be evaluated by the same

⁴³ Lucien Karpik (2010). *Valuing the Unique: The Economics of Singularities*. Princeton N.J.: Princeton University Press.

rigorous standards of peer review that are conventional in the scientific community and in other financial regulatory reviews.

It is recommended that the Fund play a significant role in the meeting of major challenges in the 4th round by:

- Recruiting specialists in comparative political economy or politics to synthesize country data relevant to outcome effectiveness and to embed AML/CFT regimes in scientific literatures of high relevance to AML/CFT.
- Creating sampling designs that enable in-country and external assessors to reach key stakeholders that presently are either chosen by governments or are not consulted.
- Engaging with the evaluation research community in academic and research institutions and in international organizations, given that many challenges analogous to those presented by AML/CFT regimes have been confronted effectively by evaluation specialists.

Assessors and Assessment Teams

65. **The quality of ROSCs and MERs depends heavily on the attributes of assessors.** In the 3rd round there appears to be an incipient tension between peer review and assessor competency. The principle of peer review or mutuality, which is at the core of the FATF assessment process, requires that assessments of one country be carried out by “peers” from other countries. Very frequently an assessor would do one country assessment only.⁴⁴ Country officials and IMF staff indicate that one-off assessors disproportionately create difficulties both in carrying their fair share of the assessment workload and in the consistency and quality of their product.

66. **A greater emphasis on effectiveness in the 2013 Methodology potentially compounds difficulties experienced with inexperienced assessors.** Heightened emphasis on risk-based analysis, and a distinctive focus on effectiveness, requires heightened capacities by assessors for refined professional judgment. For example, to recognize and accept that an alternative means to a goal is functionally equivalent to a FATF-requirement requires a flexible understanding of FATF objectives and will be facilitated by broad experience in a variety of country assessments.

67. For the FATF system in the 4th round to attain its more ambitious objectives, and for the IMF to be confident that MERs reach IMF quality standards, it may be necessary to increase the professionalization of assessors in regional bodies.

MARKERS

For the FATF, a shift towards higher quality assessments by FATF-related assessor bodies will be signaled by evidence of:

- Increase in the proportion of experienced assessors in each team.

⁴⁴ It has been said to us informally that 80 percent of assessors in the 3rd round did one assessment only.

- Inclusion of assessors with demonstrated professional judgment to assay risk in complex situations and to recognize alternative means to reaching the FATF objectives.
- Inclusion of assessors who have experience in countries with fundamental attributes similar to those of the country being assessed.

For the IMF, if IMF AML/CFT assessments are to focus more intensively on predicate crimes, then the need for assessors with substantial insight into law enforcement experience and seniority in criminal justice administration will become more critical.

IV. Global Standards, National Differences

Country Fundamentals

68. **The 2003 Standard offered no analysis of the conditions necessary for program and outcome effectiveness.** It was implicit that if the Standards were put in place, i.e., if there was program implementation, then AML/CFT would be effective, irrespective of the economic, political, cultural, and social fundamentals of a country.

69. **The 2004 Methodology began to qualify this questionable assumption.** It stated that “an effective AML/CFT system also requires that certain structural elements, not covered by the AML/CFT assessment criteria, be in place.” The 2004 Methodology specified six “elements” that would differentially influence implementation and effectiveness: (a) good governance; (b) a culture of AML/CFT compliance; (c) the combating of corruption; (d) efficient courts; (e) ethical judicial and law enforcement authorities; and (f) ethical professionalism.⁴⁵

70. **While this nominal recognition of country fundamentals for implementation of an effective regime injected a note of realism into the FATF regulatory regime, it had three limitations.**

(1) although the six elements provided potential for considered discussion in assessments, this study found almost no systematic integration of this recognition into assessments of particular countries.⁴⁶

(2) the list of country elements or fundamentals was incomplete and reflected a limited and implicit theory of the conditions under which effective outcomes would occur.

⁴⁵ See 2004 Methodology, pp.4-5.

⁴⁶ However, several experienced assessors observed that sensitivity to the significance of these elements increased over time.

(3) there was no attempt to qualify how good, efficient, and ethical these components had to be before they were acceptable.

71. Four defenses have been offered in support of the FATF's demand that all countries adopt all recommendations, whatever their circumstances.

(1) The Comparability Defense This states that full application of all standards to all countries is necessary in order to permit comparisons of compliance across countries. Nevertheless, numbers of experienced assessors acknowledge that cross-country comparisons very often are illusory.

(2) The Timing Defense This states that the FATF does not demand that all countries comply immediately or implement standards in the same sequence. However, the timing and sequencing defense is not persuasive. It assumes that all countries are on a similar developmental trajectory and given time they will sooner or later implement effectively an AML/CFT regime. This kind of developmentalism has long been subject to sustained criticism by the social sciences.

(3) The Building Block Defense This argues that while an AML regime in a country without most preconditions will not work well now, it will be better than what any given state has at present and may provide a building-block of progress towards better (i.e. more substantive) compliance with global standards in the future. It may be the case that putting formal laws and institutions in place will provide a springboard for later desirable outcomes (for example, improved mutual legal assistance in evidence and extradition), but it is also plausible that putting them in place when they are ignored or evaded may delegitimize them and produce cynicism or even backlash.

(4) The Weak Link Defense This states that any weak link in AML/CFT enforcement will weaken the overall global AML/CFT preventive strategy. It is known there are many weak links, yet few of them have any importance as money-laundering or terrorist financing nodes, or levels of money laundering would be high and near-ubiquitous. There are indeed weak links in this sense in the most affluent and powerful countries, but the notion that all criminal activity is so fungible that it flows seamlessly between states requires that a perfect market be posited in illicit activities. This is part of the judgment about "vulnerabilities" to money laundering, which 4th round evaluations should address.

72. Under the 3rd round Standards, Methodology, and assessment practices, the FATF confronted a most awkward implication from the analysis of country fundamentals. Since formal compliance and program implementation with an AML regime can be adopted by virtually all countries (although in fact many countries had not put in place even the legal building blocks), in practice the fundamental objectives of an AML regime cannot or will not be attained effectively by large numbers of countries because they are either unwilling or unable to do so. This raised, and continues to raise, the difficult question of how to proceed when

formal compliance will be subverted by the absence of necessary conditions to produce effective outcomes.

73. What are the necessary conditions or country fundamentals under which an AML/CFT regime will move from formal and program compliance to program and outcome effectiveness? These fundamentals are variously alluded to or assumed in FATF publications, stated in interviews by FATF and IMF officials, derived from FATF reports and assessments, or extrapolated from critical analysis of AML/CFT assessments.

(1) *Willingness to comply effectively with FATF Standards* Willingness requires positive motivations of all affected parties: political leaders, civil servants, market actors, professionals, civil society groups, the media. Willingness is *not* only about incentives—economic and other carrots and sticks. It stems from political, religious, and civic beliefs, from political and policing/regulatory priorities, from customs and the prevailing practices in social networks, and from the strength of social ties to other actors who may have varied degrees of willingness to deliver program or outcome effectiveness. Many of these are beyond the control and manipulation of governments or international organizations, certainly in the short or intermediate terms.

(2) *Ability to Meet Objectives* Broader research on comparative political economy and comments from FATF and IMF documents and interviews propose that many institutional fundamentals in the state, the legal system, market, and civil society will affect the probability that an AML/CFT regime will be effective.

a. The state has minimal capacities. Establishment of an effective AML/CFT regime assumes that: (a) a state has the capacity to create an effective national administration of any kind; (b) a state exercises a reasonable degree of control over its borders; (c) power within the state is divided among branches insofar as the FATF Standards assume that zones or centers of independence can be created within the state so that one part of a state—an FIU or prosecutor—alone or, more likely, in combination, can hold another part of the state—a President, government minister, judge or high-ranking civil servant—accountable for predicate crimes related to money laundering and the financing of terrorism; (d) political leaders and government officials are not routinely and heavily complicit with impunity in predicate crimes, including corruption and money laundering; (e) a state (and the private sector within it, which bears much of the cost of implementation) has the resources to invest in an “adequate” AML/CFT regime;⁴⁷ and (f) political leaders will prioritize illicit financial crimes over other crimes, such as public disorder and crimes against the person.

b. The legal system (a) has sufficiently established rule of law in a country to allow investigators and justice officials sufficient autonomy to make independent decisions on the

⁴⁷ Even if it has those resources, this may not represent optimal expenditure from the perspective of the state or of global society. Note the distinction here, since the crimes whose proceeds are laundered in one state may be committed almost exclusively in others, so there is an asymmetry of interests in money laundering control.

evidence (and, in “opportunity principle” jurisdictions, on discretionary criteria) about who to investigate, prosecute, convict, and sentence; (b) in practice places powerful politicians, officials, and business leaders under law, whether or not they are opponents of the government (e.g., they also are convicted of crimes and are appropriately punished); (c) has institutionalized a criminal justice system that can investigate and prosecute ordinary crime on the reasonable presumption that if it cannot deal with ordinary crime, it is implausible that it can deal with crimes that may be sufficient to harm the financial integrity or stability of a country or other countries; (d) and, more specifically, the criminal justice system has the competence to detect and prosecute predicate crimes.

c. Within the market, the FATF AML/CFT framework makes assumptions (a) that market actors have the capacity and willingness to monitor transactions that may involve ML and FT, and to transmit them to a Financial Intelligence Unit; and (b) that the economy is sufficiently formalized that money can be tracked and transactions are declared.

d. Civil society: Within civil society, the AML/CFT framework assumes that the very large numbers of non-state civil society and non-profit organizations in many states will have the willingness and/or resources, financial or administrative, to comply with regulatory demands.

74. It follows that the less any country has in place the fundamentals of a state, market, legal system, and civil society, the less likely it is that country can erect an FATF AML/CFT regime that produces effective outcomes.

75. This study finds no evidence that the FATF in the 3rd round made substantial progress on finding solutions to what presents a fundamental challenge to the global application of the FATF system. Since a very substantial proportion of the countries subject to the FATF Standards are unlikely to have in place all (or even many) of these fundamentals, their absence continues to pose a basic question about the salience of implanting an AML/CFT regime where the conditions for its effectiveness in controlling serious misconduct do not exist.

76. The four-fold analysis of risks, materiality, structural factors, and contextual factors in the 2013 Methodology offer real prospects of assessing country fundamentals that will inhibit or facilitate outcome effectiveness.⁴⁸

(1) Analysis of *risks* (para 6) is to focus on the “nature and extent of the money laundering and terrorist financing risk factors,” including “the level and type of proceeds-generating crime in the country; the terrorist groups active or raising funds in the country; and exposure to cross-border flows of criminal or illicit assets.”

(2) The analysis of *materiality* (para 8) offers a set of variables that could distinguish among financial systems and their varying susceptibility to risk, though it does not indicate what might be extrapolated from the elements listed.

⁴⁸ 2013 Methodology, pp.5-6., paras 5-12.

(3) The discussion of *structural* factors (para 9) parallels in many respects the necessary conditions outlined above: whether there is political will to implement effective AML regimes; whether there are “stable institutions” with certain qualities (accountability, integrity, transparency), and presumably demonstrable administrative capacity, by which a state may effectively administer programs; a “moderate state” in which power is fractured, which is signified by the criterion of “a capable, independent, and efficient judicial system;” rule of law, by which it might be assumed the FATF implies accountability of executive branches to legal restraint, and within which it can be supposed that all persons of whatever power and rank will be equally subject to the law.

(4) The discussion of *other contextual factors* (para 10) urges assessors to take into account the level of corruption and the “level of financial exclusion,” which may be intended to reflect the extent and shape of informal or black markets outside the formal financial system, to which this regulatory regime is entirely directed.

77. Although this explicit recognition of country conditions provides a foundation for recognition of wide-ranging country variations, the Methodology does not yet resolve difficult issues that follow from its important “Risk and Context” analysis.⁴⁹

(1) The Methodology is substantially reliant on a self-analysis by a country. Is it probable that a country’s self-assessment will point to all or the most important factors that are adverse to its reputation? It seems likely that the greater the absence of fundamentals in a country, the less likely it will be to admit to many or most of them, so there may be little correlation between a country’s crime and laundering problems and its level of public self-critique.

(2) In peer reviews of assessments, it may be less likely that neighbors of a state, especially neighbors that share shortcomings on structural and contextual conditions, will comment adversely on these issues, unless they are trying to level the playing field.

(3) While it is an important step to register variations in contextual factors, what is to be made of them? What implications follow, for instance, from the fact that a country has a systemically important financial system or has a scarcely functioning financial system? Implicit theories underlie the relationship between these contextual factors and risk and thereafter mitigations of risk. Surfacing those theories would go some distance towards clarifying and verifying what is thought to produce what kinds of constructive or destructive effects on AML/CFT objectives and outcomes.

78. It will be necessary in the 4th round for the FATF and IMF to imagine new approaches to countries where fundamentals are missing or are adverse in their consequences. These new approaches will need to find creative ways to meet the inhibitions to forthright analysis of country conditions that follow either from restrictions by some multi-laterals on their intrusion

⁴⁹ Id., pp.5-7.

into member “politics,” or from difficulties of collusion among members to ignore adverse country fundamentals in peer-review assessments.

RECOMMENDATIONS

It is recommended that the FATF consider:

- Developing a refined understanding about the conditions under which country-effective AML outcomes can be achieved, with corresponding analysis of probable links between particular country fundamentals and AML risks (based on past experiences).
- Developing efficient and valid techniques for accessing high-quality scientific, area, and country expertise from scholarly and scientific institutions on country fundamentals.
- Finding methods to lessen the “political” component of what hitherto has been a substantially “technical” enterprise by
 - Use of global indicators (recognizing their limitations)
 - Use of academic analysis (recognizing its variability in views and opaqueness)
 - Use of peer-review anonymous reports to provide extra eyes to enhance quality control
- Devising an alternative approach to outcomes that relies less on the implantation of an entire regulatory scheme in barren soil and more on coming to an agreement with a state on what particular intervention might grow in otherwise improbable conditions and holding the state accountable to discernible change in the short to intermediate term.

It is recommended that the IMF:

- Aggregate and classify the extensive experience and tacit knowledge of IMF staff. Our extensive interviews with experienced assessors at the IMF reveals that many have tacit theories about (a) minimal conditions for effective AML/CFT programs, and (b) ways that countries might be clustered into constellations, and that interventions to control or minimize risk might also cluster. These experiences have been enriched by the Fund’s technical aid program which requires, in effect, diagnosis and practical prescriptions for all countries receiving technical assistance.
- Extend its pioneering work on risk analysis by creating inventories of risk factors related to country constellations of fundamentals.

Functional Equivalence

79. **Study of AML/CFT Reports and the views of many stakeholders reveal three problems that recurred in the application of global AML/CFT standards across diverse countries in the 3rd round.**

(1) There was enormous variability in legal and other circumstances which made some standards irrelevant or even counter-productive in some circumstances. A strict regime

of interventions prescribed under the 2003 Standards for all countries gave very little space for creative alternative interventions that might be better suited to particular circumstances. Officials from several countries state that they believed they had more effective ways to comply in the 3rd round but that such methods would not have improved their scores on FATF recommendations.

(2) By specifying standards very precisely, it became possible for countries to “game” the system and effectively circumvent the spirit of the law by adhering to the letter of the law. If objectives are set at a higher level, and functional equivalents are permitted, gaming becomes more difficult.

(3) Specification of standards introduced a potential rigidity into law and regulation that did not lend itself to flexible adaptation, especially in legal domains that govern fast-moving situations with high stakes, such as certain kinds of crime and financial services markets.

80. The 2013 Standards and Methodology open up the prospect of mitigating these problems by permission or encouragement of countries to use functional equivalents for attaining effective outcomes.

- Several of the 2012 Recommendations (R.24, R.25, R.40) refer explicitly to equivalent measures or equivalent systems, where variations on meeting standards are acknowledged.
- The split of country reports into two components—one on technical compliance, one on effectiveness—immediately creates the possibility that achievement of outcomes⁵⁰ might be attained by means other than FATF’s prescribed technical requirements. Paragraph 42 on the three-level hierarchy of defined outcomes emphasizes that effectiveness is not primarily concerned with implementation of specific recommendations or performance of particular institutions but with achieving objectives.⁵¹ Both the high-level objective and the intermediate outcomes could accommodate functional equivalence.⁵²
- Moreover the discussion of risks and contexts⁵³ essentially lays the groundwork or premises on which functional equivalence rests, namely, national difference in circumstances, fundamentals, and capacities.

81. The Anti-Bribery Convention⁵⁴ confronts similar challenges of variation across countries⁵⁵ and illustrates the potential of the use of “functional equivalence” in AML/CFT regimes.⁵⁶

⁵⁰ 2013 Methodology, p.4, para 2,

⁵¹ Id.

⁵² Id., p.15, para 43.

⁵³ Id., pp.5-7, paras 5-12.

⁵⁴ OECD, 2011, *Convention On Combating Bribery Of Foreign Public Officials In International Business Transactions And Related Documents*.

(1) The OECD Anti-Bribery Convention proposes that the principle of functional equivalence authorizes countries to adopt a *variety of measures* that will implement the Convention effectively. It states that signatory states should take any “measures as may be necessary . . . ”⁵⁷ It accepts varieties of measures that contribute to criminal investigations, prosecutions, and sanctions. These include both criminal and civil approaches to anti-bribery efforts.

(2) The principle of functional equivalence also recognizes that circumvention may be necessary around *repositories of responsibility* in government chains of command. The Convention does not lock a government into a single structural solution when the structure itself can be compromised by its senior management.

(3) By permitting, even encouraging, functional equivalence, the Anti-Bribery legal regime places a high value on *adaptation* of law to changing circumstances. Functional equivalents, or alternative measures, can respond swiftly to new threats or vulnerabilities.

(4) Guidelines encourage both legal and regulatory *invention* in response to new threats and the *transfer of innovation* from one country to another.

82. The concept of functional equivalence if put into active practice could lead to three increased capacities to attain program and outcome effectiveness.

(1) It would reinforce the value of tailoring recommendations to the particular circumstances of a given country;

(2) It would foster innovation within countries and encourage transfers of innovation across countries with similar circumstances/configurations;

(3) It would encourage developing and transitional countries to imagine creative solutions for their challenges that would neither imitate measures more appropriate for advanced economies nor reinforce any assumption that solutions can be generated only from OECD countries or advanced economies.

83. The prospect of functional equivalence has the potential to optimize local knowledge and to strengthen country ownership of means to AML/CFT ends.

⁵⁵ There is much less variability across countries that are signatories to the Anti-Bribery Convention for two reasons: (a) countries themselves vary less; (b) the Convention governs a much narrower spectrum of behavior than does AML/CFT.

⁵⁶ It must be observed that Section 80 refers to the *formal* statement of how the Anti-Bribery Convention was intended to work, not how it always works in *practice*, since we have no independent observations on the latter beyond the formal evaluations.

⁵⁷ Op. cit., note 58.

84. This report concludes that the new emphasis on outcomes (para38) will permit the FATF assessments to stimulate creative alternative means to attain FATF objectives in ways best adapted to local circumstances.

Tailoring Recommendations

85. **If countries vary markedly in their fundamentals, and functional equivalents are permitted or encouraged to produce effective outcomes, then it should follow that AML/CFT regimes will be more likely to be effective and will allocate resources more efficiently when adapted and tailored to those fundamentals.**

86. The 3rd round has been criticized for its single formula (sometimes labeled “one-size-fits-all”)⁵⁸ for the money laundering/terrorist financing problems of every country, no matter what its level of economic development, state capacity, level of corruption, or extent of rule of law, among other country fundamentals salient to an effective AML/CFT regime. Many IMF staff expressed severe reservations about the realistic prospect of effective outcomes in countries without certain fundamental elements being in place.

87. Despite differences in the relative importance of Recommendations to a country, and the enormous variability in salience of particular Recommendations for the circumstances of a particular country, Recommendations⁵⁹ in the 3rd round were essentially treated as equally important—and were to be assessed in every DAR or MER. There were exceptions:

- Sixteen Recommendations were considered “key” or “core” and thus weighted, in effect, more heavily than others.
- Ratings were not given for some Recommendations if they were not applicable in that specific country.
- In some reports, recommendations were prioritized for the sequence in which it was recommended they be adopted.

88. **It is a strongly held view among many AML/CFT global norm-makers that to particularize recommendations for certain types of countries amounts to revocation of the requirement that all countries conform to the global standards.** No country, stated some leaders in the FATF global network, should be given a “free ride” or a “free pass” on any Recommendation. After all, every country that was part of the FATF system had agreed to be held to the same standards.

⁵⁸ Andrews (2013), op.cit., note 16. The FATF and IMF respond by saying (a) in fact, variations in ways to meet goals were sometimes permitted (e.g., in Financial Intelligence Units), and (b) countries were given different priorities or sequencing or recommendations in order to come into compliance. It has also been said that *de facto* tailoring sometimes did occur when it was manifestly obvious that countries without capacity or political will had no reasonable chance of implementing the 40+9 Recommendations in more than a formalistic manner. We have no independent evidence on variations in implementation.

⁵⁹ For clarity, we designate FATF Recommendations as *Recommendations*, and assessor recommendations, as *recommendations*.

89. **The blanket application of all Recommendations, either without the setting of priorities generally, or without tailoring recommendations for particular countries, has been criticized for its cost and relevance by some within the FATF system.** Furthermore, it is coming under increasing attack by scientific researchers because many Recommendations were irrelevant to certain countries (e.g., those on financial regulation applied to countries with minimal and systemically unimportant insurance industries; those on securities laundering in countries with no or minimal securities sector).⁶⁰

90. **During the 3rd round FATF itself established some precedents for grouping countries.** In one case, they were grouped by fundamentals that were thought to inhibit the capacity of a country to implement quickly an AML/CFT regime. For example, the Guidance Note on Low Capacity Countries⁶¹ listed some seven attributes of countries that might require some flexibility in the timing and sequencing of implementation. In another case, countries were grouped by their extent of non-compliance, i.e., a classification based on assessment of “jurisdictions that have strategic AML/CFT deficiencies.”⁶²

91. **To what degree do the 2012 Standards and 2013 Methodology permit or encourage the bundling of countries into constellations that make certain combinations of responses to AML/CFT risks more adapted to distinctive circumstances?**

(1) It is noted above that FATF itself set a narrow precedent in the 3rd round for creating a particular class of countries for tailored measures in its Guidance Note on low capacity countries. However, it appears the “tailoring” only permitted flexibility in timing and ordering of compliance provisions, not selection or functional substitution of requirements.

(2) Some of the logic of the 2012 Standards and especially the 2013 Methodology indicates that flexibility in application of measures in a country to achieve effective outcomes provides scope for bundling countries into clusters and tailoring measures accordingly. For instance, in addition to groupings or clusters in the 3rd round (i.e. low capacity countries, non-complying countries), the Methodology’s risk-based analysis now points to clusters of outlying countries, i.e., high-risk countries and low-risk countries.

(3) A stronger emphasis in the 4th round on risk-based analysis in principle puts countries on a scale from higher to lower risk. Even then, there are risks of different sorts and those risks are produced by different constellations of related factors (e.g., uncontrolled drug trade, massive flows of capital through banks that evade AML/CFT regulations, organized crime). It is highly improbable that exactly the same

⁶⁰ Cf. Sharman, op.cit., p.1.

⁶¹ *Guidance on Capacity Building for Mutual Evaluations and Implementation of the FATF Standards within Low Capacity Countries*, FATF, 29 Feb 2008.

⁶² “Improving Global AML/CFT Compliance,” 22 February 2013. Downloaded 28 June 2013 at <http://www.fatf-gafi.org/documents/documents/fatfpublicstatement22february2013.html>

recommendations will be equally salient to the reduction of risk in states where the POC are primarily generated by drugs versus countries where money laundering is enabled by large banks.

92. **The spirit of the 2013 Methodology creates new prospects for erecting regulatory regimes for the world which assume neither that one-size-fits-all nor that every country requires custom tailoring.** In research and scholarship on states, comparative analysis of states proceeds on the well established practice that countries cluster on factors relevant to a given problem or issue. Hence, political scientists can categorize 199 of the world's political regimes from 1946-2008 into six categories (e.g., parliamentary and presidential democracies, absolute monarchies, military and civilian dictatorships).⁶³ Development economists and the IFIs classify countries into groups of advanced or transitional or developing economies, with various degrees of further refinement. Those classifications derive from whatever factors are thought most salient for some analytic or practical purpose, such as predictions of future activities or present capacities to achieve certain outcomes. Sometimes countries can be arranged on a single scale. Usually it is more defensible to cluster countries that share like configurations salient to a given problem or issue.

93. **An alternative approach for the AML/CFT global system would be to cluster countries into groups with similar fundamentals and tailor recommendations and adaptations to distinctive clusters of countries.**

(1) Country Constellations It is plausible to expect that recommendations will vary in their relevance and salience for countries with different configurations or constellations of attributes. For a stylistically simplified example:

- Where a country has a long tradition of rule of law, extensive resources, a sophisticated state administrative apparatus, and political will (e.g., Australia, Netherlands), then global regulators can have high expectations that a complex regulatory regime such as AML/CFT can be implemented and might lead to the desired outcomes.
- When a country has control of its frontiers, state power is concentrated, corruption is widespread, and law is poorly developed (e.g., China, Russia), then global regulators might predict that technical compliance is highly likely but effectiveness will be much less likely.

It should follow that FATF recommendations that are less reliant on assumptions about rule of law and probity in government will be more likely to be effective, and these should be given priority.

⁶³ Cheibub, José Antonio, Jennifer Gandhi, and James Raymond Vreeland. 2010. "Democracy and Dictatorship Revisited." *Public Choice* 143:67-101.

(2) Tailoring Recommendations to Country Constellations Once constellations are identified, then it becomes possible to tailor bundles of recommendations to circumstances where they have a reasonable to high probability of being implemented and of relevant outcome objectives achieved. A distinctive type of AML/CFT regime would be matched with a particular type of country constellation. This tailored approach would be more focused, more adaptable, and in the longer term, more likely to reach objectives that are feasible for that country.

Stated schematically:

- For Country M with 'x' constellation of state attributes, it will be matched with the 'y' cluster of AML recommendations – and be open to functional equivalents adopted in countries with the same constellation of attributes.
- For Country G with an 'r' constellation of state fundamentals, it will be matched with the 'z' cluster of AML recommendations – and be open to functional equivalents adopted in countries with the same constellation of attributes.⁶⁴

94. **At the opposite extreme to one-size-fits-all recommendations is custom tailoring for every country on the seemingly plausible premise that every country is unique.** While literally true, in practice it is exceptionally difficult and would be immensely resource-intensive to approach each country as if it bore no resemblance to other countries which shared some of its country fundamentals. Low capacity countries have properties in common. Rule of law countries have different properties in common.

95. **These recommendations present a fundamental shift in the ways FATF-related bodies might approach country diagnosis and prescription in the 4th round.** It should be emphasized, however, that this shift is consistent with the directions in practice and theory that the AML/CFT global standard-setters were moving in the 3rd round and are authorized to move in the 4th round.

96. **These steps confront diplomatic, professional, and analytic hurdles.**

Diplomatically, it will be difficult to characterize countries that are FATF members or members of FATF regional bodies as lacking in the rule of law or as corrupt or as lacking other conditions that are derived from the risk and context section of the Methodology. Note though that whatever its own methodological limitations, Transparency

⁶⁴ There is a potential incentive problem. Prestige aside, countries might bid to be in lower clusters unless there are adverse consequences, e.g., for due diligence for citizens and for acceptability for bank-to-bank relationships in global risk indices.

International's Corruption Perception Index is an almost ubiquitous entry in assessment of developing country performance in many dimensions.

Professionally, it will be necessary to develop cadres of experienced assessors and technical aid specialists who can draw upon their comparative experiences in order to make explicit and effectively codify the underpinnings of their professional judgments.

Analytically, it will require deliberations beyond current conceptualizations of risk-based analysis and contextual analysis.

97. **Numbers of benefits might accrue if these challenges were to be met.**

- It would deepen and systematizes country context analysis for every report.
- It would focus attention on the necessary conditions for effective outcomes.
- It would open a way to present feasible demands to political leaders and officials, i.e., demands that have some prospect of being satisfied.

98. **IMF staff concentrate a unique degree of tacit expert knowledge about the fundamentals of countries and the “bundles” of recommendations appropriate for that country.** Rather than imagining an AML/CFT regime as a single scale⁶⁵ on which countries are rated as more or less formally and programmatically compliant, the great experience and expertise of IMF staff and consultants could be focused on re-imagining distinctive types of AML/CFT regulatory regimes.

99. **The Fund, as a leader in the community of AML/CFT international organizations, has a singular capacity to seek solutions to two deep problems scarcely confronted in earlier cycles of development of the AML/CFT standards and methodology.**

(1) It is timely to acknowledge directly the politically unpalatable but practical problem that a large number of countries—perhaps as many as half the world's countries—cannot effectively control money laundering and the financing of terrorism because those countries lack fundamentals that many IMF and other specialists believe foundational for effective outcomes.

(2) The Fund is well positioned to imagine a broader repertoire of potential interventions, including functional equivalents, and the matching of those interventions with constellations of countries.

100. **This approach has four significant merits:**

- It increases the probability that regulatory interventions will make an impact.
- It fully deploys the experience and creative capacities of IMF experts.
- It signals clearly that the IMF does not apply the FATF AML/CFT regulatory regime as if it were a single recipe for all situations and circumstances.

⁶⁵ This essentially is what ICRG listing amounts to.

- It opens up the prospect of a closer collaboration between IMF and FATF specialists and the scientific community.

RECOMMENDATIONS

It is recommended that the FATF:

- Authorize and develop a methodology for identifying and encouraging the invention of functional equivalents as country-specific ways to meet AML/CFT objectives and outcomes
- Compile examples of functional equivalents together with identification of country attributes necessary for a given functional equivalent to work in a given setting
- Tailor groups of recommendations to fit country constellations and particularities of a given country with a constellation.
- Train assessors to write each country report with variations on the theme of tailored recommendations for a given country constellation

It is recommended that the IMF:

- Codify tacit knowledge of the IMF staff on (a) necessary conditions for any aspect of an AML/CFT regime to be effective, i.e., is there a fundamental threshold below which any effort will be wasted or counter-productive; and (b) what may be conditions necessary for some AML/CFT measures, if not for others.
- Design potential alternative approaches to outcome effectiveness in countries where numbers of fundamentals are absent.
- Cooperate with social scientists:
 - i. To cluster countries into distinctive constellations that are salient to attaining the objectives of the AML/CFT regime in the 4th round
 - ii. To create bundles of prescriptions/recommendations that are tailored to the distinctive attributes for each constellation of countries

The experience and expertise of IMF staff and consultants would be focused on re-imagining distinctive types of AML/CFT regulatory regimes.

Assessment Reports

101. In the 3rd round, IMF staff and country officials registered concerns about reports on country assessments, variously designated as Mutual Evaluation Reports or Detailed Assessment Reports.

(1) Report Format. Common criticisms stated that reports were too often excessively long (e.g., ranging up to 600 pages in length), negative in tone, unreflective of a country's history, unhelpful in the setting of priorities, and unmindful of the level of risk a country confronted.

(2) Ratings. IMF staff had divergent views on the value of compliance ratings in reports on the 3rd round. Some staff preferred ratings because they conveyed a clear message to stakeholders and they could highlight strengths and weaknesses of a country's AML/CFT regime. Several staff preferred abolishing ratings altogether on grounds that ratings (a) distracted attention from the more important reasons for the ratings; or (b) diverted focus away from higher risk issues that mattered most to a country. It is possible, said one widely experienced IMF staff person, to "get the same goal without ratings and with more enhanced follow-up."

(3) International Co-operation Review Group (ICRG). Fund staff differed in their views about ICRG as a body and blacklisting as a process in the 3rd round.⁶⁶ Most staff and country officials acknowledged that the threat of blacklisting through ICRG was a "very good driving engine" to get countries to push for reforms. However, several staff noted that this can create perverse effects. The threat of blacklisting "masks the larger picture" because countries focus much more on ratings that might lead to ICRG blacklisting than on the description that produced them or the objectives that an AML/CFT system is supposed to achieve.

(4) Reports from other Assessor Bodies. In the 3rd round, the IMF had the practice of accepting MERs from FSRBs, the World Bank, and the FATF as if they had been ROSCs undertaken directly by the IMF itself. Yet it is widely acknowledged among senior officials in the AML/CFT system that reports vary significantly in quality. The divergence between the relatively high ratings given Cyprus by Moneyval, insofar as it applied the 3rd round Methodology, and what was subsequently revealed as the empirical reality of Cyprus must raise the question whether the IMF Executive Board and its financial surveillance can rely confidently on MERs from all assessor bodies as if they were assessments undertaken by the Fund itself.

102. In the 2013 Methodology the FATF, with the support of the IMF, has taken decisions to reform several aspects of reporting on assessments.

(1) Report Format. It has been stated that the FATF and IMF intend to produce reports that will:

- Be succinct
- Acknowledge achievements as well as shortfalls
- Place any given report in a longer narrative of a country's efforts to confront ML and FT
- Target issues of greatest risk and/or of greatest salience to a country
- Prioritize recommendations

⁶⁶ It should be reiterated that the views expressed by IMF staff are individual staff views only and do not necessarily reflect the views of the IMF, its Executive Board or Management.

(2) Ratings. Assessments of countries in accordance with the FATF Standards will produce two sets of ratings.

- One set of ratings will focus on technical compliance.
- A second set of ratings have been created for outcome effectiveness (Methodology paras 62-3).

The two sets of ratings present difficulties that will not easily resolve issues raised by some IMF staff.

- Effectiveness ratings may generally be more negative than technical compliance ratings, since effectiveness will likely present a higher standard for attainment. This can engender stronger conflicts between country officials and assessors.
- If the effectiveness ratings are absolute, they may not adequately reflect how far a country has come. Thus a country that has taken major strides to improve effectiveness on a given outcome over the last several years, but still is only moderately effective (which for that country may be what is maximally possible), will receive a third tier rating.
- Since several terms in the statement of Immediate Outcomes are ambiguous, and there is no agreed scientific or international criterion for several outcomes, these ratings are likely to be much disputed.

(3) International Co-operation Review Group (ICRG). It remains unclear what impact the dual system of ratings will have on which countries and the number of countries that will enter the ICRG process. Since outcome effectiveness is a very much more exacting standard than technical compliance, it is possible that many more countries—including more economically powerful countries—could be listed. This may confront the FATF with a difficult practical decision about whether to relax standards or to increase the proportion of the world's countries inside the ICRG process.

(4) Reports from other assessor bodies Because the IMF has relied in the past on reports from other assessor bodies for adoption of MERs as ROSCs, the new Methodology will pose a substantial challenge of quality control that must be exercised to assure the IMF Executive Board that a Mutual Evaluation Report is and will continue to be of sufficient quality to warrant its acceptance as a ROSC.

103. **As a partner organization in the FATF system, the Fund agreed to use a template for its reports that is very similar to the FATF template** (which was also used by the FSRBs). In application of the burden-sharing agreements between the Fund and the FATF, the Fund agreed to discuss its reports of FATF/FSRB members with the relevant plenary (i.e., they are not all discussed by the FATF plenary).

RECOMMENDATIONS

It is recommended that the FATF consider:

- Producing transparent indicators and empirical criteria for effectiveness so that effectiveness ratings are technically defensible.

It is recommended that the IMF:

- Design quality control techniques that will assure IMF Management that a Mutual Evaluation Report will be of sufficient quality to warrant its acceptance as a ROSC. The purpose of such quality control techniques would be to raise questions about whether the MER accurately or reasonably characterizes both the AML/CFT issues in a country and the effectiveness of AML/CFT regimes.
- Develop some form of validity criterion by which it can parsimoniously appraise whether an MER from another FATF-related assessor body meets IMF standards. We recommend consideration of a *face validity* criterion which tests a piece of research by its common sense, its plausibility to informed peers, its “ring of truth” given everything else that an informed peer knows about the subject, research design, data analysis, and inferences. (See the Technical paper for the general contours of a face validity method).

V. Costs, Benefits, and Adverse Outcomes

104. **Benefits of the FATF AML/CFT system have not been demonstrated.** Although there may be benefits known to international organizations, governments, regulators, and intelligence agencies, no systematic efforts have been made by the FATF network of IOs or countries or institutions to demonstrate benefits. Scientific research on benefits remains in its infancy.⁶⁷

Economic Costs of AML/CFT Regimes

105. **Both the 3rd and 4th round Standards and Methodology proceed as if the implementation of an effective AML/CFT regime delivers only public and private goods and imposes no public or private “bads.”** This study has learned of no significant effort by any of the standard-setting or assessor bodies to undertake a cost-benefit analysis despite positive but incomplete moves in some jurisdictions.

⁶⁷ Ten years ago Peter Reuter and Edward M. Truman (*Chasing Dirty Money: The Fight Against Money Laundering*, Peterson Institute on International Economics, 2004) produced a rough estimate of the cost of implementation of AML for the US economy (partitioned among government, corporations and the general public). There does not seem to be any more recent or more refined estimate, despite the substantial growth of coverage of legislation and regulatory institutions nationally and internationally.

106. **National officials and private stake-holders state that discussion or information on benefits and costs of an AML/CFT regime are limited or non-existent.** Little consideration has been given, they say, to the costs of implementing an AML/CFT regime, and little evidence has been adduced to demonstrate that the costs produce commensurate benefits in their own or indeed in any other jurisdiction. Private stakeholders have said they seldom if ever learn whether their filings of Suspicious Transaction Reports have any value or any effect, though public stakeholders have responded that most such complaints—however understandable—are unrealistic to satisfy and actually would reduce performance by diverting scarce resources to consumer feedback. A cost-benefit analysis which addresses those criticisms would be consistent with E.U. and some national governmental practices on any legislative initiative.⁶⁸

107. **Costs are substantial whether construed broadly or narrowly.** For example, in Mauritius, a county of 1.3 million, there were a total of 25 positions in its FIU. For a middle income country, that is a significant component of its financial regulatory resources, especially for largely non-prudential regulation. Moreover, an AML/CFT regime generates substantial costs on the financial sector in terms of money-laundering compliance staff and software procurement. Entire industries have grown around consulting and advising businesses and governments on AML/CFT compliance, an area stimulated recently by large fines and threats of prosecution to major international banks.

108. **Without attention to economic and financial costs, the broader intent of the 2012 Standards/2013 Methodology to produce effective outcomes will be undermined.**

- If the direct financial costs imposed on a government either conflict with its domestic political priorities or are large enough proportionately that they impede the ability of a government to implement other more politically salient programs, then it is more likely that governments will create Potemkin Villages where there is the appearance of compliance (i.e., formal compliance) without its actuality (i.e., outcome effectiveness).⁶⁹
- Country interviews in this study provide some evidence that imposition of substantial costs on governments and private parties for a regulatory enterprise about which they are skeptical will lessen support for the regime. Particularly strong views were expressed by bankers about excessive costs of misplaced demands upon the financial industry for surveillance of customers.
- Especially when correspondent banks in the West are worried about their regulatory risk exposures, AML laws and regulations may adversely affect access of marginal groups whom FATF documents describe as subject to “financial exclusion” from the formal financial system.⁷⁰ The more onerous the burdens placed on individuals, companies, and NPOs in countries where there is a substantial informal and cash economy, the more likely they are to opt out of the formal economy for reasons of cost.

⁶⁸ See also GAO cost-benefit analyses. <http://www.gao.gov/new.items/d05739sp.pdf>

⁶⁹ The Guidance Note on Low Capacity Countries (29 February 2008) appears not to address this.

⁷⁰ 2013 Methodology, p. 6, and elsewhere.

109. **Cost-benefit analysis for AML/CFT regimes presents difficult challenges.** The central component of a cost-benefit analysis is the projection of consequences of a counter-factual. If a cost-benefit analysis were to be initiated of AML/CFT as a whole, then the starting point would be an evaluation of the consequences of not having the system in place. The analyst would specify all the consequences that were relevant, some positive (benefits) and others negative (costs), and then seek to assign monetary values to each of those. However, the specification of the consequences of the counter-factual for the system as a whole is too ambitious, both for conceptual and empirical reasons.

A narrow approach would apply a cost-benefit analysis applied not to the system as a whole, but to major elements of the system. It would ask, are there components for which the costs exceed the likely benefits?

110. **Without demonstrations of benefits and attention to costs, the FATF global system and national AML/CFT regimes risk a loss of legitimacy.** Since legitimacy of a regulatory order is a foundation for compliance with that order, then failure to show that the regime has an outcome on important objectives, or a failure to show that benefits outweigh costs, may lead to greater passive and active efforts not to comply, in an area where full ongoing surveillance is not feasible.⁷¹

Evaluation Costs

111. **Effective implementation of the 2013 Methodology may incur additional costs to all stakeholders.** The CLG team considers it likely that the constructive decision to assess outcome effectiveness of AML/CFT regimes will be more expensive for governments, which must show effective outcomes in practice, and for FATF assessor bodies, which must judge whether effectiveness has in fact been demonstrated. The three-pronged assessment process—country self-assessment, external desk assessment, external effectiveness assessment—may multiply responsibilities, require more specialized and expensive personnel as assessors, and require considerably more negotiation than has been the practice in the 3rd round. To evaluate effectiveness requires new methods, new forms of data and information, deeper penetration into practices within a country, and new kinds of analysis. Arguably better data for more valid evaluations will be more expensive.

112. **The IMF has invested heavily in AML/CFT assessments in the 3rd round.**⁷² At a cost of more than \$300,000 per assessment, during a period when the IMF has reduced its resources for ROSCs in general, this is not an inconsequential cost, even if AML/CFT ROSCs serve a broader purpose than some others.

⁷¹ This raises the question of why there has not been more public criticism of the AML/CFT system in recent years, given its costs. Perhaps the fact that all financial institutions throughout the world face the same system, so that none is competitively disadvantaged, has helped mute such discussion. Another influence may be fear of regulatory *lèse-majesté*, which might seek to punish critics for the lack of respect for AML/CFT objectives.

⁷² 2011 LEG Staff report, p.10, Box 2.

113. In the absence of supporting evidence on benefits of AML/CFT assessments through technical compliance, the magnitude of this investment may require intensified efforts to produce supporting evidence for the outcome efficacy of AML/CFT regimes. Without such justification, the Legal Department must rely on rhetorical argument or unsystematic data in order to justify to IMF management what value is bought for assessment costs.

114. **Furthermore, the 2013 Methodology may require additional costs to the IMF in two respects.**

- A full desk review of technical compliance is now to be complemented by an assessment of effectiveness. If the effectiveness assessments are to reach actual behaviors and impacts, then they will need additional types of research and inquiry that will be resource intensive.
- If the IMF must now review all other MERs more thoroughly to ensure they meet IMF quality standards for ROSCs, this too may require additional personnel.

115. The expense of AML/CFT assessments by the Fund will be better justified if assessments can be shown to produce valid information salient to the core mandate of the Fund. If objectives are specified, outcomes can be measured, and valid inferences from data can be drawn in ways proposed by this Report, then the AML/CFT assessments have a greater probability of demonstrating how government and private investment in an AML/CFT regime can reduce the incidence or severity of crime, money laundering, and the financing of terrorism in a country that might in turn positively affect aspects of a country's financial integrity and financial stability. Obversely, if evidence cannot show that money-laundering and predicate crimes make a country more susceptible to financial crisis, then the financial cost of assessments or participation in the FATF system may have imposed a diagnostic cost on the IMF as a whole, whatever the advantages in showing concern about social harm reduction.

116. **More extensive integration of AML/CFT data and analysis into IMF core activities of surveillance, financial support, and technical assistance may require further resources.** If AML/CFT assessments are to provide better data and more robust analysis for IMF financial surveillance, financial support, and program activities, including Article IV reviews, FSAs, and FSAPs, then further costs will be incurred and additional resources will be necessary.

Adverse Consequences.

117. **Now that the FATF global system enters a 4th round of assessments, it is timely to open up a debate on potential adverse consequences of AML/CFT regimes.** Some of those consequences may ultimately be adverse to the governance structures for AML/CFT itself. They may also be adverse to broader objectives, such as governance transparency, which the FATF, IMF, World Bank, and the G-7 and G-20 may advocate as global norms.

118. **AML/CFT regimes can produce political harms.** Numbers of experienced assessors have observed that a fully functioning AML/CFT regime in some countries has provided tools for authoritarian rulers to repress their political opponents by denying them banking or other facilities, increasing surveillance over their accounts, and prosecuting or penally taxing them for

non-disclosure, in addition to opening up more opportunities for illegal extortion for private gain. This weapon can be applied against persons/organizations already in the formal financial system.

119. **AML/CFT regimes can cause economic harms, especially to poor countries.** Money laundering and counter-terrorism measures can reduce the volume of overseas remittances to the most vulnerable populations in the poorest countries. For instance, it is reported that “every year, Somali migrants around the world send approximately \$1.3 billion to friends and families at home, dwarfing humanitarian aid to Somalia. . . . A recent report by the UN Food and Agricultural Organisation shows that up to 40 percent of families receive some form of remittance, and that the money is integral to their survival.” The Report continues, “banks in the West are closing down the accounts of money transfer operators, thereby threatening to cut the lifeline to hundreds of thousands of Somali families.”⁷³ In 2013, the English Courts granted an interim injunction to prevent the closure of these links pending a full trial,⁷⁴ but while one report does not make a decisive case, it points to a phenomenon that warrants closer investigation.

120. **AML/CFT regimes can produce harms to civil society in three ways.**

- Some assessors observe that the registration and reporting requirements on voluntary associations and charities will increase the intrusion of state monitoring and thereby control of their affairs. While the FATF is sensitive to the dangers of regulation in the NPO sector,⁷⁵ efforts to bring them into the formal financial system and demands that they produce records for regulators can adversely affect their role in civil society.
- Administrative and financial costs imposed on voluntary associations, most of which are very small and poorly funded, can threaten the survival of small associations.
- In Islamic societies, controls intended to restrict the financing of terrorism can deprive societies of the locally delivered charitable activities that are most efficient and responsive to local needs.

121. **Harms to civil society can undermine effective AML/CFT outcomes.** If multiplied across a country, then the adverse effects of transparency and traceability on NPOs can suppress the very civil society that can advocate for clean politics and against corruption.

⁷³ Nairobi Forum: Remittance Transfers to Somalia, states, “However, banks and regulators are in danger of inadvertently undermining this financial lifeline and driving it underground, as interpretation of UK and USA money laundering and counter terrorism legislation becomes tighter. . . . Individual transfers are usually less than \$300, and often as little as \$35. Families depend on the money for basic costs such as food, water, education and healthcare, and to cope with new crises.”

<http://us5.campaign-archive2.com/?u=bbe4bf6326e7666108dd11e6f&id=61f975f6b2&e=25dcb31569>

⁷⁴ *Barclays v Dahabshiil (and Ors)* [2013] EWHC 3379 (Ch)

⁷⁵ 2012 Standards, pp. 54-58, B (3)(a)).

RECOMMENDATIONS

In collaboration with other leading institutions in the FATF global network, the Fund takes steps to:

- Define, measure, and propagate benefits on an AML/CFT regime, or principal elements in an AML/CFT regime.
- Evaluate economic costs of technical compliance and effective outcomes for government, private industry, and non-market groups. Particular attention will be given to the cost for developing countries, where the burden for government financial regulatory capacity may be disproportionately heavy.
- Open discussions within and beyond the AML/CFT regulatory community on economic, social, and political costs of an AML/CFT regime, particularly in authoritarian countries.

MARKERS

As the Fund AML/CFT assessments seek to provide added value to core Fund mandates:

- The Legal Department (LEG) seeks resources sufficient to provide more robust evidence of benefits yielded by all or some elements of an AML/CFT regime for purposes of meeting IMF objectives through the activities of surveillance, financial support, and technical assistance.
- The Fund provides resources sufficient to enable more assessments sufficiently robust to evaluate outcome effectiveness.

VI. Levers and Mechanisms to Produce Compliance

122. **The FATF AML/CFT system in the 3rd round was built upon a set of behavioral assumptions about levers and mechanisms that produce compliance. The FATF system has assumed that compliance will be produced through a mix of *positive inducements* and *negative sanctions*.**

- (1) There were four sets of *inducements*, although these might have not been explicit.
- The praise and relative status conferred by performing highly in the AML/CFT compliance ratings, especially if ratings were proposed by high-status bodies. The corollary of this was avoiding sanctions by conformity or the appearance of conformity.
 - The opportunity to receive technical assistance from the IMF and elsewhere for internal reforms that were desired by the jurisdiction and for conducting national risk assessments. The payoff might not only be funding for AML/CFT work but for bolstering institutions, surveillance, and other governance capabilities.

- As a way of addressing a country's endogenous and imported crime and public insecurity problems, including both illegal markets and predatory crimes, and for some it was also for reducing tax evasion.
 - As a weapon authoritarian regimes or leaders might use to deploy financial surveillance powers in order to crush political opponents or for corrupt regimes to extort funds via selective enforcement.
- (2) There were three principal sets of *negative sanctions*.
- Social and diplomatic pressures by other similarly situated states ("peers") or powerful jurisdictions to comply.
 - Shaming that followed upon listing in the ICRG process, which might then lead to a reduction or withdrawal of correspondent banking facilities and to higher costs for raising capital if countries received poor ratings or were listed in the ICRG process.
 - Domestic and/or foreign regulatory and criminal justice actions against illicit practices emanating or portrayed as emanating from the jurisdiction and/or institution.

123. **Taken as a whole, the combination of positive inducements and sanctions have been successful in achieving a quite high degree of formal and program compliance in the 3rd round.**

124. **The combination of positive inducements and sanctions in the 3rd round have not prevented enormous banking scandals involving money laundering in advanced (HK, UK, US) and other (e.g., Cyprus) economies.** Considering criminal, deferred prosecution and regulatory cases together, many major banks have been sanctioned in the U.S. and, less often, in the U.K., but barely at all in other financial services centers.

125. **The scale of money laundering by prominent international banks has been alleged, in serious commentary, to be systemic, though neither the 3rd round evaluations nor the prosecution process in FATF or FSRB member states gave them even passing mention.**

- Current levels of sanctions do not appear to have long-lasting effects either on those sanctioned or on others, although this may be because until recently, sanctions were both modest and rare.
- Commercial sanctions against smaller and poorer nations, or financial institutions in those countries, such as removal of corresponding banking privileges, can have effects. It is not clear that they are decisive deterrents, at least at the moment of decision-making.
- Many large banks continually violate their own rules with respect to AML controls, whether intentionally or through ineffective management controls. The recent large expansion of staffing in both sanctioned and other banks may mitigate these violations, but generate problems of overlap and clear lines of responsibility in complex organizations.

- Institutional reputational cost, at least as expressed in share prices,⁷⁶ is minimal.
- The “nuclear option” of prosecuting banks or taking away their licenses has been reserved for marginal players, the collateral damage of drastic action being deemed too high for major banks, some of whom instead have been subjected to regime change under Deferred Prosecution Agreements or severe regulatory warnings. The application of occupational and penal sanctions to individuals for failing to carry out their duties is not well collated.

126. These failures do not mean that sanctions have had no impact on money laundering, but they indicate that the regime put in place has not yet had the expected effects in those jurisdictions where it might be expected to work best—the founding members of the FATF.

127. **The 4th round faces the critical question of whether the mix of levers and mechanisms will be adequate to remedy the weaknesses of the 3rd round and meet the more challenging objectives of AML/CFT effectiveness.** The 4th Round mechanism provides more ambitious objectives for MS to attain, and hence the inducements – whether positive or negative – may need to be greater to improve performance.

128. Although a turn towards “real world evaluation” in the 2013 Methodology through the emphasis on outcome effectiveness will offer significantly more realism in assessments of compliance, its effectiveness would require the FATF and other assessor bodies to shift from an emphasis on sanctions for failure to emphasize rewards for virtue and success.⁷⁷ However it is difficult to assess the criteria by which it would be known what level of success was attributable to particular AML controls, or, beyond predatory crimes that are capable of being measured with reasonable accuracy, how it would be possible to judge the success of control measures.

129. Even if national regulatory levers and mechanisms were to be redesigned and recalibrated, a mismatch remains between national regulation of major banks and their international business. The AML system of control is founded upon nation states as the core mechanisms through which changes are measured and controlled. There is no equivalent of the “lead jurisdiction” in banking regulation that was introduced in the aftermath of the BCCI scandal (which was both a money laundering and a fraud/prudential banking collapse). So no one country has an obvious primary responsibility for regulating the AML activities of international banks, professional service providers, or global money service businesses (like Western Union).

⁷⁶ A \$1.9 bn fine is over a fifth of HSBC’s profits in the current year, and – embarrassment apart - should be enough to attract attention from CEOs, even if the threat of revocation of the Deferred Prosecution Agreement had been absent. However, its impact on share prices to date is modest.

⁷⁷ See John Braithwaite (2005) *Markets in Vice, Markets in Virtue*, New York: Oxford University Press.

RECOMMENDATIONS

It is timely for the FATF global network to:

- Recognize that neither positive inducements nor negative sanctions will overcome powerful social forces in a society inimical to AML/CFT regimes that are not readily manipulable by national governments or international governance institutions.
- Give serious consideration to shift from “markets in vice” to “markets in virtue.”
- Consider alternative methods to hold major financial institutions accountable in order to forestall incidents of massive deviance
- Examine behavioral science findings about cultural change and potential influences that operate on persons and institutions at the point of decision-making or negligence.

ANNEX 1



INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

Facsimile Number
1-202-623-4661

Center on Law and Globalization and the American Bar Foundation

Study of the IMF's AML/CFT ROSC Program

Terms of Reference for Study

Set out below are Terms of Reference for an assessment that will be conducted by the Center on Law and Globalization and the American Bar Foundation of the International Monetary Fund's ("the Fund") Reports on the Observance of Standards and Codes (ROSCs) in the area of anti-money laundering and combating the financing of terrorism (AML/CFT). The terms of reference for this assessment were agreed between the Legal Department of the Fund and the Center on Law and Globalization.

The purpose of the assessment is to evaluate the design, form and substance of IMF ROSCs on Anti-Money Laundering and Combating of Financing of Terrorism. The assessment panel will ask the following questions with respect to the AML/CFT ROSCs:

- What does the IMF and FATF intend to accomplish with the ROSCs?
- What is the validity of the assumptions and models of crime, regulation and compliance that underlie the ROSCs?
- What aspects of AML/CFT regulation do ROSCs currently treat and not treat?
- Should exactly the same evaluation instruments be used in countries that vary widely from each other on almost every characteristic salient to money laundering and the financing of terrorism?
- Are there more effective ways of designing and executing ROSCs that might be better adapted to the variety of circumstances of Fund member countries?

The panel will answer these questions by:

- Analyzing IMF documentary materials, including policy documents, IMF working materials (e.g., template, assessors' handbook, questions for DARs), and IMF draft and final reports negotiated with countries and presented to FATF and the IMF Board;
- Studying materials from countries evaluated by the IMF, including their responses to IMF questionnaires and queries;
- Interviewing IMF personnel and consultants involved in managing and producing country reports;
- Interviewing country officials who participated in an IMF ROSC assessment; and
- Analyzing other academic and grey literature.

To obtain valid information from a variety of countries, the panel will examine the assessments of a cross-section of countries with varying levels of reputed money-laundering activity, varieties of state capacity and economic development.

The panel will be comprised of:

Professor Terence C. Halliday, Co-Director, Center on Law and Globalization, American Bar Foundation; Specialist on global law-making, international organizations, and global legal change. Consultant to World Bank, OECD, Government of China. Chair of panel.

Professor Michael Levi, Professor of Criminology, Cardiff University, U.K., specialist and consultant on organized crime, financial crime and money laundering to Council of Europe, European Commission, U.K. Home Office, World Bank and prolific author on economic crime and financing of terrorism.

Professor Peter Reuter, economist, Professor, School of Public Policy and Department of Criminology, University of Maryland. Specialist on organization of illegal markets, drug wars, and money laundering. Consultant to IMF, World Bank, National Research Council.

Members of the panel have undertaken extensive empirical research and written widely on money laundering, financing of terrorism, illegal markets, and regional and global regulation of crime and markets.

The panel will produce a draft report for IMF management by July 15, 2012, and a final report for IMF management by October 15, 2012. The panel will subsequently write academic publications under the terms of the agreement with the IMF.

ANNEX 2 DESIGN OF THE STUDY

The CLG team examined information from a variety of sources.

Within the IMF Legal Department, the team conducted more than 65 interviews⁷⁸ with senior managers in LEG and FIG and conducted systematic interviews with assessors on specific country assessments; examined internal memorandums and reports; reviewed staff working papers on money laundering, risk-based analysis, and technical assistance; and reviewed Executive Board papers related to AML/CFT, ROSCs, FSAPs, and the IMF financial surveillance mandate. Within the FATF Secretariat, the team conducted numerous interviews with senior FATF officials.

In a sample of eleven countries on which the IMF had conducted assessments in the previous five years,⁷⁹ the team reviewed IMF Detailed Assessment Reports and ROSCs; and the team conducted systematic interviews with country assessors, including IMF staff and consultants.

In the more intensive study of four countries (Armenia, Germany, Mauritius, and the Netherlands), the team undertook:

- (1) Documentary analysis: IMF staff requested permission from authorities in eleven countries for the CLG to have access to the confidential and classified materials exchanged between the IMF and the country. Armenia, Germany, Mauritius and the Netherlands, granted access to these materials. The CLG team studied correspondence, the countries' responses to the Detailed Assessment Questionnaire, draft DARs, and editorial commentary on respective drafts.
- (2) Site visits: The CLG also undertook site visits to Germany, Netherlands, and Mauritius where team members interviewed state and non-state participants in IMF assessments and other informed persons.
- (3) In addition, the CLG team (a) reviewed scholarly and scientific publications on AML/CFT and the FATF, and (b) analyzed international and local media for news reports on money laundering and the financing of terrorism.

In its qualitative analysis, the CLG team used standard research techniques of the social sciences⁸⁰ to systematize data gathered by interview and from documentary materials.⁸¹

⁷⁸ Several FIG staff members were interviewed on more than one occasion.

⁷⁹ Albania, Armenia, Austria, Paraguay, Maldives, Kuwait, Netherlands, Mauritius, Mexico, UAE, Germany.

⁸⁰ These are scientific methodologies that are standard in social science research supported by leading national scientific bodies, such as the National Science Foundation (U.S.) and Economic and Social Research Council (U.K.).

⁸¹ Interviews with IMF assessors and country officials were structured in a systematic format so that responses could be compared and contrasted. The systematic interviews enable (a) comparability of responses across all informants, within countries, between countries, within the IMF, between the IMF and countries; and (b) flexibility to adapt interviews to important unanticipated topics or comments that arise. Interviews were conducted with national and international specialists on AML/CFT, scholars, and officials, industry and academic specialists who are neither part of the FATF regulatory regime nor participated in country assessments. This

There are significant limitations to the design which may qualify findings and recommendations of this report. These include:

- (a) the CLG did not have the resources to undertake an extensive research program on a fully representative sample of IMF ROSCs undertaken between 2007 and 2012;
- (b) the four countries which provided access to their classified materials are not fully representative of all the IMF's AML/CFT assessments or those of FATF and FSRB assessments more generally;
- (c) while it was not the primary mandate for the CLG study to undertake a substantive analysis of the FATF 40+9 Recommendations or the methodology for assessing compliance in the 3rd round, this Report does attend to practices by IMF assessors in relation to objectives and methodology of the 3rd round, and considers prospects for changed practices under the 2012 Recommendations and 2013 Methodology that will govern the 4th round;
- (d) the CLG team did not seek to re-assess country reports or question ratings on standards for any country, though it heard many representations about them;
- (e) the CLG team did not compare reports produced by different FATF-related bodies.

Despite these limitations, the data collected and analyzed for this report are extensive and evocative. Even in cases where there is significant bias in the data—for example, an intensive analysis of Germany and the Netherlands, which are not typical of countries worldwide—the bias itself can produce a methodological benefit.

If the AML/CFT regulatory regime can work effectively in any country, and if the current practices of assessing countries and writing reports are to be exemplified, it should work best in countries where there is (a) an advanced economy with major resources; (b) a sophisticated state administrative apparatus; (c) a legal and criminal justice system that predominantly adheres to the rule of law and maintains effective control of serious crime; (d) low levels of corruption; and (e) sophisticated scientific establishments and administrative analytical tools to generate high quality salient data. If there are problems with the AML/CFT regulatory regime or the quality of assessments in these countries, then they are likely to be magnified substantially in countries that do not have many preconditions commonly identified as necessary for an effective AML/CFT regime.

technique permits the team “outside” perspectives from informed parties that had no direct stake in FAT/IMF assessments. Where possible, the CLG team employed systematic content analysis of country reports and media stories.

ANNEX 3

IMF OBJECTIVES AND AML/CFT-RELATED SUPPORT⁸²

The table below, prepared by the Fund, sets forth the Fund’s main objectives and provides information on the scope and extent of the way they are supported by the AML/CFT program. The institution’s work is articulated along three main activities, namely, surveillance, financial support, and technical assistance. It should be noted that the Financial Sector Assessment Program (FSAP), of which AML/CFT assessments are a component, is part of the Fund’s technical assistance, except in the case of 25 jurisdictions with systematically important financial sectors which undergo mandatory financial stability assessments under the FSAP as part of bilateral surveillance. In all cases the key findings of the FSAP feed into bilateral surveillance. Weaknesses identified in an FSAP can be considered in the design of conditionality for Fund-supported programs and can be addressed with the support of Fund technical assistance.

IMF Objectives		AML/CFT-related support	
Description	Detailed information	Type of support	Source/Examples
Surveillance	http://www.imf.org/external/np/exr/facts/surv.htm	Inclusion of ML/TF-related issues in Article IV discussions when relevant for economic stability	<p>Guidance note on the inclusion of AML/CFT in surveillance: http://www.imf.org/external/np/pp/eng/2012/121412a.pdf</p> <p>2013 Article IV consultation for Libya (see on AML and corruption: page 2 and paragraphs 13, 20, 28, 39 and 41). http://www.imf.org/external/pubs/ft/scr/2013/cr13150.pdf</p> <p>2013 Article IV consultation for Italy (see on corruption, tax crimes and AML: paragraphs 4 and 7). http://www.imf.org/external/np/ms/2013/070413.htm</p> <p>2013 Article IV consultation for Switzerland (see on AML and tax crimes: paragraph 15) http://www.imf.org/external/pubs/ft/scr/2013/cr13128.pdf</p> <p>2012 Article IV consultation for Latvia (see on AML:</p>

⁸² Source: IMF Legal Department, September, 2013.

			<p>paragraphs 21 and Appendix I).</p> <p>http://www.imf.org/external/pubs/ft/scr/2013/cr1328.pdf</p>
Financial support	<p>http://www.imf.org/external/np/exr/facts/howlend.htm</p>	<p>Inclusion of ML/TF-related issues when relevant for the success of the Fund-supported program or for financing assurances</p>	<p>Greece - Extended Fund Facility (see on tax crimes, corruption and AML: paragraphs 8, 24, and 38). http://www.imf.org/external/pubs/ft/scr/2013/cr13241.pdf</p> <p>Afghanistan - Extended Credit Facility (see on corruption, fraud and AML/CFT: page 4, paragraphs 9, 19, 20, 26, 28, 29 and table 1). http://www.imf.org/external/pubs/ft/scr/2012/cr12245.pdf</p> <p>Cyprus - Extended Fund Facility (see on ML: paragraphs 19, 28, and 41). http://www.imf.org/external/pubs/ft/scr/2013/cr13125.pdf</p>
Technical assistance	<p>http://www.imf.org/external/np/exr/facts/tech.htm</p>	<p>AML/CFT assessments</p> <p>Build AML/CFT capacity and contribute to the effectiveness of the IMF's surveillance and lending programs</p>	<p>Description of AML/CFT assessments and technical assistance in the latest staff paper to the IMF Executive Board: http://www.imf.org/external/np/pp/eng/2011/051111.pdf</p> <p>Description of the AML/CFT topical trust fund: http://www.imf.org/external/np/sec/pr/2009/pr09108.htm</p>