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The Scope of Action to Combat Money Laundering

Criminal activities that should be made subject to money laundering offences

Introduction

Commonwealth Heads of Government agreed to tackle the laundering of the proceeds of **all types of serious crime.** There is however no universal definition of "serious crime".

Among those countries that have introduced wide-ranging money laundering legislation, a number of approaches have been adopted. These have included:

a list of specific offences – such lists invariably include drug trafficking, and may also cover blackmail, extortion, kidnapping and other activities associated with organised crime, arms trafficking, financial fraud, fiscal (tax) evasion, bank robbery and other highly profitable crimes. The list is usually capable of extension through secondary legislation;

a definition based on the severity of the sentence – this may be expressed in terms of the maximum or minimum length of sentence or size of fine available. In some cases additional highly profitable crimes may be included, even though the actual sentence available is below the chosen threshold;

a definition based on the category of court in which the prosecution may be conducted – where there are magistrates' courts covering lesser offences and higher courts covering more serious ones, laundering offences may be restricted to those which can or must be tried in the higher courts;

a definition that covers all criminal activity – this approach would allow laundering prosecutions relating to the proceeds of any criminal activity.

This is an issue that has been considered by Law Ministers, and in the light of their consideration, the draft model money laundering law adopts a definition based on the severity of the sentence. This does not preclude the possibility of using other approaches in accordance with individual country circumstances.

While the issue of predicate offences is primarily for Commonwealth Law Ministers, Finance Ministers have a distinct interest in the treatment of **economic crimes**, including tax evasion which was highlighted at the Finance Ministers Meeting in Malta as an important concern of some countries. This is an area that is considered in detail in Part 5 of this paper.

The role of the financial sector

Introduction

As is stated at the end of Part 1, of the five elements of an anti-money laundering strategy, two in particular are of direct relevance to the financial sector, and indeed require the active and willing participation of the financial sector if they are to work. These are **customer identification and record keeping,** and **alerting the authorities.**

Customer identification and record keeping

Practical aspects of customer identification and record keeping are discussed in Part 3 of this paper. However it is important to consider ***why*** these are such important issues.

Customer identification serves two purposes. The first is to provide an audit trail for investigators pursuing money laundering operations. If financial transactions can be linked to individual account holders it is possible for law enforcement authorities to put together an effective case when they wish to prosecute criminals and confiscate the proceeds of their crimes. Every failure of identification or record keeping makes it easier for criminals to retain their money.

Effective customer identification procedures serve a second purpose, in that they will ***make it difficult for*** criminals from using financial institutions. In situations where individuals are required to provide evidence of their identity, criminals have the choice of having their true identity recorded, leaving them open to greater risk of capture, conviction and confiscation, or of using false identification documentation, which may be spotted by staff in financial institutions, leading again to capture and conviction. The only alternative for determined launderers is to use non-financial institutions, which are clearly less well suited for their purposes. Again the costs are increased, and the risk of detection is higher.

Financial institutions tend to be very sensitive to any damage to their reputation. They will want the minimum of publicity about any money laundering investigations in which they are involved. Where they have effective customer identification and record keeping systems, the task of tracking transactions by the law enforcement agencies will be facilitated, and they will tend to co-operate in keeping the operation out of the public eye. However, where a financial institution helps to frustrate an investigation, there is less cause for the investigators to co-operate, and the involvement of the institution in a money laundering operation is more likely to become public, with the adverse consequences for that institution's reputation that inevitably follows such a revelation.

Experience in many countries has been that the introduction of identification and record keeping procedures has benefited financial institutions. The requirement to identify their customers has empowered the institutions to obtain information that assists them in their risk management, without deterring customers, who now know that they would be asked the same questions in any other institution. At the same time, legitimate customers who are aware of the legal responsibilities placed on financial institutions are more willing to provide information to the institutions.

Alerting the authorities

The mechanisms by which financial institutions may alert the authorities to suspicions of criminal activities are discussed in Part 3. It should be noted at this stage that money laundering legislation is not intended to turn financial institutions and their employees into detectives. Staff will not be expected to go looking for signs of criminal activity. However it is important that financial institutions and their staff do not ignore potential money laundering if they become aware of it. Financial institutions do owe a duty of confidentiality to their customers. This does not however extend to participation in, connivance with, or even turning a blind eye to, possible criminal activities carried on by their customers. Confidentiality issues are discussed in more detail in Part 4.

Issues for discussion

What steps can governments and Central Banks take to encourage all financial institutions to play their part in tackling money laundering? Is the reputational threat posed by potential, albeit unwitting, involvement in money laundering sufficient, or are further measures likely to be needed? How can the positive benefits of the introduction of an anti-money laundering regime be put across to financial institutions and their customers?

The FATF Recommendations relevant to the financial sector

The key FATF Recommendations relating to the financial sector are numbers 9 to 29. These are attached at Annex A. The FATF Recommendations were published in early 1990, and were drafted primarily with banks and similar deposit taking institutions in mind. Experience in FATF member countries since then has been that money laundering activity is also occurring within other parts of the financial sector, including the securities business. Annex B, based on work done by the FATF, describes how the FATF Recommendations can be applied to this area.

The scope of application of the legislation

Introduction

While the basic money laundering offences – conversion, transfer, concealment, etc. of funds knowing or suspecting that they derive from criminal activity – will apply universally, the legislation aimed at strengthening the financial sector against abuse by money launderers, which covers issues such as customer identification, record keeping and the reporting of suspicions can be limited in its application to financial institutions. It is, however, important that the definition of "financial institution" is sufficiently broad to cover all the types of commercial activity that might be considered particularly at risk from being used by launderers.

Definition of "Financial Institution"

Given that the intention is to apply the legislation to any institution that might be used to launder money, the best starting point is the legal definition of laundering, and the various operations that are covered by the definition. Any institution that conducts one or more of these operations for legitimate purposes might be unwittingly used by launderers to conduct the operation with the proceeds of crime.

The elements of the Vienna Convention laundering offence, together with illustrations of some of the forms they might take in practice, are:

conversion – this would include the exchange of one currency for another, or the exchange of cash for travellers cheques or other negotiable instruments or securities. It would cover the trading of securities. It could be taken to include the acceptance of cash or cheques for deposit in an account – converting the money into an accounting record;

transfer – this would cover any form of money transmission service, including wire transfer;

concealment – this might be taken to cover acceptance of deposits, and also activities such as the establishment of trusts or companies to hold assets;

disguising the true nature, source, location, disposition, movement, rights with respect to, and/or ownership – this is very similar to concealment, and would particularly include offshore trust and company formation activities;

acquisition – this might include the receipt of funds through correspondent accounts with other financial institutions, or acceptance as a trustee;

possession – again, this might cover holding funds on behalf of another party, particularly when there is a degree of discretion over the disposition of the funds;

use – this might cover discretionary investment of funds held for a client;

participation in, association, conspiracy, attempting, aiding, abetting, facilitating and/or counselling – this might cover a wide range of advisory services, including investment advice and brokerage services.

The Vienna Convention definition clearly covers a wide range of financial activities, and the definition of "financial institution" needs to be equally wide. At the very least it must cover:

- **deposit taking** by institutions such as banks, building societies and credit unions;
- **money lending** including personal and mortgage lenders, factoring and financing of commercial transactions;
- **finance leasing;**
- **venture or risk capital;**
- **money transmission services;**
- **issuing and administrating means of payment** including credit cards, travellers' cheques and bankers drafts;
- **making guarantees and commitments;**
- **trading** in:

  money market instruments;

  foreign exchange;

  financial futures and options;

  exchange and interest rate instruments;

  transferable instruments;
- **underwriting and participating in share issues;**
- **money broking;**
- **investment advice and intermediation;**
- **insurance business.**

Several of the activities listed above may in some Commonwealth countries be conducted outside the formal financial sector, by unlicensed remitters, bureaux de change and in some cases casinos. It is important that these informal activities are captured as effectively as possible, to maximise the effectiveness of the system and to minimise displacement, which is discussed below.

Displacement

Experience in countries that have introduced legislation has indicated that where money laundering legislation is applied only to part of the financial sector, laundering activity shifts into those areas where the legislation does not apply. This process is known as displacement. Displacement also occurs out of the financial sector into other areas. These may include sectors such as retailing where money laundering is much harder to conceal, and in consequence takes longer, costs more, and is more likely to be detected.

More worryingly, money laundering activity may be displaced from the formal financial sector into the informal sector and the parallel economy. This is discussed in Part 5.

The legal definition of "financial institution"

Most money laundering legislation, including the draft model law, contains a definition of "financial institution" very much as described above. Most also contains provisions allowing the definition to be extended by secondary legislation. This gives flexibility to deal both with displacement and with developments in the financial sector, which might lead to the evolution of new forms of institution and new financial activities, which might offer new opportunities to the money launderer.

On the basis of the responses to the questionnaire circulated by the Secretariat in preparation for the Sri Lanka meeting, the financial sectors of Commonwealth countries demonstrate a great diversity. In almost all Commonwealth members banks are subject to a supervisory regime. In a small minority of countries there are some unlicensed deposit-taking institutions, although these are usually small in scale.

Other types of financial institution are less universally subject to a regulatory regime. These include money transmission services, foreign exchange dealers and institutions offering fiduciary services. In most countries these institutions are not considered to present any systemic risk to the financial sector, and they are not therefore

subject to prudential supervision in the same way as banks. Nonetheless these types of institutions have been shown on many occasions to be used, albeit unwittingly, in money laundering operations. It is essential therefore that they are made subject to the requirements of money laundering legislation, and that mechanisms are established to ensure their compliance. These mechanisms might involve a degree of supervision, but may well require a different kind of oversight.

More problematic, from the legislative angle, is the existence in many Commonwealth members of a large "parallel economy", where financial transactions including money transmission and foreign exchange may take place out of sight of any regulatory or legislative control. The particular problems posed by the existence of the parallel economy are considered more fully in Part 5.

Issues for discussion

What approaches can be taken for supervision of the parallel economy? What forms of financial institution are currently outside the supervisory regime? What approaches can be taken to widen the regulatory coverage without imposing too great a compliance burden on the institutions and/or too great an increase in government expenditure? How can effective coverage of the financial sector be reconciled with increased financial liberalisation?