

Chapter II

Money Laundering Impacts Development

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Criminal enterprises and terrorist financing operations succeed largely to the extent that they are able to sanitize and conceal their proceeds by moving them through national and international financial systems. The absence of, or a lax or corrupt, anti-money laundering regime in a particular country permits criminals and those who finance terrorism financing to operate, using their financial gains to expand their criminal pursuits and fostering illegal activities such as corruption, drug trafficking, illicit trafficking and exploitation of human beings, arms trafficking, smuggling, and terrorism.

While money laundering and the financing of terrorism can occur in any country, they have particularly significant economic and social consequences for developing countries, because those markets tend to be small and, therefore, more susceptible to disruption from criminal or terrorist influences. Money laundering and terrorist financing also have significant economic and social consequences for countries with fragile financial systems because they

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too are susceptible to disruption from such influences. The economy, society, and ultimately the security of countries used as money-laundering platforms are all imperiled.¹ The magnitude of these adverse consequences is difficult to establish, however, since such adverse impacts cannot be quantified with precision, either in general or for a specific country.

On the other hand, an effective framework for anti-money laundering (AML) and combating the financing of terrorism (CFT) have important benefits, both domestically and internationally, for a country. These benefits include lower levels of crime and corruption, enhanced stability of financial institutions and markets, positive impact on economic development and reputation in the world community, enhanced risk management techniques for the country's financial institutions, and increased market integrity.

A. The Adverse Implications for Developing Countries

1. Increased Crime and Corruption

Successful money laundering helps make criminal activities profitable. Thus, to the extent that a country is viewed as a haven for money laundering, it is likely to attract criminals and promote corruption. Havens for money laundering and terrorist financing have:

- a weak AML/CFT regime;
- some or many types of financial institutions that are not covered by the AML/CFT framework;
- little, weak or selective enforcement of AML/CFT;
- ineffective penalties, including difficult confiscation provisions; and
- a limited number of predicate crimes for money laundering.

1. For a detailed discussion of negative economic effects of money laundering see Brent L. Bartlett, "Negative Effects of Money Laundering on Economic Development" (an Economic Research Report prepared for the Asian Development Bank, June 2002). See also John McDowell and Gary Novis, "Economic Perspectives," United States, State Department (May 2001).

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If money laundering is prevalent in a country, it generates more crime and corruption. It also enhances the use of bribery in critical gateways, such as:

- employees and management of financial institutions,
- lawyers and accountants,
- the legislature,
- enforcement agencies,
- supervisory authorities,
- police authorities,
- prosecutors, and
- the courts.

A comprehensive and effective AML/CFT framework, together with timely implementation and effective enforcement, on the other hand, reduce the profitable aspects of criminal activity and, in fact, discourage criminals and terrorists from utilizing a country. This is especially true when the proceeds from criminal activities are aggressively confiscated and forfeited as part of a country's AML/CFT framework.

2. Damaged Reputation and International Consequences

A reputation as a money laundering or terrorist financing haven, alone, could cause significant adverse consequences for development in a country. Foreign financial institutions may decide to limit their transactions with institutions from money laundering havens; subject these transactions to extra scrutiny, making them more expensive; or terminate correspondent or lending relationships altogether. Even legitimate businesses and enterprises from money laundering havens may suffer from reduced access to world markets or access at a higher cost due to extra scrutiny of their ownership, organization and control systems.

Any country known for lax enforcement of AML/CFT is less likely to receive foreign private investment. For developing nations, eligibility for foreign governmental assistance is also likely to be severely limited.

Finally, the Financial Action Task Force on Money Laundering (FATF) maintains a list of countries that do not comply with AML requirements or

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that do not cooperate sufficiently in the fight against money laundering. Being placed on this list, known as the “non-cooperating countries and territories” (NCCT) list,² gives public notice that the listed country does not have in place even minimum standards. Beyond the negative impacts referred to here, member countries of FATF could also impose specific counter-measures against a country that does not take action to remedy its AML/CFT deficiencies.³

3. Weakened Financial Institutions

Money laundering and terrorist financing can harm the soundness of a country’s financial sector, as well as the stability of individual financial institutions in multiple ways. The following discussion focuses on banking institutions, but the same consequences are also applicable to other types of financial institutions, such as securities firms, insurance companies, and investment management firms. The adverse consequences generally described as reputational, operational, legal and concentration risks are interrelated. Each has specific costs:

- loss of profitable business
- liquidity problems through withdrawal of funds,
- termination of correspondent banking facilities,
- investigation costs and fines,
- asset seizures,
- loan losses and
- declines in the stock value of financial institutions.⁴

Reputational risk is the potential that adverse publicity regarding a bank’s business practices and associations, whether accurate or not, will cause a loss of confidence in the integrity of the institution.⁵ Customers, both borrowers and depositors, as well as investors cease doing business with an institution whose reputation has been damaged by suspicions or allegations

2. See Chapter III, FATF, The NCCT List.

3. *Id.*

4. Basel Committee on Bank Supervision, Customer due diligence for banks, (October 2001), paragraphs 8-17, <http://www.bis.org/publ/bcbs85.pdf>.

5. *Id.*, paragraph 7.

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of money laundering or terrorist financing.⁶ The loss of high quality borrowers reduces profitable loans and increases the risk of the overall loan portfolio. Depositors may also withdraw their funds, thereby reducing an expensive source of funding for the bank.

Moreover, funds placed on deposit with a bank by money launderers cannot be relied upon as a stable source of funding. Large amounts of laundered funds are often subject to unanticipated withdrawals from a financial institution through wire transfers or other transfers, causing potential liquidity problems.

Operational risk is the potential for loss resulting from inadequate or failed internal processes, people and systems, or external events.⁷ As noted above, such losses occur when institutions incur reduced, terminated, or increased costs for inter-bank or correspondent banking services. Increased borrowing or funding costs can also be included in such losses.

Legal risk is the potential for law suits, adverse judgments, unenforceable contracts, fines and penalties generating losses, increased expenses for an institution, or even closure of such an institution.⁸ Money laundering involves criminals in almost every aspect of the money laundering process. As a consequence, legitimate customers may also be victims of a financial crime, lose money and sue the institution for reimbursement. There may be investigations, by banking or other law enforcement authorities resulting in increased costs, as well as fines and other penalties involved. Also, certain contracts may be unenforceable due to fraud on the part of the criminal customer.

Concentration risk is the potential for loss resulting from too much credit or loan exposure to one borrower.⁹ Statutory provisions or regulations usually restrict a bank's exposure to a single borrower or group of related borrowers. Lack of knowledge about a particular customer, the customer's business, or what the customer's relationship is to other borrowers, can place a bank at risk in this regard. This is particularly a concern where there are related counter-parties, connected borrowers, and a common source of income or assets for repayment. Loan losses also result, of course, from unenforceable contracts and contracts made with fictitious persons.

6. *Id.*, paragraph 11.

7. *Id.*, paragraph 12.

8. *Id.*, paragraph 13.

9. *Id.*, paragraph 14.

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Banks and their account holders are protected when effective due diligence regimes are in place.¹⁰ Identification of the beneficial owners of an account is critical to an effective AML/CFT regime. Such identification procedures protect against business relationships with fictitious persons or corporate entities without substantial assets, such as shell corporations, as well as known criminals or terrorists. Due diligence procedures also help the financial institution to understand the nature of the customer's business interests and underlying financial issues.

4. Compromised Economy and Private Sector

Money launderers are known to use "front companies," i.e., business enterprises that appear legitimate and engage in legitimate business but are, in fact, controlled by criminals.

These front companies co-mingle the illicit funds with legitimate funds in order to hide the ill-gotten proceeds. Front companies' access to illicit funds, allows them to subsidize the front company's products and services, even at below-market prices. As a consequence, legitimate enterprises find it difficult to compete with such front companies, the sole purpose of which is to preserve and protect the illicit funds, not to produce a profit.

By using front companies and other investments in legitimate companies money laundering proceeds can be utilized to control whole industries or sectors of the economy of certain countries. This increases the potential for monetary and economic instability due to the misallocation of resources from artificial distortions in asset and commodity prices.¹¹ It also provides a vehicle for evading taxation, thus depriving the country of revenue.

10. See Chapter VI, Customer Identification and Due Diligence.

11. John McDowell and Gary Novis, *Economic Perspectives*, U.S. State Department, May 2001.

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5. Damaged Privatization Efforts

Money launderers threaten the efforts of many countries to reform their economies through privatization.¹² These criminal organizations are capable of outbidding legitimate purchasers of former state-owned enterprises. When illicit proceeds are invested in this manner, criminals increase their potential for more criminal activities and corruption, as well as deprive the country of what should be a legitimate, market-based, tax paying enterprise.

B. The Benefits of an Effective AML/CFT Framework

1. Fighting Crime and Corruption

A strong AML/CFT institutional framework helps fight crime and corruption. When money laundering itself is made a crime, it provides another avenue to prosecute criminals, both those who commit criminal acts and those who assist them through laundering illegally obtained funds. Similarly, an AML/CFT framework that is enforced effectively provides fewer opportunities for criminals to bribe or otherwise corrupt public officials.

An effective AML regime is a deterrent to criminal activities in and of itself. Such a regime makes it more difficult for criminals to benefit from their acts. In this regard, confiscation and forfeiture of money laundering proceeds are crucial to the success of any AML program. Forfeiture eliminates certain profits altogether, thereby reducing the incentive to commit criminal acts. Thus, it should go without saying that the broad scope of predicate offenses for money laundering, the greater the potential benefit.

2. Enhancing Stability of Financial Institutions

Public confidence in financial institutions, and hence their stability, is enhanced by sound banking practices that reduce financial risks to their operations. These risks include the potential that either individuals or finan-

12. *Id.*

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cial institutions will experience loss as a result of fraud from direct criminal activity, lax internal controls, or violations of laws and regulations.

Customer identification and due diligence procedures, also known as “know your customer” (KYC) rules, are part of an effective AML/CFT regime. These rules are not only consistent with, but also enhance, the safe and sound operation of banks and other types of financial institutions. These policies and procedures are an effective risk management tool. For example, in situations where a given individual or corporation may own several businesses that are seemingly separate entities and an institution has comprehensive knowledge of that particular customer’s operations by performing KYC procedures, that institution that can limit its exposure to that borrower and, thereby, its lending risk. Because of the risk management benefits of KYC procedures, the Basel Committee on Banking Supervision incorporates a KYC policy as part of its Core Principles for Effective Banking Supervision, aside from the AML reasons.¹³

In addition to the public confidence benefits, an effective AML/CFT regime reduces the potential that the institution could experience losses from fraud. Proper customer identification procedures and determination of beneficial ownership provide specific due diligence for higher risk accounts and permit monitoring for suspicious activities. Such prudential internal controls are consistent with the safe and sound operation of a financial institution.

3. Encouraging Economic Development

Money laundering has a direct negative effect on economic growth by diverting resources to less productive activities. Laundered illegal funds follow a different path through the economy than legal funds. Rather than being placed in productive channels for further investment, laundered funds are often placed into “sterile” investments to preserve their value or make them more easily transferable. Such investments include real state, art, jewelry, antiques or high-value consumption assets such as luxury automobiles. Such investments do not generate additional productivity for the broader economy.

13. See Core Principles for Effective Banking Supervision, Principle 15, Basel Committee on Bank Supervision, www.bis.org/publ/bcbs30.pdf.

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Even worse, criminal organizations may transform productive enterprises into sterile investments by operating them for the primary purpose of laundering illegal proceeds, rather than as profit-generating enterprises. Such an enterprise does not respond to consumer demand or to other legitimate and productive uses for capital. Having a country's resources dedicated to sterile investments, as opposed to investments that drive other productive purposes, ultimately reduces the productivity of the overall economy.

Strong AML/CFT regimes provide a disincentive for the criminal involvement in the economy. This permits investments to be put into productive purposes that respond to consumer needs and help the productivity of the overall economy.

