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The Fight Against Money Laundering and Terrorist Financing: An Analysis of the Financial Action Task Force and its Current Challenges

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Key Points

- The Financial Action Task Force (FATF) fulfills a critical role in international financial governance as the global standards-setter for anti-money laundering and combating the financing of terrorism (AML/CFT).
- Money laundering and terrorist-financing challenges are evolving, particularly as AML/CFT regimes in developed countries become more robust and illicit financial flows move deeper into primarily cash-based informal economies.
- Recent political maneuvering by FATF member states to influence the organization's decisions and global AML/CFT standards-setting has demonstrated that the FATF and AML/CFT policymaking are vulnerable to individual state interests and that the organization's political independence needs to be strengthened.
- To more effectively address the above challenges, the FATF should establish an independent oversight function, provide clearer guidance and technical support to countries with deficient AML/CFT regimes, and expand the diversity of its membership.

About the Author

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Introduction

Estimates of the value of criminal proceeds laundered annually amount to between $1.6 and 4 trillion.

Despite strong advances made against criminals and terrorists abusing the global financial system in recent years, efforts to combat money laundering and terrorist financing face major headwinds. Estimates of the value of criminal proceeds laundered annually amount to between $1.6 and 4 trillion,[1] and illicit financial flows are increasingly circumventing the formal banking system. As such, it is critical that state actors work closely not only to strengthen existing anti-money laundering and combating the financing of terrorism (AML/CFT) regimes, but also to innovate more effective methods for denying criminal entities the ability to move, store, and use ill-gotten money.

The Financial Action Task Force (FATF), an intergovernmental organization formed by the G7 in 1989 to develop and promote policies to combat money laundering, is ideally positioned to lead such an effort. However, recent political jockeying by certain member states, as well as the organization's inability to effectively respond to such political maneuvering, undermines the FATF's capacity to adequately address rapidly evolving AML/CFT challenges. This paper first examines the FATF's critical role in curbing illicit financial flows, as well as challenges within the broader AML/CFT landscape. Second, it assesses difficulties currently facing the FATF and ways in which the organization's authority is being tested. Finally, this paper offers policy recommendations and considerations to aid the FATF in bolstering its political independence and effectiveness in leading the global effort to combat money laundering and terrorist financing.

The FATF's Broad Mandate

The G7 states founded the Paris-based FATF due to concerns that money laundering, particularly from illicit drug trafficking, was posing an increasingly serious threat to financial institutions and the international banking system. In 2001, after the September 11th terrorist attacks, FATF's mandate expanded to include efforts to combat terrorist financing. At the time of its formation, the organization had 16 member states that were high-income countries and represented most of the world's major global financial centers. As of 2019, the FATF is comprised of 39 members – 37 countries and two regional organizations (the European Commission and the Gulf Cooperation Council) – reflecting an increasing global commitment to curbing illicit financial flows.

Unsatisfactory evaluation results and subsequent placement on the FATF grey list or black list can have important economic and reputational consequences for affected states.

Importantly, the FATF's objectives are principally technical in nature. The organization is tasked with setting standards and promoting "effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system."[2] These standards are defined in two principal documents: FATF's Forty Recommendations on money laundering, and the Nine Special Recommendations on Terrorism Financing. The FATF promotes the implementation of these standards through exercising broad monitoring powers, which include a mutual evaluation process and the public identification of countries with strategic deficiencies (i.e., grey-listing and black-listing) to compel target states to develop and maintain AML/CFT regimes that align with its recommendations. Mutual evaluations are not limited to FATF members, as non-member jurisdictions can participate in the review process even if they do not belong to a FATF-style regional body. They can also be nominated by a FATF member based on a specific AML/CFT threat.[3]

Unsatisfactory evaluation results and subsequent placement on the FATF grey list or black list can have important economic and reputational consequences for affected states. Perspectives vary on the degree to which grey-listed or black-listed jurisdictions suffer from loss of reputation, lower sovereign debt ratings, or weakened financial sector performance,[4] but government officials and financial services professionals within affected countries are nonetheless highly eager to avoid such public censure and the possibility of loss of access to international financial markets. Removal is granted only when states demonstrate "the necessary political commitment and institutional capacity to sustain implementation."[5] In order to sufficiently carry out its duties, the FATF – as a technical body – should be impervious to governmental lobbying and manipulation. Nevertheless, individual state interests are coming to the fore as the process of grey-listing and black-listing becomes politicized by member countries.

The Evolving AML/CFT Environment

Financial tools of statecraft, such as United Nations Security Council (UNSC) sanctions and embargoes, have often been politicized and employed to further individual state interests. Efforts to curb illicit financial flows through AML/CFT, however, have historically been less susceptible to political interference and have enjoyed broad support from the international community.[6] Indeed, in the immediate aftermath of the September 11th attacks, the UNSC passed resolution 1373, which requires all states to implement measures to "prevent and suppress the financing of terrorist acts." In March 2019, the UNSC reaffirmed its commitment to AML and to the Financial Action Task Force by passing resolution 2462, which urges all countries to adopt and implement the FATF's global standards for combating financial crime – an impressive display of consensus among UNSC member states as the Security Council experiences high levels of political paralysis in other issue areas.

Because dollar-denominated transactions, from oil purchases to currency swap settlements, must pass through dollar-clearing accounts, denial of access to the American banking system represents significant isolation from international financial markets.

The United States, a FATF founding member and one of the organization's strongest proponents, has led much of the effort in denying criminal actors access to the formal financial system. Under Section 311 of the USA PATRIOT Act, the U.S. Treasury Department is granted broad authority to target specific money laundering and terrorist financing risks. More specifically, the Treasury Department's Financial Crimes Enforcement Network (FinCEN) can "determine that a foreign jurisdiction, financial institution, class of transaction, or type of account is of 'primary money laundering concern' and can impose a variety of regulatory measures that trigger a number of obligations for U.S. financial institutions."[7] Financial institutions are also prohibited from providing services or fund transfers to individuals or entities specifically designated by the Treasury Department as being actively engaged in or supporting terrorism. As such, financial activity performed on behalf of a designated individual or entity that passes through the American financial system is a legal violation of the U.S. sanction and would be accordingly blocked. Failure to comply and engaging in sanctioned conduct may result in harsh monetary penalties or denial of access to the American financial system.[8]

Foreign states and institutions are compelled to comply with U.S. money laundering laws largely due to the predominance of the American financial system and the U.S. dollar's status as the global reserve currency. Because dollar-denominated transactions, from oil purchases to currency swap settlements, must pass through dollar-clearing accounts, denial of access to the American banking system represents significant isolation from international financial markets, an outcome that most foreign states and entities cannot afford. For example, in 2005, the Treasury Department used Section 311 against the Macau-based bank, Banco Delta Asia (BDA), which U.S. officials charged was providing financial services to North Korean government agencies and front companies, a violation of U.S. economic sanctions. The Section 311 regulation advised U.S. firms to sever business ties to BDA, which included relationships with any financial institutions or entities that either provided services to or were clients of the Macau-based firm. Although Banco Delta Asia served few U.S.-based entities, it found itself cut off from its clients and partners virtually overnight. Chinese firms – despite China's close relationship with North Korea at the time – became concerned that they would appear complicit in facilitating North Korean financial activity and closed or scrutinized any accounts servicing North Korean entities. They also froze all accounts with ties to BDA.[9]

Threatened with loss of access to the world's most significant financial system and high regulatory risk exposure, foreign financial institutions and government entities – particularly in advanced economies – have been greatly incentivized to implement FATF recommendations and to strictly adhere to AML/CFT regulations. For instance, financial institutions closed thousands of customer accounts held by money transfer firms and foreign banks that were deemed suspicious, high risk, or difficult to monitor, potentially driving illicit transactions underground and out of reach of government surveillance.[10] As such, although it has become more difficult for criminals to divert illicit financial flows into the formal economy within developed countries, criminal actors nevertheless continue to circumvent bank controls, and the United Nations estimates that only one percent of illicit money in the financial system is ultimately confiscated.[11]

In jurisdictions with cash-denominated, rather than bank-based, economies, enforcement of effective AML/CFT legislation is difficult to achieve.

In many developing countries, where informal economic practices dominate and banking systems are less mature, the cost of implementation and enforcement of FATF guidance often exceeds any direct benefit to the economy. In jurisdictions with cash-denominated, rather than bank-based, economies, enforcement of effective AML/CFT legislation is difficult to achieve, and as a result, criminal actors have been shifting illicit financial flows deeper into informal economies, out of reach of financial surveillance and controls. For example, organizations operating within underground banking networks – such as the hawala system used primarily in the Middle East, North Africa, and South Asia – do not file currency transaction reports or Suspicious Activity Reports that alert authorities to account holders attempting to hide or engage in illicit financial activity and that are required of formal financial institutions. Put simply, the volume of illicit money falling outside of the scope of mechanisms intended to curb money laundering may increase as banking institutions in advanced economies clamp down on suspicious or high-risk accounts and the challenge of informal economies within developing countries remains largely unaddressed.[12] In 2019, the World Bank estimated that the size of the informal economy accounts for about a third of GDP in emerging market and developing economies,[13] unchanged from estimates from 2003.[14] While the FATF has flagged the urgent need to update tools to counter the financing of terrorism through informal economies, it remains unable to offer better solutions.[15]

Political Challenges to FATF Effectiveness

Despite increasingly robust anti-money-laundering regimes in developed countries, UN Security Council support, and the FATF's success in raising global standards, the politicization of AML/CFT frameworks is hampering both the FATF's credibility and global AML/CFT policymaking. Three notable events from the past two years underscore this concerning development.

First, in June 2019, FATF member states engaged in political "horse-trading" over Pakistan's grey list status as a terrorist financing and money laundering risk.[16] India, with support from the United States and the United Kingdom, called for the FATF to place Pakistan on the black list, citing a mutual evaluation that found a lack of progress made on a June 2018 action plan for Pakistan to address its inadequate AML/CFT regime. Pakistan argued that India was politicizing the global illicit finance watchdog, and at the FATF's June 2019 meeting, Pakistan avoided being placed on the black list after securing diplomatic support from Turkey, China, and Malaysia.[17]

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Despite the lack of demonstrated progress by Pakistan, its concerns over the impartiality of the FATF process may be warranted. Members are unlikely to vote to penalize other members when the threat of retaliation is present, or when the jurisdiction in question has the resources or diplomatic means to evade censure (e.g., Saudi Arabia, see below). Furthermore, India has clear political motivation to have Pakistan black-listed and is able to exercise more influence as the chair of the Asia/Pacific Group on Money Laundering, a FATF regional body, despite its own inconsistent track record in curbing dark money and illicit financial flows.[18] Importantly, some analysts argue that Pakistan's AML/CFT deficiencies are in large measure derived from the state's limited resources in dealing with an impoverished population engaging mainly in informal economic transactions, an area in which the FATF's guidance is markedly lacking.[19]

Second, the FATF has a long track record of engaging with Iran in the hopes that the country will raise its AML/CFT standards and curb its sponsorship of terrorism. In June 2016, after a mutually agreed-upon action plan was created, the FATF even suspended counter-measures that it had asked member states to impose on Iran, which eased requirements on banks doing business with the country.[20] In May 2018, after the United States withdrew from the Iran nuclear deal, or the Joint Comprehensive Plan of Action (JCPOA), Germany, France, and Britain (the E3) sought to keep the agreement alive by creating a mechanism to facilitate trade with Iran that avoids U.S. sanctions and dollar-denominated transactions. The E3 also expressed their expectation that Iran would in turn implement all elements of its FATF action plan.[21]

Although the results of FATF assessments have repeatedly demonstrated that Iran has failed to complete most of its action plan items and pass meaningful AML/CFT legislation, the FATF, as well as the E3, are providing Iran with leeway despite the country's clear non-compliance.[22] For example, in the absence of the re-imposition of counter-measures, Iranian banks are permitted to maintain branches or representative offices in FATF member jurisdictions. Provided that these financial institutions – in their dealings with FATF members and EU countries – avoid exposure to the American financial system, such transactions do not run afoul of U.S. sanctions and rather extend to Iran's banking system an important lifeline.[23] At its June 2019 plenary, the FATF continued to suspend counter-measures, with the exception of calling upon jurisdictions to require increased supervisory exams for branches of Iran-based financial institutions, raising the question of whether or not the organization is

adhering to its technical mandate, or if it has succumbed to political influence by member states.

Finally, in February 2019, the European Commission produced its own list of countries that it deemed to present money laundering risks. This blacklist was compiled employing a methodology more expansive than the FATF's, as it included jurisdictions which the commission determined did not provide sufficient information on company ownership, or whose rules on reporting suspicious transactions or monitoring customers were considered too lenient. The list included countries identified by the FATF, and 11 additional jurisdictions, including Saudi Arabia (a FATF member), and four U.S. territories. The United States and all European Union (EU) member countries – with the exception of Belgium, which abstained – soundly rejected the European Commission's findings after Saudi Arabia reportedly lobbied intensely for rejection of the list.[24] According to one EU official, Riyadh threatened to cut contracts with EU states if the commission's list was approved.[25] The European Commission's list undercut global financial governance and ultimately further exposed the vulnerability of financial crime policymaking to political interference.

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Potential Areas for Reform at the FATF

The following is a brief list of policy recommendations for the FATF, intended to address the dual challenges of combating illicit financial flows' expansion and precluding political interests from influencing AML/CFT policymaking.

The FATF effectively compels countries to adhere to its global standards by threatening to 'name and shame.'

Recommendation/ Consideration	Rationale
1. Establish an independent oversight board or ombudsperson	FATF's political independence is essential for its credibility and authority; therefore, it is important to establish a mechanism through which the organization can bolster its impartiality. An independent oversight board comprised of AML/CFT evaluators and officials from across the UN system (e.g., the UN Office on Drugs and Crime, International Monetary Fund, and World Bank) would increase transparency and restrain member states from exerting undue influence in the grey-listing and black-listing of countries.
2. Conduct a comprehensive review of FATF's effectiveness and establish separate set of AML/CFT criteria for countries with primarily informal economies	A large component of the mutual evaluation process assesses how closely countries implement the FATF's recommendations, rather than on how effectively financial crime itself is addressed.[26] The last revision of the 40 Recommendations was in 2012, and a re-evaluation would be helpful in identifying areas of improvement for the FATF. It is also important to address the differences between AML/CFT challenges facing high-income countries and those facing developing countries that have largely cash-based or informal economies. In establishing evaluation criteria for countries with large informal economies, special attention should be given to supporting financial inclusion (providing more individuals and businesses with access to formal financial services), which would bring economic activity within reach of mechanisms designed to curb money laundering. Grey-listing or black-listing may impede banking sector development and be counterproductive for increasing financial inclusion.
3. Provide greater technical assistance to countries	The FATF effectively compels countries to adhere to its global standards by threatening to "name and shame." While this process may largely be useful in driving implementation of the FATF's recommendations, countries that possess the political will but lack the institutional capacity to execute have little recourse against being placed on the grey list or black list. Greater FATF involvement in improving AML/CFT regimes within deficient countries would provide the FATF with greater "on the ground" knowledge and assist governments in more effectively meeting money laundering challenges.
4. Continue to expand FATF membership	The FATF continues to be dominated by members of the European Union and high-income countries. Increased membership would allow for a greater diversity of perspectives in addressing money laundering challenges and provides greater voice to countries that may currently feel underrepresented but are making significant efforts to address AML/CFT deficiencies.

Conclusion

This paper has aimed to introduce the Financial Action Task Force and to explore the critical function it serves in curbing illicit financial flows within an evolving AML/CFT environment. It has also examined challenges to the FATF's legitimacy from certain member jurisdictions seeking to advance their own political interests and offered recommendations for how to address these difficulties – namely, to establish an independent oversight function and to de-politicize the FATF, to provide deficient countries with clearer guidance and technical support, and to expand the diversity of the FATF's membership. At its inception, the FATF's survival was far from guaranteed, and yet 30 years later, its role as the custodian of global AML/CFT standards is largely undisputed. To preserve its role in coordinating the fight against money laundering and terrorism financing, the FATF must confront head-on the challenges it currently faces and critically reflect upon its effectiveness.

At its inception, the FATF's survival was far from guaranteed, and yet 30 years later, its role as the custodian of global AML/CFT standards is largely undisputed.

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