Anti-

EXECUTIVE SUMMARY

-Money Laundering and Combating the Financing of Terrorism

response to money laundering and the financing of terrorism. This paper reviews how the T program has evolved during the past five years and discusses how the Fund could move forward in this area.

AML/CFT technical assistance program. It is now being delivered more strategically than in the past and is almost exclusively funded by external resources. Its central pillar is now the AML/CFT Topical Trust Fund.

AML/CFT assessments have been, and continue to be, an important part of the ROSC and FSAP programs, and rely on close cooperation and coordination with other key players, notably the Financial Action Task Force (FATF) and the World Bank. For the purposes of the FSAP and ROSC programs, the Fund and Bank make use of unique burden-sharing arrangements under which they rely upon assessments conducted by other assessor bodies; these burden-sharing arrangements have generally worked well. Moreover, FSAP policy currently requires that all full FSAPs and FSAP updates incorporate a full AML/CFT assessment; in contrast to other standards that form part of the ROSC program, there is no framework for targeted, risk-focused assessments. The comprehensiveness of the FATF standard and the associated methodology have demonstrable benefits (e.g., by assessing institutional arrangements and effectiveness) but also pose challenges both with respect to compliance (which has been generally low) and the assessment process (which has been relatively time consuming and expensive).

Moving forward, the paper sets out considerations that would form the basis of a way forward in two important areas.

Adopt a targeted (risk-focused) approach to AML/CFT ROSCs. Such an approach would allow for the conduct of partial AML/CFT assessments focusing on the areas where there is the greatest risk of money laundering or terrorist financing taking place without detection or sanction. The introduction of such a framework would align AML/CFT ROSCs with ROSC policy for other standards. The Executive Boards of the Fund and the Bank could also consider revising the current policy requiring all FSAPs and FSAP updates to include an AML/CFT component; abandoning this mandatory link would further align AML/CFT ROSC policy with practices vis-à-vis other standards and would facilitate a more cost-effective approach to AML/CFT assessments. However, it may signal a withdrawal from the importance that the Executive Boards of the Fund and the Bank have placed on their respective contributions to this area over the past several years. To the extent that the Executive Boards of the Fund and the Bank were to support a move towards targeted, risk-focused ROSCs and/or a revised policy on linking AML/CFT assessments to the FSAP, staff of the two institutions would seek to reach agreement with FATF and other stakeholders in the AML/CFT community on the operational

implications, which would subsequently be presented to the Executive Boards of the two institutions for approval.

Establish criteria that would be taken into account in determining when AML/CFT issuHVPDSRVHULVNVWRWKHVWDELOLWRIDPHPEHU¶GRPHVWLFILQDQFLDOVVWHP or external stability. These
including the relative importance of AML/CFT versus other issues to external and financial stability issues, as well as the risk that AML/CFT issues could have important spillover effects on other members. These considerations would be used to guide staff in its Article IV surveillance, as well as in deciding whether to include AML/CFT issues in a modular financial stability assessment.

I. INTRODUCTION AND BACKGROUND

1. **Over the past decade, the Fund has contributed significantly to the efforts of the international community to combat money laundering and terrorist financing.**[1] The

established by the Financial Action Task Force (FATF, see Box 1), the examination of AML/CFT issues in the context of Article IV surveillance, the provision of technical assistance, and research and policy development.

2. **evolved gradually** in line with the
response to money laundering and terrorist financing and a growing recognition of the importance of these issues for the Fund.[2] The evolution of the
series of Executive Board decisions,[3] the principal features of which are as follows:

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[1] Money laundering (ML) refers to activities intended to conceal or disguise the origins of the proceeds of crime; terrorism financing (TF) involves the raising and processing of funds to supply terrorists with resources to carry out their attacks. While the phenomena differ in key ways, they often exploit the same vulnerabilities in financial systems that allow for an inappropriate level of anonymity and nontransparency in the execution of financial transactions. Left unchecked, ML and TF enable criminals to amass wealth, power, and influence, which in turn undermine the rule of law and have a corrosive, corrupting effect on society and the economic system. AML/CFT controls, when effectively implemented, mitigate the adverse effects of criminal economic activity and promote integrity and stability in financial markets.

[2] At the time the Fund first considered contributing to international AML/CFT issues in 2000, the important link between financial market integrity and financial stability had already been underscored in the Basel Core Principles for Effective Supervision and in the Code of Good Practices on Transparency in Monetary and
which was understood to encompass money laundering, financial fraud, tax evasion and avoidance, circumvention of exchange restrictions, connected-party lending, and stock manipulation
performance, impose welfare losses, and negative cross-border externalities. *Financial System Abuse, Financial Crime, and Money Laundering±Background Paper*, (http://www.imf.org/external/np/ml/2001/eng/021201.pdf).

[3] World Bank policy on AML/CFT issues has evolved in a broadly similar manner. Indeed, many of the Board papers on AML/CFT policy over the past ten years have been joint products of Fund and Bank staff. As noted below, while the present paper has been issued by Fund staff alone, the proposal set out in paragraphs 30 44 on

Box 1. The Financial Action Task Force (FATF)

Membership and network. The FATF was established by the G-7 in 1989. Its membership has grown from 14 countries at its inception to 34 jurisdictions at present. The FATF is complemented by eight FATF-style regional bodies (FSRBs) whose membership comprises an additional 146 jurisdictions.

Recommendations.
international standard for AML/CFT. They encompass a broad range of issues including the regulation of services provided by financial institutions and nonfinancial businesses and professions, cross-border movements of currency, the transparency of legal entities, substantive and procedural criminal law, institutional capacity, sanctions, and domestic and international cooperation.

Peer Review, Transparency, and Follow-up. The FATF pioneered the

peer reviews respecting their implementation of its standard, the publication

progress in addressing deficiencies. These practices have been followed by other international bodies such as the Financial Stability Board (with respect to implementation of the BCP, IOSCO, and IAIAS principles).

II. REVIEW OF EXPERIENCE

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compliance with the FATF standard and (B) the provision of technical assistance.

A. Assessing Compliance with the FATF Standard

5. **AML/CFT assessments are an important part of the joint Bank/Fund ROSC and FSAP programs.**[5] Since 2004, the Fund has conducted detailed assessments of 34 countries[6] against a comprehensive, uniform methodology. These assessments have generated 30

[5]As noted in *IMF Executive Board Reviews the Quality and Consistency of Assessment Reports for Anti-Money Laundering and Combating the Financing of Terrorism and the Effectiveness of Coordination*, PIN 06/72, June 30, 2006
countries to develop strong programs on anti-money laundering and combating the financing of terrorism, and continued support for comprehensive assessments of these programs within the context of the Financial Sector

continue to

[6] Covering assessment missions completed between December 2004 and January 2011.

ROSCs,[7] of which 27 have been published. The World Bank, the FATF, and the FSRBs have together conducted an additional 152 assessments that have produced 140 published detailed reports and 23 ROSCs. In their totality, these reports provide a comprehensive baseline of public information on AML/CFT regimes worldwide.

6. **The current framework for the conduct of these assessments differs from the rules governing ROSCs in other areas in at least three important respects.**

FSAP policy requires that every full FSAP and FSAP update incorporate a full AML/CFT assessment.[8] Under FSAP policy, AML/CFT assessments should, to the extent possible, be conducted within 18 months before or after the relevant FSAP mission and should be conducted *approximately* every five years.

While the ROSC program itself is entirely voluntary, most Fund members are required to undergo a full AML/CFT assessment approximately every five years and to publish the results by virtue of their membership in FATF or one of the eight FATF-style regional bodies (FSRBs).[9]

The AML/CFT program incorporates unique burden-sharing arrangements under which the Fund and the World Bank, for the purposes of the FSAP and ROSC programs, make use of assessments prepared, not only by Fund and Bank staff, but also by FATF and the FSRBs, which represents a significant leveraging of the Fund resources allocated to the assessment program

Fund and the Bank.[10]

7. **These rules and arrangements reflect two important features of the AML/CFT program, in particular, in the area of assessments**. It is deeply integrated into another the FSAP. Moreover, it forms part of a broader effort within the international community to combat money laundering and terrorist financing. As such, it relies heavily on close cooperation and coordination with other key players in the AML/CFT community in particular, FATF

8. **The experience with the AML/CFT assessment program points to several important lessons.** They relate to three issues: (i) the comprehensiveness of the FATF standard and the assessment process; (ii) burden-sharing arrangements with other assessor bodies; and (iii) the use of Fund assessments in the context of FATF initiatives to deal with
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Scope of the AML/CFT standard

9. **The FATF standard and the associated assessment methodology are comprehensive and exacting.** As money laundering and terrorist financing can occur through many different avenues in different sectors of the economy, the standard itself has become equally broad in scope, and broader than standards in other areas that relate to relatively discrete areas of the economy (e.g., banking regulation, the fiscal sector). The

peer review process, which over twenty years, has prompted the gradual expansion and refinement of the standard.

10. **The comprehensive nature of the standard sets a high benchmark both with respect to country compliance and the assessment process.**

Compliance by countries with the standard is low. Of the 161 countries assessed using the current methodology from 2004 to April 2011, full compliance with any principle was rare, occurring in only 12.3 percent of the cases.[11] Countries achieved the second highest score, largely compliant, only 25.5 percent of the time.

Compliance is expensive. To achieve relatively high levels of compliance, countries must invest in building institutions and promote active interagency coordination and international cooperation. It is, therefore, not surprising that relatively high levels of compliance have been achieved by countries with higher per capita income levels and more well-developed frameworks for financial regulation and fighting corruption.[12] In contrast, compliance by many emerging market and low-income countries is impeded by a relatively poor understanding of AML/CFT best practices, inadequate budgets for training staff, and the absence of important preconditions (e.g., rule of law, transparency, and good governance) for the effective implementation of AML/CFT measures.

The assessment process itself requires a significant commitment of time and resources, both for the country being assessed and for the assessors (see Box 2).

[11] For a complete analysis of global compliance with the AML/CFT standard, see Annex 1.

[12] The analysis of global compliance with the AML/CFT standard reveals an absence of correlation, however, standard and its contribution to global drug production, consumption, and trafficking, a crime known to generate significant proceeds that need laundering. See also, C. Verdugo -Coun Working Paper (forthcoming).

Box 2. The AML/CFT Assessment Methodology

The AML/CFT assessment
compliance with the FATF AML/CFT standard.

Compared with assessments of other standards and codes, AML/CFT assessments are time consuming and costly for both the assessors and the authorities.

Assessment missions take up to 2 ½ weeks on site and, in the case of the Fund, typically involve teams of 4 6 assessors. Pre-and post-assessment work has taken on average 17 weeks of staff work per assessor.

IMF assessments cost, on average, some $310,000. In contrast, data ROSCs, i.e., the second costliest ROSC, cost, on average, $225,000. However, factoring in the assessments prepared by the other AML/CFT assessor bodies under the existing burden-

The comprehensive nature of the methodology does not always allow assessors to focus on issues that are of the greatest relevance for particular countries. Under current policy, all AML/CFT assessments must be comprehensive and cannot be targeted to the circumstances of individual countries. While this approach was appropriate during the first round of assessments, its usefulness is gradually diminishing. Moving forward, it may force assessors to revisit issues that have already been covered and that may be of limited relevance for a particular country. Moreover, re-examining such issues may divert attention away from more important issues that would benefit from a deeper examination. For example, where a country has a small banking sector with a strong record of compliance but also has nonfinancial firms (e.g., trust and company service providers) that present significant vulnerabilities, it would appear appropriate to devote relatively little attention to the

first area and a great deal of attention to the latter.[17] The current methodology, however, requires both areas to be fully covered.

Box 3. Technical Assistance on the Regulation of Trade in Precious Metals and Stones

Fund staff recently undertook a risk-focused AML/CFT technical assistance project targeting countries that produce and trade in precious stones and metals in Sub-Saharan Africa.

Dealers in precious stones and metals, a relatively recent addition to the list of designated professions that should be incorporated into a country s AML/CFT regime, constitute a particularly relevant category in this region, where precious mineral exports account for a high share of total exports and formal financial systems are underdeveloped. The trade in precious minerals has been linked to illicit financial flows, corruption, drug trafficking, arms smuggling, and the financing of terrorism.

Better regulation and oversight of the precious minerals sector would be very effective in helping countries in Sub-Saharan Africa to combat money laundering and terrorism financing and should also strengthen revenue collection and improve the fiscal positions of the countries in question.

After having raised awareness in 13 countries through two regional workshops, the project is now turning to direct and tailored technical assistance to countries of the region.

Cooperation and burden sharing

11. **The burden-sharing arrangements between the Fund, the World Bank, the FATF, and the FSRBs for conducting AML/CFT assessments have generally worked well.** Assessors apply a common methodology and the IMF, World Bank, and FATF have collaborated closely in developing and implementing technical assistance and training programs for assessors and assessed country officials. Assessment reports provide a sound basis for follow-up technical assistance, and the involvement of multiple assessor bodies has enriched the ongoing discussion on possible improvements of the standard and the assessment methodology.

12. **At the same time, burden sharing has given rise to difficulties related to the poor quality of the reports prepared by some assessor bodies.** While all assessments examine the same issues, there have been notable differences in the quality of the reports. A study prepared by an independent panel at the request of the Executive Boards of the Fund and the

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regulation of trade in precious metals and stones. In some poorer developing countries with rudimentary banking systems, trade in precious metals and stones can form an important conduit through which money laundering can take place that may give rise to risks that are more serious than those which may arise through the banking system. The Fund has provided technical assistance on these issues to a number of countries in Africa (See Box 3).

Bank in 2006 pointed to these differences and, while noting the high quality of the reports produced by Fund staff and some other bodies, pointed to significant weaknesses in other cases.[18] In the context of the most recent review of AML/CFT policy in 2006, the Executive Board expressed concern with these problems but recognized the need for the Fund to continue to rely on reports from other assessor bodies, given prevailing budgetary conditions.[19] In response to these concerns, and in cooperation with the World Bank and several of the FSRBs, Fund staff has continued to help strengthen the FSRBs by training their assessors, providing comments on their assessment reports, participating in their plenary meetings, and preparing the authorities of countries about to undergo an assessment. Staff has also provided pre-assessment training to officials from 31 countries over the past five years. Many of the relevant assessor bodies have made significant progress in strengthening the quality of their assessments. Nevertheless, improving the quality and consistency of assessment reports remains a work in progress.

13. **The FATF currently engages in the International Cooperation Review Group or to identify and engage with**
significant risk to the international financial system -cooperative jurisdiction-
makes use of Fund and Bank ROSCs in
standard, and it applies both positive and negative incentives to encourage countries to strengthen their AML/CFT regimes. The FATF has issued a series of public statements expressing concern about significant deficiencies in AML/CFT regimes of a small pool of jurisdictions.

14. **As explained in the recent review of the Standard and Codes Initiative,[20] NCJ processes like the ICRG present challenges to the cooperative and voluntary nature of the ROSC program.** In particular, the use of Fund and Bank ROSCs in a process that involves the application of coercive elements may undermine the cooperative nature of the

voluntary approach.

15. **Since**
ICRG process is conducted in a manner that respects the principles underlying the

[18] See *Anti-money Laundering and Combating the Financing of Terrorism² Review of the Quality and Consistency of Assessment Reports and the Effectiveness of Coordination* (Box 1, http://www.imf.org/external/np/pp/eng/2006/041806r.pdf).

[19] See *IMF Executive Board Reviews the Quality and Consistency of Assessment Reports for Anti-Money Laundering and Combating the Financing of Terrorism and the Effectiveness of Coordination*, PIN 06/72, June 30, 2006.

[20] See *2011 Review of the Standards and Codes Initiative*, (http://www.imf.org/external/np/pp/eng/2011/021611.pdf), and *IMF Executive Board Concludes Review of Standards and Codes Initiative*, PIN 11/38, March 22, 2011.

ROSC program.[21] Fund and Bank staff have participated in the ICRG process as observers and, with the have provided information on Fund and Bank TA to countries under scrutiny and their efforts to strengthen their AML/CFT regimes. At the same time, Fund and Bank staff have not participated in the issuance of public statements or the application of coercive measures against countries under review.

16. **In response to concerns expressed by Fund and Bank staff, the FATF has designed the ICRG process in a manner that respects the ROSC principles.** While the FATF makes use of Fund and Bank ROSCs in the process, it does not issue public statements

both to confirm facts and to provide them with an opportunity to outline their plans to address the deficiencies. The statements themselves differentiate between jurisdictions that have committed to an action plan and those that have not. The public statements are designed to encourage rapid progress toward compliance with the FATF standard, but they also recognize the commitments that jurisdictions have made to improve their position.

17. **Moving forward, Fund staff, in coordination with Bank staff, will continue to engage with the ICRG process as long as it continues to respect the voluntary and cooperative principles underlying the ROSC program.** In this connection, Fund staff will implement the guidance recently provided by the Fund and Bank Boards in the context of the review of the Standards and Codes Initiative for engagement in NCJ processes.[22] In particular, Fund staff will continue to monitor developments in the ICRG and to play a good role in providing relevant information on member countries under review as described above, while refraining from participation in those aspects of the process that are coercive in nature.

B. Technical Assistance in the area of AML/CFT

18. **Technical assistance (TA) has always been an important component of the s work in the area of AML/CFT.** The assessment and technical assistance programs have been mutually reinforcing. The past five years have witnessed significant changes to the

financing and (ii) the relationship between AML/CFT assessments and TA.

Transition to External Financing for TA

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[21] Board guidance with respect to the non-cooperative countries and territories (NCCTs) initiative undertaken by the FATF between 1999 and 2006. I
with the FATF on the suspension of the NCCT initiative. Then, in 2004, in the context of the decision to make AML/CFT assessments a regular part of the ROSC program, Directors agreed on the importance of continuing collaboration with the FATF and welcomed the fact that the FATF had no plans to conduct a further round of the NCCT exercise.

[22] See *2011 Review of the Standards and Codes Initiative*, (http://www.imf.org/external/np/pp/eng/2011/021611.pdf), and *IMF Executive Board Concludes Review of Standards and Codes Initiative*, PIN 11/38, March 22, 2011.

19. **Over the past three years,**
program has undergone a complete transformation.
historically been financed primarily through internal resources, this approach was abandoned in FY2008
AML/CFT TA would be financed with external resources.

20. **The central pillar of this new approach was the establishment of the AML/CFT Topical Trust Fund (TTF) in FY2009.** The TTF was the first topical trust fund established by the Fund and has been followed by similar trust funds in the areas of tax policy and administration and managing natural resource wealth. The AML/CFT TTF is a multi-donor trust fund that is designed to provide the Fund with a pool of resources to finance virtually all of its AML/CFT TA. The TTF is supported by twelve donors[23] who have pledged $25,274,610 for five years of operations through FY2014. The donors comprise a steering committee that meets annually and provides strategic guidance to Fund staff, reviews and approves the TTF work and financial plans, and facilitates cooperation among donors and
e-year program document, annual meetings, and regular reviews of progress and performance promote results-based management and accountability by Fund staff and recipient countries.[24]

21. **With the establishment of the TTF, the AML/CFT TA program has been adjusted to ensure that it focuses**
results in specific, value-adding contributions to global AML/CFT efforts. Specifically, the allocation of AML/CFT TTF resources is directed toward medium-term capacity building and follows a four-pronged prioritized strategy:

> Focusing on systemically-important countries, middle-income countries, and countries with significant ML or TF risks;[25]
>
> , overall system design, financial sector regulatory issues, law reform, good governance, and institution building;
>
> Striking the appropriate balance between bilateral programs for systemically-important members and regional approaches; and

[23] Canada, France, Japan, Korea, Kuwait, Luxembourg, the Netherlands, Norway, Qatar, Saudi Arabia, Switzerland, and the United Kingdom.

[24] A more detailed description of the TA projects financed under the TTF is set out in Annex 2.

[25] *per se*
focus on systemically-important engagements will tend to result in the allocation of a significant proportion of resources to emerging and middle-income economies whose financial systems have outpaced their AML/CFT capacity.

Enhancing TA delivery through: (i) long-term planning with emphasis on fostering closer relationships with country officials and area departments; (ii) developing regional and country strategies; (iii) maximizing the use of external resources; (iv) combining staff expertise with short- and long-term field experts to optimize skill mixes and realize savings on travel cost; and (v) implementing strict quality control measures.

22. **The AML/CFT TTF and support from other external sources demonstrates the advantages that external financing offers for Fund TA in the AML/CFT area.** The TA program financed by the TTF has already had a number of early successes including an important project in Thailand, which has received high-level political support (Box 4). External financing has
the international community attaches to Fund TA in this area.

23. **Of course, challenges remain in meeting demand, designing programs, and focusing on Fund priorities and results in TA programs.** One risk associated with external financing is that priorities set by the donors may not always align with those of the Fund. It is also important to donors that the Fund itself continues to demonstrate an internal commitment to the program. At present, Fund staff has almost no internal resources to respond to requests for TA, even where such TA may be necessary to support broader Fund initiatives in a member country (e.g., related to a Fund-supported program).
interests may be better protected through the setting aside of a small pool of resources that would ensure that these requests could be promptly met. Moreover, although the donor community analytical work on AML/CFT,
they do expect the Fund itself to support these initiatives.

Box 4. IMF AML/CFT TA to Thailand

The Kingdom of Thailand has a significant economy and a well-integrated financial sector, but it demonstrated poor compliance with the international AML/CFT standard during a 2007 FSAP. The FATF s International Cooperation Review Group (ICRG) has identified Thailand as a country with strategic AML/CFT deficiencies. Following the FSAP, the Thai authorities asked the Fund to enter into a 3 5 year strategic partnership to enhance the performance and capacities of its Anti-Money Laundering Office (AMLO) and other primary AML/CFT-related agencies.

After securing financial support from the externally-financed AML/CFT TTF, the Fund entered into the strategic partnership with Thailand in April 2009 to address the deficiencies identified by the assessment and respond to concerns raised by the ICRG. The overall objective of the program is for Thailand to establish a comprehensive AML/CFT legal, regulatory, and institutional framework (including laws, regulations, guidelines, and training of personnel) to comply with AML/CFT standards.

The program represents a significant investment by the TTF; it has been designed around a high-level Master Implementation Plan (MIP) endorsed by the Thai Cabinet and involves a series of modules delivered by a core project team of experts operating peripatetically, complemented by specialized expertise to address specific issues, and overseen by HQ staff. The program has been structured to take into account the absorptive capacity and consensus-oriented culture of the Thai authorities, the resource capacity of Fund staff, and the timetable for implementation of the MIP.

The MIP and the 3 5 year TA program of planned TTF modules was officially launched by the Minister of Justice at a national seminar convened by the Thai authorities on October 28 29, 2009 and attended by over 50 key agencies and private sector stakeholders, which helped secure broad national commitment. In December 2010, the Cabinet formally endorsed a detailed National AML/CFT Strategy that articulates detailed objectives, timelines, and responsible parties across the full range of measures required for an effective AML/CFT regime. The TA program has also helped the authorities prepare comprehensive draft legislation on AML and CFT and to respond to the FATF ICRG process. Training of personnel is underway and Fund staff is coordinating effectively with other TA providers.

Relationship between assessments and TA

24. **Experience over the past five years has highlighted the synergies that can be realized between AML/CFT assessments and the provision of TA.** Along with the World Bank, the Fund is the only global institution that has a permanent staff of assessors and a global reach that facilitates conducting assessments and providing TA. Assessment experience develops technical expertise in the standard that is highly useful to members seeking to improve their compliance, whereas TA experience develops practical and comparative perspectives that inform assessments. Of the 34 assessments conducted by the Fund since 2004, 5 of them have led to follow-up technical assistance relationships. The Fund (together with the World Bank) is also unique, among other AML/CFT actors, in its ability to link AML/CFT to the broader macroeconomic, financial sector stability and development imperatives currently confronting the international community.

25. **Fund staff has conducted cross-**

sector problems arising from money laundering or terrorism financing activities through Article IV consultations.[28] This has generally taken place and, during the period covered by the 2004 to the 2009 consultation cycles, about 50 percent of Article IV s

or core[31] areas of the standard or where the standard has been amended, and/or (iii) areas where individual countries face particular risks, either domestic or cross border.[32]

30. **A strong case can be made for the Fund and the Bank to move towards a targeted, risk-focused approach in the conduct of their AML/CFT assessments.** Under this approach, both institutions would dispense with the requirement that every AML/CFT assessment take the form of a full assessment and, rather, would allow the Bank and the Fund, where appropriate, to engage in more targeted and focused assessments. The scope of the assessment and the choice of areas that would be examined would be based upon the circumstances of the country whose framework was being assessed. More specifically, the Fund and the Bank would continue to insist that a member undergo a comprehensive assessment against the full AML/CFT standard *but only once*. Subsequent assessments of standard would be based upon an analysis of the relevant risks and, in most cases, would take the form of a partial update.[33] Given that the vast majority of countries have already been assessed under the current standard, the frequency of full AML/CFT assessments conducted by the Bank and the Fund would be expected to diminish over time.

31. **This approach would bring the Fund and the Bank AML/CFT assessment programs in line with the ROSC policy for other standards.** Over the past two years, the Bank and Fund have moved towards targeted, risk-focused assessments for all existing standards other than AML/CFT.[34] Under the current policy for financial sector ROSCs, a

subsequent assessments are targeted to the most important areas that are chosen on the basis of criteria that Fund and Bank staff have developed in cooperation with the relevant standard

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[31] The FATF standard recognizes 16 Recommendations as bei .
Recommendations are those related to the criminalization of ML and TF (Recommendation 1, Special Recommendation II), customer identification/record-keeping requirements (Recommendations 5, 10), and STR reporting (Recommendation 13 and Special Recommendation
related to international cooperation and mutual legal assistance (Recommendations 35, 36, 40, Special Recommendations I and V), freezing and confiscation (Recommendation 3 and Special Recommendation III), financial secrecy (Recommendation 4), adequate regulation and supervision (Recommendation 23), and functional FIU (Recommendation 26).

[32] In October 2010, FATF held a preliminary discussion on specific areas where processes and procedures could be reviewed, including the possibility of conducting more focused and risk-based compliance assessments. Further discussions on assessment processes and procedures will resume after October 2011. The next round of mutual evaluations is not likely to be launched before late 2012.

[33] Full reassessments could still be done, either because a risk analysis suggests that it should be done, or subject to available resources because a member had specifically requested it.

[34] In September 2009, the Executive Board decided to allow risk-based ROSCs to be conducted for the banking, insurance, and securities supervision standards (see *Revised Approach to Financial Regulation and Supervision Standards Assessment in FSAP Updates* (http://www.imf.org/external/np/pp/eng/2009/082809D.pdf). More recently, in March 2011, the Executive Board decided to extend this approach to all ROSCs other than AML/CFT (see *IMF Executive Board Concludes Review of Standards and Codes Initiative*, PIN 11/38, March 22, 2011).

setters (see Box 5). These criteria, in particular, focus on principles that (i) reflect significant weaknesses identified in previous assessments, (ii) are associated with key areas of risk, (iii) are new or have been significantly revised since the last assessment, or (iv) have been

32. **A risk-focused approach to AML/CFT assessments would be more effective and would allow the Bank and the Fund to focus on what matters most with respect to each member.** It would avoid the need for staff and the authorities to waste resources assessing principles that, under the previous assessments, have been identified as posing little ML/TF risk for the relevant member. At the same time, it would free up resources that would allow the Fund and Bank to focus greater attention on issues that present the most serious risks for the member. Given the large number of full assessments that have already been completed by the international community, the Bank and the Fund have in place an extensive record of material would be of great assistance in identifying the areas that should be covered in a risk-focused assessment for a particular country.

Box 5. The Criteria for Identifying the Principles to be Assessed Under a Risk-Focused, Financial-Sector ROSC

With the exception of the AML/CFT standard, Fund policy now permits the Fund, in certain circumstances, to conduct targeted, risk-focused compliance assessments of standards in order to identify the principles to be assessed. In the new framework, the mission team will take into account the relevant risks and vulnerabilities in the country in question and will focus on:

33. **While a risk-focused approach for AML/CFT assessments could follow the criteria that are currently in place for other risk-based ROSCs, it could also focus more closely on the specific risks presented by ML/TF issues.** Many of the criteria under existing ROSC policy identify cases where compliance with the relevant standard is weakest. The criteria for AML/CFT assessments could build on this approach but place less emphasis on cases of weak compliance per se and more emphasis on cases where such weak compliance is most likely to lead to significant ML and TF activities not being detected or sanctioned. The fact that a country has a poor record of compliance in a particular area of its AML/CFT framework does not necessarily mean that it represents a high risk for ML or TF activities. Poor compliance would lead to substantial ML or TF activity only if conditions in that country were such that a large volume of ML or TF were likely to take place through that channel.

34. **There are compelling reasons why the criteria for AML/CFT assessments may need to be more exacting**
standard than may be necessary with respect to other ROSCs. In particular, the broad scope of the AML/CFT standard compared to other standards may require the exercise of greater rigor in eliminating less important areas and in ensuring that assessment will target the issues related to the most significant risks. Thus, the choice of areas to be covered would need to consider the likelihood that significant money laundering or terrorist financing will actually take place.

35. **Staff in the Fund and the Bank are working on a methodology for understanding and assessing money laundering and terrorist financing risks.** While some aspects of the methodology are not yet fully elaborated, and Fund and Bank staff are continuing to experiment with different approaches in the context of technical assistance, staff from both institutions agree that international risk management standards should be applied in assessing the threats, vulnerabilities, and consequences that may arise from a particular money laundering or terrorist financing event (see Box 6). [35] Staff from both institutions are also contributing to ongoing discussions within FATF working groups that are also examining these issues, and despite the inherent difficulties in assessing ML and TF risks a broad consensus is emerging to continue working along the lines outlined by Fund and Bank staff.

[35] nalysis for AML/CFT, see Annex 3.

Box 6. Applying International Risk-Management Standards to AML/CFT

Fund and Bank -management frameworks seek to focus on mitigating the risks that flow from substantial ML or TF occurring. isk account the likelihood of an event occurring and the consequences that will ensue if it occurs. In determining the likelihood of an event occurring, the framework examines the threat that derives from the pool of illegally-acquired assets that need laundering or processing, and the vulnerabilities associated with relevant financial markets and AML/CFT controls. An assessment of consequences examines the various social, economic, and political outcomes that result from the occurrence of ML or TF risk events.

Applying risk-management principles to ML or TF is complex due in large part to the lack of sufficient data or information about past ML or TF events. Accordingly, an assessment of ML or TF risk needs to rely on a semi-qualitative, risk-scoring system that focuses on the key ML or TF risk events. These events are:

ML or TF is attempted:

Due to a co-existence of substantial amounts of proceeds of crime or of terrorist funds that need processing; and

The perpetrator of the ML or TF is not caught:

if it is attempted, ML or TF will not be detected by the authorities (either directly or as a result of the efforts of businesses that are required to make suspicious reports); or
if it is detected, ML or TF will not be investigated by the authorities; or
if investigated, the perpetrator will not be prosecuted; or
if prosecuted, the perpetrator will not be convicted; or

The perpetrator of the ML or TF is not sanctioned:

if convicted, the perpetrator will not be punished adequately, or
if punished, the perpetrator will not be deprived of his assets.

The relevance of any given consequence will vary depending on the objectives of a given risk-management exercise. The methodology currently under development by Fund staff focuses on the consequence of ML or TF being conducted without detection or sanction.

36. **Implementing a risk-focused approach to AML/CFT assessments would present operational challenges.**[36] First, in order to protect the integrity of the ROSC process, a methodology for choosing the principles selected for reassessment would have to be developed in cooperation with the FATF and FSRBs.[37] R
compliance with a defined set of FATF Recommendations in every case, AML/CFT assessors would have to develop a deeper understanding of the economies (including the criminal and underground economies) they would assess and, on this basis, identify the areas that merit detailed examination in advance of the mission. Assessors would also have to determine whether measures adopted by assessed countries would be effective in addressing AML/CFT risks. For these purposes, an assessment would presumably need to be preceded by consultations with the relevant member and with other assessor bodies. As such, a risk-focu

profile presented by a given jurisdiction and the joint methodology among assessor bodies envisioned above.[38]

39. **This option would establish consistency in the approach taken on all standard assessments in the context of the FSAP and allow for a more efficient and strategic allocation of scarce resources**. It would be in line with recent trends in the FSAP/ROSC programs towards greater flexibility and the efforts of the Fund and the Bank to customize the scope and depth of coverage of an FSAP towards the circumstances of individual members.[39] FSAP stability modules and mandatory stability assessments under Article IV are *not* subject to the mandatory link, although their coverage of financial stability issues is identical to that undertaken -Bank FSAPs. Moreover, this option would recognize that regular AML/CFT assessments are now the norm for the vast majority of IMF members, given the conditions attached to membership of the FATF and similar regional bodies. It would, nevertheless, not preclude AML/CFT issues receiving extensive treatment in the context of an FSAP whenever justified by the relevant risks. However, it may be seen as implying a withdrawal by the Bank and the Fund from AML/CFT issues and the attention that they have received in the FSAP context.

40. **In the second option, the Fund and the**

approach under which the length of time since the last assessment would be one factor in determining the scope of an assessment.[41]

41.

laundering and terrorist financing. It would recognize that the FSAP framework has provided an effective mechanism through which to ensure that AML/CFT issues are addressed in member countries on a consistent basis, and would acknowledge that significant progress still needs to be made in strengthening AML/CFT frameworks. However, this option would retain the unique status of the AML/CFT standard among all other components of financial surveillance and all other financial sector standards. Under this option, the differential treatment that AML/CFT assessments receive with respect to FSAPs and modular stability assessments would also be maintained: while an AML/CFT assessment is required for every FSAP/FSAP update, no similar requirement would apply to modular stability assessments.

42. **Under either option, the Fund and the Bank would retain the existing burden-sharing arrangement with other assessor bodies but would need to ensure that assessments are conducted in a consistent manner**. While there have historically been inconsistencies in the *quality* of the assessments being conducted by different assessors, a targeted approach runs the risk of creating inconsistencies arising in the *coverage* of different assessments. To continue with the current rules on the mutual recognition of assessments and, in particular, the policy under which the Fund and Bank would treat mutual assessments conducted by other bodies as ROSCs, the Bank and Fund would need to be satisfied that such assessments do cover the relevant issues. That is, different assessor bodies may have

to assess different recommendations. These challenges may be effectively addressed through the formulation of clear criteria and a methodology for the assessment of risks and for the choice of principles to be assessed. It would also be important to rely upon the mechanisms and working arrangements among the various assessor bodies that have been established over the past six years including joint consultations.

43. **If the Boards of the Bank and the Fund approve in principle moving to targeted, risk-focused AML/CFT assessments, staff from the two institutions will discuss with FATF and the FSRBs the modalities of implementation**. FATF itself will be discussing the feasibility of a risk-focused approach over the course of the next year and Bank and Fund staff intend to participate actively in these discussions. Similarly, following guidance from the Executive Boards with respect to the nature of the relationship between AML/CFT assessments and FSAPs and FSAP updates, Fund and Bank staff would discuss operational implications with external stakeholders. To the extent that a consensus was to emerge in favor of a revised approach, Fund and Bank staff would return to their respective Executive Boards with a specific proposal for consideration. At that time, the operational details would

[41] Thus, if five years had passed since the last full assessment, a full reassessment may or may not be appropriate, depending on the circumstances of the member.

be spelled out and, if approved, Fund and Bank staff could begin to undertake a new generation of targeted, risk-focused assessments in concert with the FATF and FSRBs.

B. Treatment of AML/CFT Issues in Modular Stability Assessments and Article IV Surveillance

44. **Another important issue concerns the circumstances in which AML/CFT should sessments under the FSAP or bilateral surveillance under Article IV.** This section sets out a conceptual framework for assessing risk in these circumstances and then applies it in these contexts.

45. **Any framework of rules for the coverage of AML/CFT issues in modular stability assessments or bilateral surveillance must be based upon an assessment of risk.** However, the types of risk that are relevant in these circumstances differ from those that are relevant for risk-based AML/CFT -focused ach for ROSCs described above would be concerned with the risk of substantial ML or TF taking place without detection or sanction. In contrast, and as discussed in greater detail below, modular FSAP stability assessments are concerned with risks that threaten the stability of the domestic financial system, while bilateral surveillance is concerned with risks to the external stability . of payments position that does not, and is not likely to, give rise to disruptive exchange rate

domestic financial system is stable, a member may find itself in a position of external instability either because of problems in the domestic economy that are unrelated to the financial system, or because of problems in the external position of the member that are unrelated to the domestic economy. At the same time, it should be recognized that there are important linkages between and among all of these risks.

46. **The challenge in articulating an effective framework of rules for the coverage of AML/CFT in modular stability assessments and bilateral surveillance** is to identify cases where money laundering or terrorist financing is so serious as to threaten the stability of the domestic financial system (in the case of modular stability assessments) or external stability (in the case of Article IV surveillance). Set out below is a conceptual framework for this analysis along with factors that could be taken into account in applying the framework.

Background, Cases, Analytical, and Conceptual Work

47. **Money laundering and financial abuse can undermi financial system or its broader economy.** system depends heavily on trust and the expectation that the highest professional, legal, and ethical standards are observed. Financial and external stability may be undermined by the act of money laundering or terrorist financing itself but also from the associated crimes (i.e.,

48. **For the purposes of analyzing the impact on financial or external stability, it is often difficult to separate the act of money laundering or terrorist financing from the related predicate crime.** There is often a very close relationship between the criminal act

that gives rise to proceeds and the laundering of these proceeds. Similarly, there is often a very close nexus between operations to finance a terrorist act and the terrorist act itself. It is, therefore, not surprising that the FATF standard calls for the application of a range of measures that deal not only with money laundering or terrorist financing per se, but also the predicate crimes to which they relate.[42]

49. **There are a number of ways in which money laundering or terrorist financing, or their related p**
system or its broader economy. These are discussed in greater detail in Annex 4 and summarized below.

Some of these are directly attributable to problems of money laundering and terroris financing, per se

> **Loss of Access to global financial markets:** The failure of a member to deal effectively with money laundering or terrorist financing may result in a loss of access of its financial system to global financial markets, with potentially negative consequences for financial stability and the economy as a whole. It is becoming a more frequent practice for national supervisors to prohibit their banks from dealing with financial institutions from countries with weak AML/CFT frameworks, or to at least subject transactions with institutions from such countries to stricter conditions.[43] Even in the absence of specific guidance from the relevant national authorities, financial institutions in some countries may prove reluctant to deal with banks from jurisdictions where money laundering or terrorist financing is a major concern.
>
> **Destabilizing Inflows and Outflows:** Money laundering or terrorist financing
>
> flowing into and out of individual financial institutions in the country in ways that are destabilizing for these institutions. Such inflows or outflows can be either cross border or domestic in nature and, where transactions in illegal markets or criminal these
> flows can affect the entire financial system.

Threats to financial stability can also arise from predicate crimes, often in combination with money laundering or terrorist financing.

> **Financial Sector Fraud:** Money laundering may also be associated with broader problems of financial sector fraud. The potentially adverse effects on financial

[42] Although the FATF standard largely deals with predicate crime indirectly through its focus on money laundering, eight of the 49 Recommendations explicitly address predicate crimes. In addition, the assessment methodology calls for the assessment reports to contain a discussion of the quantum and type of predicate offenses for money laundering, and for assessors to take into account the amount and type of predicate crime activity when considering the effectiveness of implementation.

[43] The application of such measures towards financial institutions from such countries is expressly contemplated

stability that may arise from large-
small island economies have been well-publicized. Financial fraud may undermine a
system in many different ways through large-scale bank

outflows of capital from the banking system as the scale of the fraud becomes known, or by the loss of access to international financial markets arising from the deterioration in the juris

Problems with Financial Sector Supervision: Money laundering and terrorist financing may serve as evidence of deeper problems respecting the integrity of a framework for financial sector supervision. Where important financial institutions within a country are owned or controlled by criminal elements, the authorities may encounter difficulty in supervising these institutions or in identifying and addressing problems before domestic financial stability is undermined.

Corruption: The proceeds of grand corruption are among the largest sources of laundered funds. Bribery, corruption, and associated governance issues can have direct and indirect impacts on financial stability. The proceeds of corruption are a key component of illicit financial flows that can create reputational risk for recipient financial institutions, wherever they are located, pose particular threats for offshore financial centers (OFCs) with smaller financial sectors, and represent potentially destabilizing outflows from the source country.

Terrorist Financing and Economic Paralysis: Incidents of terrorism and terrorist
either
because of a history of terrorist incidents or through the effect of a single but significant incident. These circumstances may make key sectors of the economy vulnerable to declines in economic activity to the point where the stability of individual banks may be threatened. More broadly, banks that are regarded as serving as a conduit for terrorist financing may be subjected to international sanctions or, more generally, may encounter difficulty in finding counterparts with which to deal in ways that undermine their own stability.

Tax Fraud: Money laundering may be associated with tax fraud that can undermine financial or macroeconomic activity in important ways. Significant levels of tax fraud

significantly undermined. Moreover, as noted above, the injection of large amounts of

volatile inflows and outflows that can threaten its stability. By limiting opportunities for the banking system to be used to launder the proceeds of tax evasion, a robust framework of AML/CFT controls can serve as an effective instrument in combating tax evasion. While tax crimes have not yet been incorporated as a predicate crime into the FATF standard, discussions are underway in FATF to do so.

50. **In most cases of money laundering, these problems will be transmitted through a**
Criminal proceeds and terrorist financing will generally have to
nd may either remain there or may be

transferred abroad to the financial systems of other countries. However, there are circumstances in which the predicate crimes to which money laundering or terrorist financing relate will have an adverse effect on the stability of the broader economy without necessarily directly involving the financial system. This will particularly be the case in countries with only rudimentary banking systems where illegal transactions are conducted in cash and the proceeds of crime are never introduced into the banking system. This phenomenon, in itself, i.e., funds are not being used for formal intermediation purposes through the banking system, which impedes economic growth). Beyond their effect on the banking system, however, these cases may undermine broader macroeconomic stability in at least two important ways:

> **Problems with economic policymaking:** Where the illegal sector forms a significant part of the economy and criminal proceeds remain in cash (i.e., without introduction to the banking system), official data on employment, consumption, and foreign exchange transactions may not fully reflect the underlying economic realities. Economic policymakers will have great difficulty in gaining a real understanding of the state of the economy and in making economic policy.
>
> **Adverse effects on growth:** Corruption, especially grand corruption at the national level, has a demonstrated negative effect on fiscal balances, FDI, and growth. Production and trafficking in illegal narcotics diverts resources from legal and productive investments and activity.[44] Illegal logging and other environmental crimes despoil natural resource wealth in ways that are incompatible with sustainable growth and development. In general, large illegal sectors can represent deadweights on formal economies resulting in sub-optimal growth. In extreme cases, unchecked criminal activity can rise to the level of threatening state functions and the rule of law, with associated adverse economic effects.

51. **Money laundering, terrorist financing, and their related predicate crimes may undermine the stability of the country in which they originate but may also have adverse spillover effects on the stability of other countries.** For example, extensive criminal activities in one country may lead to illicit transfers from and large short-term

economy. The availability of money laundering services in one jurisdiction may encourage and facilitate tax evasion in neighboring countries with adverse effects on their fiscal positions.

52. **A key determinant of the risks posed by these activities for financial stability is the magnitude of the consequences that flow from the identified threat and the vulnerabilities related to a given financial sector or economy.** Thus, a relatively large threat operating in combination with a significant set of vulnerabilities in relation to a relatively small financial sector or economy will pose a relatively high overall risk. For example, the sudden influx of significant foreign proceeds of crime into a relatively small

[44] See Box 7 for a summary of staff research on the effects of coca production on non-coca GDP in Andean countries.

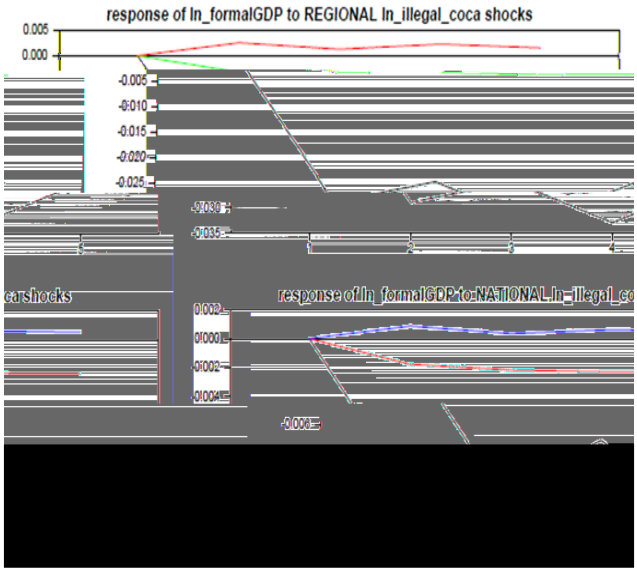
jurisdiction can result in substantial interest and exchange rate volatility for that Fsuctio.n

Box 7. The Effect of Coca Production on non-Coca GDP in Andean Countries

Available data from the United Nations Office on Drugs and Crime (UNODC) suggests that a total of 167,600 hectares were cultivated in Bolivia, Colombia, and Peru in 2008 to produce coca. This implies a potential manufacture of cocaine in the region of some 845 metric tons in the same year representing nearly 100 percent of the production.

Official data in Andean Countries suggest that the coca/cocaine sector represents only a modest share of total GDP. and cocaine production in GDP. Staff has estimated that the share of production of coca and cocaine represents 0.9 percent of total GDP in 2009. Bolivia reports that the cultivation of coca leaf represents some -1¼ percent of total GDP during the period 1990 2008, while Colombian statistics indicate that the share of production of coca and cocaine has ranged between ¾ 3¾ percent of total GDP from 2000 to 2008, declining toward the end of the period as a result of the coca eradication efforts.

Staff estimates suggest that coca and cocaine production have a significant indirect effect on economic activity in Andean countries.



For Peru, Pedroni and Verdugo (2010)[1] finds that illegal coca and cocaine production tends to crowd out legal formal sector production at regional level regardless of whether changes in illegal coca production originate at the national or regional level. They construct regional level estimates for coca production for 11of 24 regions from 2001 to 2009 based on the input-output matrix for illicit crops elaborated by the Peruvian authorities in 2007, and IDEI (2009) estimates of tons of illegal and legal coca produced by regions. Using dynamic heterogeneous panel models taking into account regional heterogeneity and complex unobserved inter-dependencies in the relationship between coca and non-coca-related activities they show the median response of regional formal sector GDP to coca shocks originating both at the local regional level and the national level are negative. One standard deviation positive shock to illegal regional coca production decreases formal GDP in the same region typically by ¼ percent in a two-year horizon.

For Colombia and Bolivia, given the lack of regional data, staff uses a simple structural bi-variate VAR model with national GDP (excluding the direct effect of coca and cocaine production) vis-à-vis an estimate of the coca and cocaine GDP for these countries (based on estimates from national statistics). While for Colombia, a negative impact on non-coca real GDP growth is found, for Bolivia the opposite occurs. The latter could be a result of measurement errors in national statistics since cocaine production is not measured.

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[1] Sources: For Peru, Pedroni Paper (forthcoming). For Bolivia, Staff calculations based on Unidad deAnalisis de Politicas Sociales y Economicas (UDAPE 2010). For Colombia, Staff calculations based on Departamento Administrativo Nacional de Estatistica (DANE 2010).

Modular Financial Stability Assessments

54. **Under the revised FSAP policy, a modular financial stability assessment is designed to assess near-term vulnerabilities for the stability of the domestic financial system.** Modular financial stability assessments must include the following three components:

> An evaluation of the source, probability, and potential impact of the main risks to macro-financial stability in the near term;
>
> ; and
>
> capacity to manage and resolve a financial crisis, should the risks materialize**.**

All three elements are expected to be covered in all FSSAs. Of course, stability assessments in individual cases may cover additional areas, if needed, and may also be accompanied by detailed assessments of compliance with standards and codes.[45]

55. **Under present Fund policy, modular stability assessments may take two different forms:** (i) a voluntary assessment that is conducted as a form of technical assistance at the request of the relevant member; and (ii) a mandatory assessment that is conducted in the context of bilateral surveillance under Article IV. There is no requirement that a modular financial stability assessment in either case include an examination of AML/CFT issues.[46] However, in either case, it is possible for the Fund and the relevant member to agree to discuss, on an additional and voluntary basis, AML/CFT issues as part of the assessment. The modalities for addressing these issues may range from a comprehensive re-assessment (in extreme cases), to a partial ROSC update, a technical note, or simply the incorporation of a few key issues into the FSSA.

56. **There is no compelling reason for the Fund to depart from the current approach under which AML/CFT issues may be included in modular stability assessments on a case-by-case basis.** In principle, it should continue to be the case that such issues should only be included in a modular stability assessment if the relevant member agrees, and Fund staff believes them to be of such importance to the domestic financial stability of the member that they should be discussed. However, Fund staff and member country authorities would be better placed to assess whether AML/CFT issues should be included in a modular stability assessment if they had a clearer understanding of the circumstances in which such problems may threaten domestic financial stability. Moving forward, in determining whether to propose to a member that its modular stability assessment include a discussion of AML/CFT issues, staff would be guided by the following considerations:

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[45] *IMF Executive Board Discusses Integrating Stability Assessments into Article IV Surveillance,* PIN 10/135, September 27, 2010.

[46] *Idem*.

financial markets is vulnerable to AML/CFT-related sanctions and blacklisting;

The actual or potential level of abuse of financial institutions as instrumentalities for

sector or GDP;

The estimated level of proceeds of crime generated in the country is large relative to

Transactions in specific illegal markets (e.g., drug production and trafficking) are large relative to the count ;

Criminal elements own, control, or hold a significant proportion of financial sector assets, or a significant equity interest in key financial institutions;

Regulatory capture by criminal elements or weaknesses in the regulatory and criminal justice systems hamper effective supervision of the financial sector;

There is a significant risk of financial sector fraud of a magnitude that could undermine the stability of the domestic financial system;

Corruption by government or elected officials is significant relative to the size of the economy or the government budget; and

A recent terrorist attack or the threat of one makes key sectors vulnerable (e.g., banking, tourism, foreign investment), or the level and nature of terrorist incidents otherwise threatens domestic financial stability.

The decision to examine these issues in a stability assessment would be based on an overall , including the relative importance of AML/CFT issues to other financial stability issues that may need to be covered.

Article IV Surveillance

57. **There are also circumstances where AML/CFT issues may fall within the scope of bilateral surveillance under Article IV.** As the purpose of bilateral surveillance is for the Fund to assess the compliance of members with their obligations under Article IV, Section 1, the scope of bilateral surveillance is delineated by these obligations. Article IV, Section 1 requires members to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. Moreover, as examples of this general obligation, it sets out specific obligations governing the conduct of a

58.

Some features of the framework are domestic in nature for example, controls on domestic operations (e.g., the transfer of balances between two

domestic banks). Other features of the framework involve external policies for example, rules governing the making of payments and transfers to financial institutions abroad.

59. **Any analysis of the relevance surveillance under Article IV needs to be conducted with reference to the 2007 Surveillance Decision.**[47] It was adopted by the Executive Board to provide clear guidance on the scope of bilateral surveillance. As noted above, it establishes, as the central organizing principle of bilateral surveillance . The 2007 Decision recognizes that members comply with their obligations under Article IV, Section 1 by implementing policies that promote their own external stability. It also recognizes that, in the conduct of their domestic economic and financial policies, members promote external stability by promoting their own domestic stability.

60. **The 2007 Surveillance Decision requires the Fund, in its bilateral surveillance, to assess the extent to which a member is promoting its own external stability.** It provides that the Fund will focus on those policies of members that can significantly influence present

ect to each member.

61. **Against this background, the question arises: in what circumstances would it be appropriate for money laundering, terrorist financing, or their related predicate crimes to be the focus of attention in the context of bilateral surveillance, that is on a mandatory basis under Article IV?** As is always the case under the 2007 Surveillance Decision, the decision whether to examine any issue is based upon an assessment of its importance for external stability, and bilateral surveillance with respect to any member needs to focus on the issues that are the most relevant for this purpose. In principle, there would appear to be three broad cases where it may be appropriate to discuss AML/CFT issues in the context of bilateral surveillance:

> **Where problems with money laundering, terrorist financing, or predicate crimes may undermine the :** The considerations that the Fund could take into account in determining when an analysis of these issues (and the related policies of the member) are relevant for the purposes of a modular stability assessment would appear to be equally valid for the purposes of bilateral surveillance.
>
> **Where problems in a member country with money laundering, terrorist financing, or predicate crime may have important spillover effects on other members:** While a modular stability assessment deals exclusively with the stability pillover The discussion set out above has demonstrated how the negative effects of money laundering, terrorist financing, and their related predicate crimes can spread beyond the country in which

[47] See ,QWHJUDWHG6XUYHLOODQFHRYHU0HPEHU&RXQWULHV Decision No. 13919-(07/51), adopted June 15, 2007).

There is a significant risk of tax fraud of a magnitude that undermines a fiscal balance, or that may have important spillover effects on other countries;

Corruption by governmental or elected officials is significant relative to the size of the economy or the government budget; and

Macroeconomic policy execution is impaired by the existence of unaccounted for economic transactions generated in the informal or illegal sectors.

63. **While the 2007 Surveillance Decision specifies the circumstances in which issues are required to be discussed (i.e., on a mandatory basis as part of Article IV**

Fund and members to voluntarily agree to discuss other issues in an Article IV consultation even where they fall outside of the scope of Article IV. The discussion of such

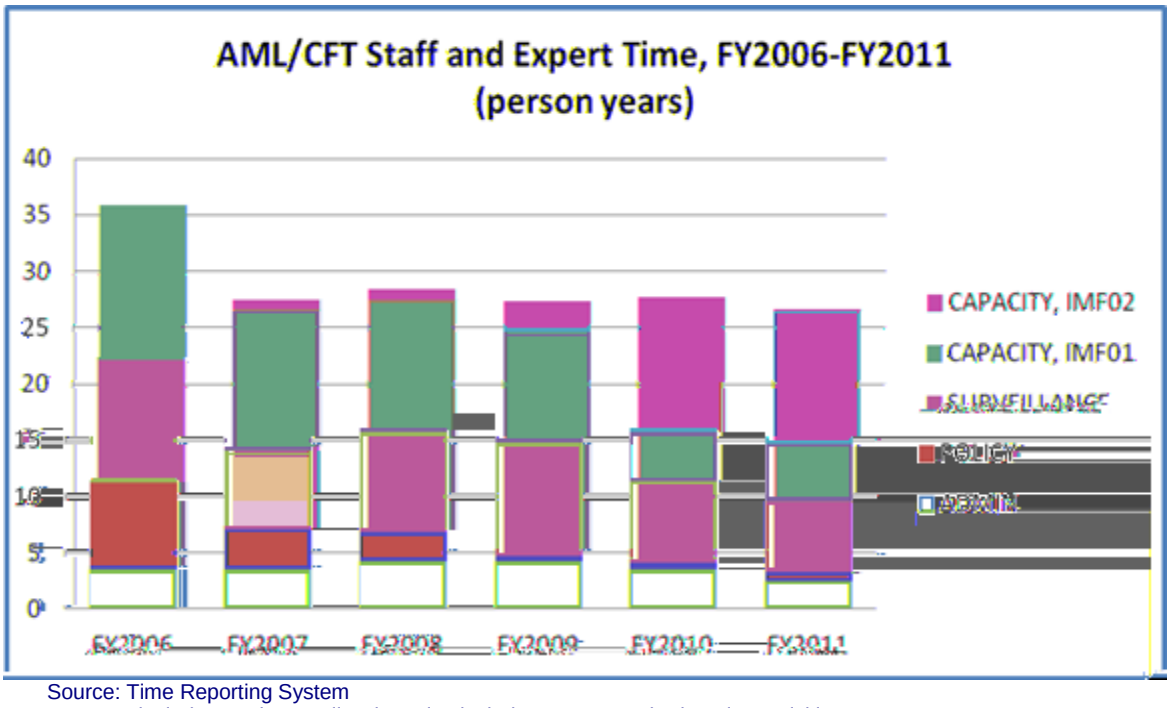
Articles and has formed the basis for the discussion of AML/CFT issues in some Article IV consultations with members. It is proposed that, moving forward, the inclusion of AML/CFT issues in Article IV consultations on a voluntary basis should continue to be possible.

IV. RESOURCE IMPLICATIONS

64. **Since FY2006, the Fund has substantially reduced its IMF01 expenditure on AML/CFT.**[49] Approximately 36 person years were expended in FY2006 for AML/CFT work. By FY2011, the expenditure in AML/CFT had been reduced to approximately 20 person years. Thus, in real terms, the Fund now devotes about half the level of resources it did six year
gone from 1 percent to 0.4 percent. now
devoted largely to complying with the May 2006 Executive Board decision that staff should conduct 6 7 some
related policy and surveillance support.

[49] Whereas in FY2006, the Fund budgeted $9 million and approximately 39 person years to AML/CFT and -Term Budgetary Framework Selected Topics and http://www.imf.org/external/np/pp/eng/2005/040105.pdf). However, in FY2011, the allocation was only $5.9 million for approximately 24 person years.

Figure 1. AML/CFT Staff and Expert Time, FY 2006 FY 2011 (person years)



Source: Time Reporting System
Does not include overtime. Policy time also includes some standard-setting activities.

65. **Fund expenditures on AML/CFT have, nevertheless, exceeded the combined expenditures on all other ROSCs.**[50] This may be explained by the complexities of AML/CFT assessments relative to those of other standards (see Box 2). At the same time, the annual number of assessments and associated ROSCs for the other standards and codes has declined significantly over the past six years, reflecting: (i) a decrease in the overall budget allocated to ROSCs; (ii) a reduction in the number of countries undergoing initial assessments; (iii) a shift from formal ROSCs towards technical notes; and (iv) a sharp decline in FSAP-related ROSCs (the average number of standards assessments conducted during FSAP missions dropped from about four in the initial years of the Program (2000 2004) to about one in 2008 and 2009).[51]

66. **Although the cost of preparing an AML/CFT assessment is higher than for other standards and codes, factoring in the assessments prepared by the other AML/CFT assessor bodies under the existing burden-sharing arrangements, the cost of an AML/CFT ROSC to the Fund is closer to the average cost for all ROSCs.** Between 2004 to 2010, Fund staff produced 30 AML/CFT ROSCs at an estimated average cost $310,000 per assessment; factoring in the 53 ROSCs produced by other assessor bodies

[50] See *2011 Review of the Standards and Codes Initiative* (http://www.imf.org/external/np/pp/eng/2011/021611.pdf), Appendix II, para. 3.

[51] See *2011 Review of the Standards and Codes Initiative*, para. 10.

reduces the average cost of AML/CFT ROSCs to some $112,000 or close to the average cost for all ROSCs.[52]

67. **External funding has enabled the Fund to continue to deliver a robust program of AML/CFT technical assistance to members as well as pursue some research.** Pledges to the AML/CFT TTF of $25.2 million has permitted the Fund to finance five years of AML/CFT technical assistance and has resulted in an increase in the relative proportion and the absolute level of resources devoted to technical assistance.

Figure 2. Cost of AML/CFT Technical Assistance



Source: PeopleSoft Financials

68. **While staff is seeking to continue the AML/CFT program on a resource-neutral basis, the resource implications of the proposals set out above are not yet clear.** In particular, it is not possible to fully assess the resource implications of a move to risk-based AML/CFT ROSCs without first reaching agreement on the precise features of such a framework with the broader AML/CFT community and determining the number of assessments that can be carried out within a given resource envelope.[53] As noted above, if

[52] Based on *2011 Review of the Standards and Codes Initiative* (http://www.imf.org/external/np/pp/eng/2011/021611.pdf). AML/CFT ROSCs prepared by the other assessor bodies are available to the Fund at little cost, i.e., they are subject to a *pro forma* review by Fund staff.

[53] Although there may be some resource savings from dropping the current requirement that all FSAP/FSAP updates incorporate an AML/CFT component, these savings would likely not be substantial since the majority of such assessments are conducted by outside assessor bodies and there would also be some offsetting requirements for staff to scope risks in advance of deciding whether an AML/CFT component should be included or not.

agreement were reached with FATF and other stakeholders on a system of targeted, risk-focused AML/CFT ROSCs, staff would return to the Board with a specific proposal that would include an assessment of the resource implications.

69. **Efforts to better integrate AML/CFT in modular financial stability assessments and Article IV surveillance would also have resource implications**. In particular, additional preparatory work would be needed to determine whether AML/CFT issues should be addressed in either context. Enhanced involvement may also require responding to demand to create and maintain a statistical database that would support more robust assessments of risk and effectiveness.[54]

70. **The additional costs associated with enhanced involvement in modular financial stability assessments and surveillance cannot be predicted with any degree of certainty.** In any event, staff does not expect the approach outlined above to lead to a significant increase in coverage of AML/CFT issues in modular stability assessments or Article IV surveillance. Staff would also exploit synergies between its assessment, technical assistance and research work for these purposes.

71. **Operationally, staff would systematically monitor country conditions in light of the factors outlined above and provide briefings and data to the relevant country teams as needed or requested, usually in the context of the pre-mission briefing exercise.** For this purpose, staff would continue to rely on existing AML/CFT experts in the Legal . If it were to appear that staff will be unable to provide sufficient support ML/CFT program, staff would revisit the resource implications of the revised program either through the budget process or through an update to the Executive Board.

[54] As noted in paragraph 32, the Fund and the Bank have compiled with the FATF standard. However, to conduct risk analysis and better measure the effectiveness of AML/CFT systems would require, among other things, economic and financial statistics, as well as criminal justice statistics. Fund staff would work on the creation of such a database and seek synergies to avoid duplication of existing sets of data within the Fund.

V. ISSUES FOR DISCUSSION

Directors may wish to focus on the following issues:

Do Directors agree that the Fund and Bank should explore further the modalities for conducting targeted, risk-focused AML/CFT assessments with the FATF and other assessor bodies and return to the Board within two years for a report on the status of these discussions?

As regards the relationship between AML/CFT assessments and FSAPs and FSAP updates, which option would Directors favor going forward?

Do Directors agree with the framework outlined above for assessing the systemic risks of AML/CFT issues? Does it provide a useful basis for deciding on how these issues should be integrated into modular financial stability assessments and bilateral surveillance under Article IV?

ANNEX 1. JURISDICTIONS COMPLIANCE WITH THE AML/CFT STANDARD[1]

1. **The International Standard for anti-money laundering and combating the financing of terrorism (AML/CFT) is particularly rigorous and detailed.** Established by the Financial Action Task Force (FATF) in 1990, the standard has been updated several times and now consists of 40 Recommendations respecting money laundering and 9 Special R

1.

4. **One clear conclusion is that elements of the standard that have been in place longer have higher compliance ratings, for example:**

i. The AML Recommendations, which have been in place since 1990, were more highly rated than the CFT Special Recommendations which were introduced in October 2001.[5] The degree of compliance[6] for the 40 AML Recommendations was 45 percent and 31.5 percent for the 9 Special Recommendations on CFT.

ii. Recommendations concerning designated nonfinancial businesses and professions, which were made subject to the standard only in 2003, have had some of the lowest compliance scores, averaging only 12.1 percent of the theoretical maximum.

5. **It also appears to be easier to enact legislation and set up government institutions than to ensure that the system functions well on an ongoing basis.**

i. The degree of compliance for those Recommendations evaluating the criminalization of ML and TF were relatively high at 45.1 percent, and a somewhat broader measure of the strength of the legal system was 41.4 percent.

ii. The Recommendations that assess the strength of AML/CFT institutions (financial intelligence units (FIU), the specialized supervisory bodies, the police, and the judiciary) show a degree of compliance at 50.6 percent**.**

iii. Compliance with the Recommendations that assess the strength of preventive measures in the financial institutions was lower at 40.1 percent, and, as noted above, compliance was much lower for designated nonfinancial businesses and professions.

iv. One particular weakness in system functionality was indicated by the significantly low compliance (22.1 percent of the theoretical maximum) that all countries received on Recommendation 5 which concerns customer due diligence measures in financial institutions.

6. Countries were also relatively strong in the area of international cooperation, showing a degree of compliance at 56.3 percent on applicable Recommendations.

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[5] The AML Recommendations were revised substantially in 1996 and, again, in 2003. The Special Recommendations on CFT were originally eight until a ninth Recommendation was adopted in October 2004.

[6] For any given recommendation or grouping of recommendations, the degree of compliance is measured as a share of the real and theoretical maximum ratings.

7. Compliance with the Recommendations that call on countries to have adequate transparency of legal persons and arrangements is relatively high at 40.1 percent.

8. **The analysis of compliance[7] as a function of macroeconomic, institutional, and financial variables reflects the following findings:**

i. **A higher degree of compliance appears to be associated with a higher level of economic development.** In the 46 advanced economies in our sample, the degree of compliance with the AML/CFT is 56.8 percent, whereas, in the 115 emerging economies in our sample, the degree of compliance was lower (37 percent), indicating that wealthy countries have more resources to devote to constructing and implementing complex AML/CFT systems. GDP per capita expressed in PPP, used as a proxy for overall financial and economic development, is a significant explanatory variable of compliance, and the parameter estimates have the expected positive sign. However, a somewhat more direct measure of financial sector development, M2/GDP, was not statistically significant to explain compliance.

ii. **Stronger domestic governance[8] is associated with higher compliance with the AML/CFT standard.** A better regulatory quality framework is estimated to have a positive and statistically signif
compliance with the AML/CFT standard. Also, countries with a low level of control over corruption tend to have lower compliance scores, and the parameter estimates have the expected negative sign.

iii. **Jurisdictions with high net interest margins[9] show lesser overall compliance with the AML/CFT regime.** An increase in net interest margin is estimated to have a negative and statistically significant impact on a , indicating that more competitive banking systems tend to have higher levels of AML/CFT compliance.

iv. **in the global drug economy, which can be seen as a rough proxy for**

[7] Verdugo, op. cit., constructed an index of overall AML/CFT compliance from assessments conducted mostly during 2004 2008. For 116 countries, the value of the index of overall compliance for a given country is equal to the sum of the seven standardized components. For convenience, it rescaled values to a scale of 0 to 100.100 equals the best score.

[8] When controlled for GDP per capita.

[9] Net interest margin can be interpreted as a measure of the efficiency of banking sector performance, because it customers. Large net interest margins often indicate inefficient banking operations, high risks in lending, and monopoly power of banks; thus, lower margins would be preferable. The margin
as a share of its interest-bearing (total earning) assets.

ML/TF risk.[10] In other words, there are countries with high levels of AML/CFT compliance and low levels of involvement in the drug trade and countries with high AML/CFT compliance and that contribute a great deal to the global drug problem. Similarly, low compliance countries are randomly distributed over the UNODC index. While these results could be explained by any number of hypotheses,[11] they do at least raise the question of whether focusing on AML/CFT compliance ensures progress toward mitigating real ML/TF risk.

9. As set forth in Annex 3, Fund staff has been working with the FATF to better understand ML and TF risks on the basis of analyzing threat, vulnerability, and consequence. In this connection, future research should include the development of different, broader metrics for analyzing the level of ML/TF risks and the level of criminal activity in a given jurisdiction as well as better methods of capturing and presenting cross-border flows.

10. In this regard, Fund staff have analyzed the relationship between ranking of jurisd 2011) as a measure of financial sector vulnerability and ranking on systemically-important financial sectors (2008). Figures 1 and 2 present that relationship. The negative relationship indicates that, in general, smaller, less-connected financial systems are also less compliant with the standard, which is consistent with the rest of the analysis. Looking more closely at the scatter plot, however, helps identify those relatively large and interconnected financial systems that are also relatively vulnerable to money laundering based on their low compliance with the standard. This, in turn, can provide a basis for prioritizing the TA and surveillance agenda of the Fund in the area of AML/CFT.

11. These pictures, therefore, contribute to analysis of risk, although, of course, they are only a point of departure. A more complete analysis would require both a better proxy for systemic vulnerability than can be provided by compliance scores and other variables which add to the threat dimension. In general, work remains to be done in testing the relationship of compliance to ML/TF risks and on measuring the effectiveness of AML/CFT regimes. Continued work in these directions could open the door to a more nuanced understanding of where the ML/TF-related threats to the international financial system lie than can be derived from simple comp
AML/CFT assessments.

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[10] of contribution to the global drug problem is a proxy for proceeds of crime related to drugs only. However, this proxy does not account for other crimes and the financing of terrorism as well as the international dimension of ML/TF.

[11] For example, one would need to account for the possibility that participation in the drug economy may be independent of vulnerability to laundering activity because laundering may often take place in jurisdictions other than those that produce or consume large quantities of drugs.

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of AML/CFT Recommendations
Advanced Economies

Country	Year of Assessment	Legal	Institutional	Preventing Financial Institutions	Preventing DNFBPs	Preventing Informal Sector	Entity Transparency	International Cooperation	AML	CFT	Total AML/CFT
Andorra	2007	2.33	4	7.33	1	0.33	1.33	4	18.33	2	20.33
Austria	2008	2.64	4.64	12.58	0.99	0.99	0.99	3.63	22.16	4.3	26.46
Australia	2005	4.33	5	7	0.33	1.33	1.33	6.33	21.33	4.33	25.67
Belgium	2005	4.67	5.33	17.67	1.33	1	2.33	5	31	6.33	37.33
Bermuda	2007	3	3.67	5.67	0	1	2.33	5.33	17.67	3.33	21
British Virgin	2008	4.67	5.67	11.67	1	2	1.33	6.67	26.67	6.33	33
Canada	2007	4	4.33	8.67	0	2	1	5	20	5	25
Cayman Islan	2007	4.33	5.33	12.67	1.33	1.33	2.33	6	28.33	5	33.33
Cyprus	2005	4.33	5.67	14.67	1	1.67	1.67	6	29	6	35
Czech Republ	2005	1.98	5.31	9.92	0.33	1.32	1.33	4.63	20.53	4.29	24.82
Denmark	2006	3	4.67	8.67	0.33	1.33	1.33	5	20	4.33	24.33
Estonia	2008	3.33	5.67	12.67	1	1.33	2	5	26.67	4.33	31
Finland	2007	3	4	9.33	0.33	1.33	1.67	4.67	20.33	4	24.33
France	2010	3.67	4.33	14.33	0.67	1.67	2	5	25.33	6.33	31.67
Germany	2009	3	4.33	12	0	1.67	0.67	4.33	20.67	5.33	26
Gibraltar	2006	4	5	13.33	1	1	2	4.33	25.67	5	30.67
Greece	2006	2	2.33	7.33	0	0.67	1	4	14.67	2.67	17.33
Guernsey	2010	4.33	6	19	1.67	1.67	2	5.67	33.67	6.67	40.33
Hong Kong Ch	2007	3	5.33	12.67	0	0.67	1.33	5.33	24.67	3.67	28.33
Iceland	2006	2.67	4	10.33	0.67	1.33	1.33	4	21.67	2.67	24.33
Ireland	2005	3.67	5	11	0.67	1.33	1	6.67	25	4.33	29.33
Isle of Man	2008	2.64	5.3	15.25	0.99	1.32	1.98	4.65	27.51	4.62	32.13
Israel	2007	4	5.67	11.67	0	1	1.33	5.67	24	5.33	29.33
Italy	2005	4	5.33	10.67	0	2	2.33	6.33	24.67	6	30.67
Japan	2008	3	5	9.67	0.67	1	0.33	3	19.33	3.33	22.67
[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	5.3	29.85	6.28	36.13

Korea	2008	167	3.67	8	0	167	0.33	4.67	17.33	2.67	20
Liechtenstein	2007	2.67	5.33	10.33	133	1	1	3.33	22.33	2.67	25
Luxembourg	2009	2	3.33	6.33	0	0.33	0.67	4.33	14.67	2.33	17
Macau, SAR	2006	3.33	4	13.33	133	1	133	2.67	23	4	27
Malta	2005	4	5.67	12.67	133	133	2	6.67	28.67	5	33.67
Monaco	2006	2.67	4.33	10	0.33	133	133	3	18.67	4.33	23
Netherlands	2010	3.33	4.67	12.33	1	167	133	3	22	5.33	27.33
New Zealand	2009	4.33	4.67	5.67	0	133	0.33	5	17	4.33	21.33
Norway	2005	4	4.33	13.33	167	133	167	4.67	27.67	3.33	31
Portugal	2006	3.33	4.67	14	1	167	133	6.67	28	4.67	32.67
San Marino	2007	2.33	2.67	4	0	0.67	0.33	3	11.67	1.33	13
Singapore	2007	3.67	5.67	15.67	0.33	133	133	5.67	27.33	6.33	33.67
Slovakia	2005	2	3.33	6.33	0.33	0.67	133	3.67	15.33	2.33	17.67
Slovenia	2005	4.67	5.33	13.67	133	167	2.33	6.33	29	6.33	35.33
Spain	2005	3.67	3.67	13.33	0.67	133	2	6	25	5.67	30.67
Sweden	2005	3.67	4.33	10	0.67	1	167	5.67	23.33	3.67	27
Switzerland	2005	4	5	12.33	133	0.67	167	5.33	26	4.33	30.33
Taiwan, POC	2007	133	5.33	11.33	0	0.33	133	3.67	21	2.33	23.33
UK	2006	6	5.67	12.67	133	167	133	6.67	28	7.33	35.33
USA	2005	4.67	5.67	15.33	0.33	2	1	5.33	27.33	7	34.33
No. of Recommendations		6.0	7.0	21.0	3.0	2.0	3.0	7.0	40.0	9.0	49.0
Total countries		46.0	46.0	46.0	46.0	46.0	46.0	46.0	46.0	46.0	46.0
Theoretical Compliance		276.0	322.0	966.0	138.0	92.0	138.0	322.0	1840.0	414.0	2254.0
Real Compliance		157.2	217.9	521.7	30.9	58.0	66.6	226.9	1072.1	207.1	1279.2
Degree of Compliance		57.0	67.7	54.0	22.4	63.0	48.2	70.5	58.3	50.0	56.8

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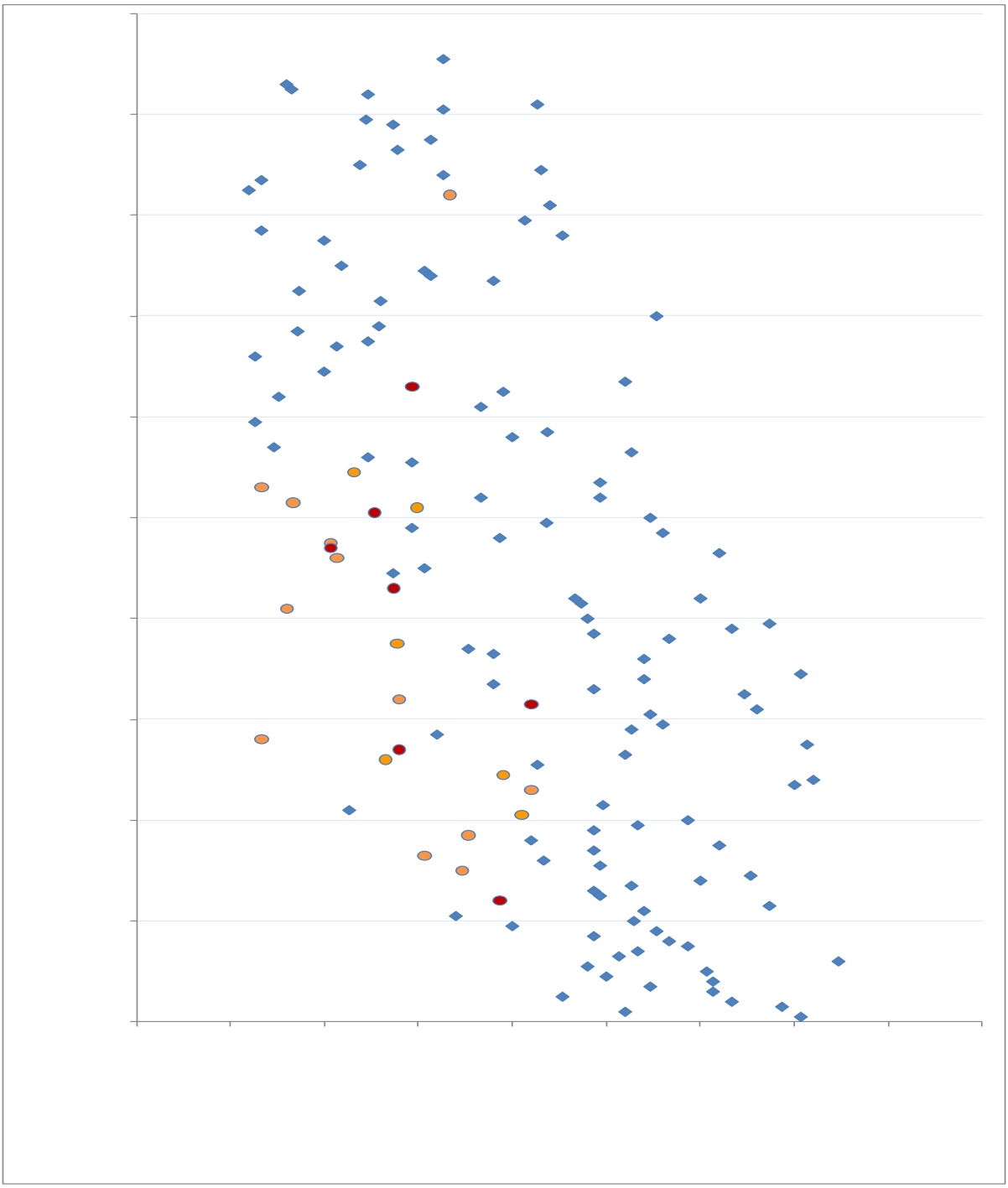
Emerging and Developing Economies

Country	Year of Assessment	Legal	Institutional	Preventing Financial Institutions	Preventing DNFBPs	Preventing Informal Sector	Entity Transparency	International Cooperation	AML	CFT	Total AML/CFT
Albania	2011	2.67	3	9	1	0.67	1.33	3.67	18.67	2.67	21.33
Anguilla	2009	4	4.33	11.33	1	0.33	1.67	6	24.67	4	28.67
Antigua & Barb	2007	2.33	3.67	3	0.33	1.33	0.33	5.67	15	1.67	16.67
Argentina	2009	1.67	1.67	4.67	0	0.67	0	2.67	9.67	1.67	11.33
Armenia	2009	2.67	3.33	13.67	0.33	0.67	1.67	3.67	22.67	3.33	26
Aruba	2008	1.65	1.65	4.97	0	0.66	1	2.98	12.58	0.33	12.91
Azerbaijan	2008	1.33	2	5	0	0.67	1.33	3.33	11.67	2	13.67
Bahamas	2006	3.67	5	9	1	1.33	1.67	5.33	22.67	4.33	27
Bahrain	2005	2	4	12	0.67	0.33	2	5	22	4	26
Bangladesh	2008	1.65	2.31	6.28	0	0.99	0.33	2.31	11.89	1.98	13.87
Barbados	2006	3.33	5.33	8.67	0	1.67	1.33	4.33	20.33	4.33	24.67
Belarus	2008	3.33	3.67	9	0.33	1	2.33	4.33	20.67	3.33	24
Benin	2009	1.67	2.33	4.33	0	0	1	3	12.33	0	12.33
Bolivia	2006	2	2	5.33	0	0	0.33	3	12.33	0.33	12.67
Bosnia and He	2009	2	2.33	8.67	0	0.67	1.33	4.33	16.67	2.67	19.33
Botswana	2007	1	2.33	5.67	0	0.33	0	3	12.33	0	12.33
Brazil	2009	1	3.67	13	0	1	1.33	4.33	21.67	2.67	24.33
Brunei	2010	2	2.33	5.33	0	0.33	1	3.67	12.33	2.33	14.67
Bulgaria	2007	3.67	5.33	12.67	1	1.33	2	6.33	26.67	5.67	32.33
Burkina Faso	2009	1.32	1.32	1.98	0	0	1	2.97	8.59	0	8.59
Cambodia	2007	0	1	3.33	0.33	0	1.67	1	7	0.33	7.33
Cape Verde	2007	1.67	1.67	1.67	0	0.33	1.67	1.67	8.33	0.33	8.67
Chile	2010	2.97	4.96	11.25	0.66	0.99	0.33	4.31	23.16	2.31	25.47
China	2006	2	5	9.33	0	1.33	1	5.33	20.33	3.67	24
Colombia	2008	4.33	6	15.33	1	1.67	1.33	6	30.33	5.33	35.67
Comoros	2009	1.67	1.67	2	0	0.33	0	2.33	7	1	8
Cook Islands	2009	1.33	1.33	2	0	0	1	3	8.67	0	8.67
Costa Rica	2006	1.33	3.67	6.33	0	0	0.33	3	13.67	1	14.67
Croatia	2006	2	5	6	0	0.67	1.33	4	17.33	1.67	19

Djibouti	2007										
Dominica	2008	2.31	1.65	3.31	0	0.66	0.33	3.97	10.58	1.65	12.23
Dominican Rep	2005	1.33	2.67	7.33	0	1	0.33	2.67	13.33	2	15.33
Ecuador	2005	1	2.33	2.33	0	0	0.67	1.67	8	0	8
Egypt	2008	3	4.33	10.33	0.67	1	2.33	5	22.33	4.33	26.67
El Salvador	2009	4.67	3	9.67	0	1.33	1.33	4.67	20.33	4.33	24.67
Fiji	2006	2	3.67	10	1	1.33	1	3.67	20.33	2.33	22.67
Gambia	2008	3	1.67	7	0	0	1	3	13.33	2.33	15.67
Georgia	2006	2	4	6.67	0.67	0.67	1.67	4.33	18	2	20
Ghana	2008	1.65	2.31	4.63	0	0.33	0.33	2.31	9.58	1.98	11.56
Grenada	2008	1.98	3.63	2.98	0	0.33	0	4.98	13.24	0.66	13.9
Guatemala	2009	3	3.67	13.33	0	1.33	1	5	22.67	4.67	27.33
Guinea Bissau	2008	1.32	1	2.31	0	0.33	1	2.31	7.94	0.33	8.27
Haiti	2007	0.67	1.67	4	0	0.33	1	2.33	9.67	0.33	10
Honduras	2007	2.64	2.65	6.65	0	0.33	0	2.64	12.59	2.32	14.91
Hungary	2010	3	5.33	17.33	1.67	1.33	2	5.33	31.67	4.33	36
India	2009	2.67	5	13	0	1	0.67	4.33	22.67	4	26.67
Indonesia	2007	1.33	3.33	7.67	0	1.33	1	3	16.33	1.33	17.67
Jamaica	2005	4	4.67	11	0	1	1.67	4	21.33	5	26.33
Jordan	2008	1.67	3.33	9.33	0.33	0	1.67	2.67	17.67	1.33	19
Kyrgyz Repub	2007	0.67	3	9.33	0	1.33	1.33	3.33	17.67	1.33	19
Latvia	2006	3.67	5.33	10.67	0.67	1	2	5	25	3.33	28.33
Lebanon	2009	3.67	3.67	13	1	1	1	4.67	23	5	28
Lithuania	2006	2.67	4.67	13	1	1.33	1.67	5.67	26	4	30
Macedonia	2007	2.33	3.67	6.33	0	1	1.33	3.67	16.33	2	18.33
Malawi	2008	2.67	2.67	9.67	0	1	0.67	4	18	2.67	20.67
Malaysia	2007	3.67	5	14	1	1	1	4.33	25.67	4.33	30
Mali	2008	1.33	0.67	1.67	0	0	1	1.67	6	0.33	6.33
Mauritania	2005	1.67	2	5.67	0	0.67	1.67	4	12.67	3	15.67
Mauritius	2007	2.33	3.67	10.33	0.33	1.33	1.33	4.33	21	2.67	23.67

Mexico	2008	2.33	4.33	12.33	0	0.33	1	4.33	22	2.67	24.67
Moldova	2005	2	3	6.33	0	1	1.67	4.33	15.67	2.67	18.33
Mongolia	2006	1	2.33	6	0	1.33	1	3.67	14.33	1	15.33
Montenegro	2008	2.67	5	12	0.67	1	1.33	5	25	2.67	27.67
Morocco	2007	2	1.33	4.67	0	0	1.67	4.33	12.33	1.67	14
Myanmar	2008	1.33	3	6	0.33	0.67	1.67	1.67	13.67	1	14.67
Namibia	2005	1	2	3.33	0	1	0.33	3	9.67	1	10.67
Nepal	2005										
Nicaragua	2008	2.64	1.98	8.27	0	0.99	1.33	4.31	16.88	2.64	19.52
Niger	2008	1.32	1.33	2.64	0	0.33	1.33	3.97	10.26	0.66	10.92
Nigeria	2007	1.33	3.33	4.67	0.33	0.67	1	2.67	13.33	0.67	14
Pakistan	2009	0	1.67	2.33	0	1	0	1.67	6.67	0	6.67
Palau	2008	2.67	3	4.67	0	1.33	1	3.67	13.67	2.67	16.33
Panama	2005	4	5	15.33	1	1	1	5.67	27.67	5.33	33
Paraguay	2008	1	1.33	4	0	0	0	2	8.33	0	8.33
Peru	2008	3.67	5	9.67	1	1	2	5	23.67	3.67	27.33
Philippines	2008	1.65	2.97	9.6	0	0.99	1.32	3.97	18.52	1.98	20.5
Poland	2006	2.33	4.33	7.67	0.33	1.67	1.33	4	19.67	2	21.67
Qatar	2007	2	3.33	5.67	0.33	0.33	1.67	2.67	14.67	1.33	16
Romania	2007	3	5	9.33	0.33	1	2	5.67	23	3.33	26.33
Russian Feder	2007	4	4.67	9.67	1	1	1.67	5.67	24.33	3.33	27.67
Rwanda	2005										
Samoa	2006	1.33	2.33	6	1	1	0.33	1.67	12.33	1.33	13.67
Saudi Arabia	2009	2.33	4.33	13	0	1.33	2	3.33	22.67	3.67	26.33
Senegal	2007	2.97	4.63	6.63	0.33	0.99	1.33	4.98	19.88	1.98	21.86
Serbia	2009	2.33	3.67	11	0.33	1	1.33	3.67	20.33	3	23.33
Seychelles	2006	1.98	1.32	5.63	0	0.33	0	2.64	10.25	1.65	11.9
Sierra Leone	2006	1	1	3.33	0	0.33	0.33	0.67	6.67	0	6.67
Solomon Islar	2009	3.33	4	9	0	0.33	0.33	4.33	18	3.33	21.33
South Africa	2008	4	4.67	8	0.67	1.33	0.67	5.33	20.33	4.33	24.67

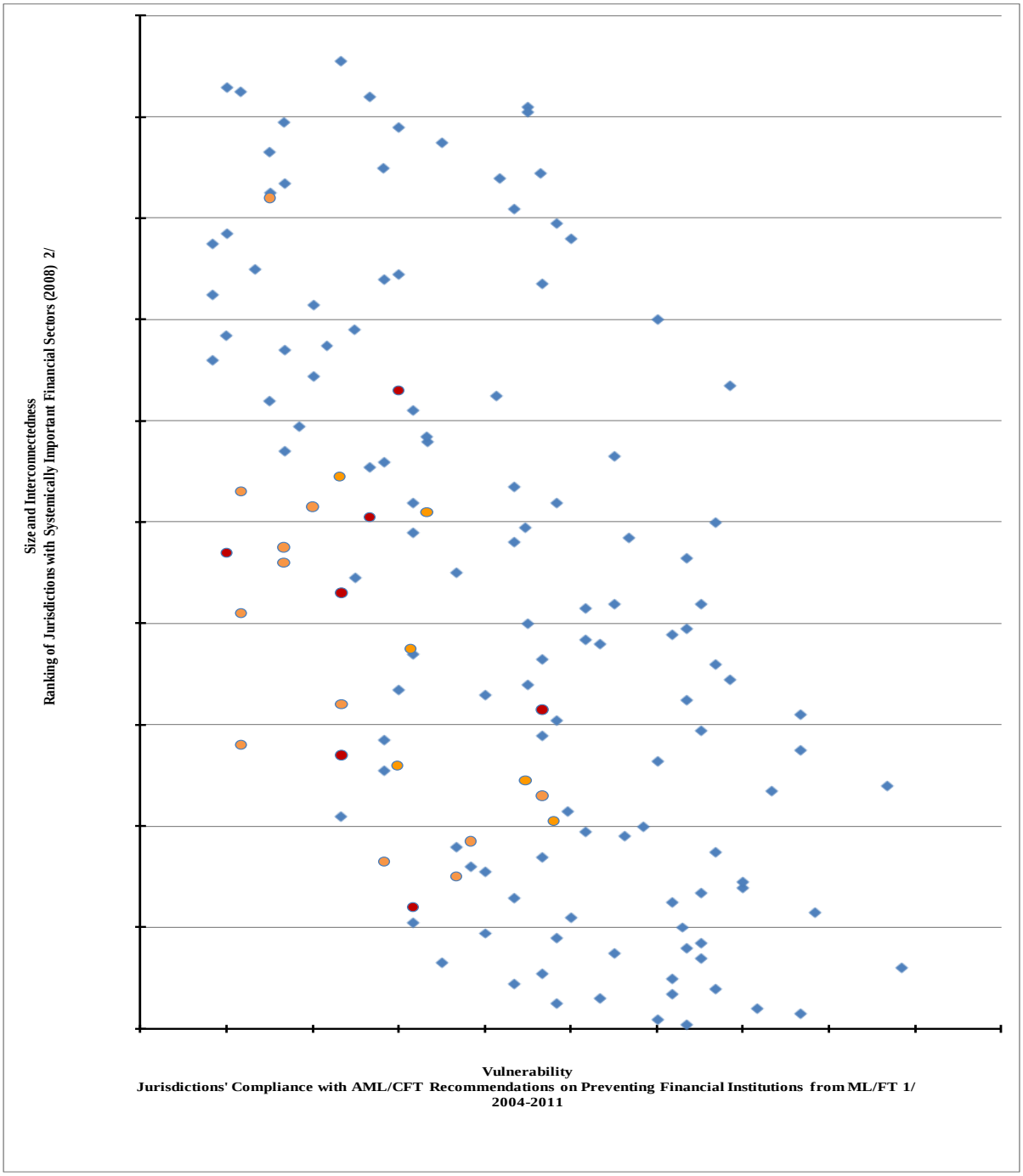
Figure 1. Relationship between Jurisdictions with Systemically Important Financial Sectors and Compliance with the AML/CFT International Standard



Source: Staff calculations based on:
1. Verdugo, Concepcion, "Compliance with the AML/CFT International Standard: Lessons from a Cross-Country Analysis". Forthcoming Working Paper and Table 1 of this annex.
2. Stability Assessments under the Financial Sector Assessment Program into Article IV Surveillance; IMF Policy Paper; August 27, 2010.
Note that the ranking might change over time (Staff used 2008 data for the paper) when data on size and interconnectedness are updated and/or methodology gets revisited.

Note: The following countries, among the 33 jurisdictions identified by the ICRG as having AML/CFT deficiencies, are not included in this chart due to the fact that there was no assessment conducted during the period of 2004-2011: Angola, The Democratic Popular Republic of Korea, Ethiopia, Iran, Kenya, Sao Tome and Principe, and Turkmenistan.

Figure 2. Relationship between Jurisdictions with Systemically Important Financial Sectors and Compliance with the AML/CFT Recommendations on Preventing Financial Institutions from ML/TF



Source: Staff calculations based on:
1. Verdugo, Concepcion, "Compliance with the AML/CFT International Standard: Lessons from a Cross-Country Analysis." Forthcoming Working Paper and Table 1 of this annex
2. Stability Assessments under the Financial Sector Assessment Program into Article IV Surveillance; IMF Policy Paper; August 27, 2010.
Note that the ranking might change over time (Staff used 2008 data for the paper) when data on size and interconnectedness are updated and/or methodology gets revisited.

Note: The following countries, among the 33 jurisdictions identified by the ICRG as having AML/CFT deficiencies, are not included in this chart due to the fact that there was no assessment conducted during the period of 2004-2011: Angola, The Democratic Popular Republic of Korea, Ethiopia, Iran, Kenya, Sao Tome and Principe, and Turkmenistan.

ANNEX 2. TECHNICAL ASSISTANCE ON AML/CFT

TA Record: FY2006 FY2011

1.
AML/CFT program. Fund staff provide technical assistance to countries in a number of areas, including general advice to the authorities on AML/CFT strategy and coordination, the drafting of AML/CFT legislation and regulations, the establishment and operation of financial intelligence units, and the development of specialized AML/CFT supervisory units, manuals, and procedures. Fund staff is currently working with several countries to advance their understanding of money laundering risk so that they can better allocate scarce resources to address these issues.

2. **During the period May 2007 April 2011, the Fund provided AML/CFT TA for a wide range of countries across all regions.** Over this period, staff delivered direct TA to 69 countries, requiring 796 missions as well as direct advice from headquarters. In addition, staff delivered 73 regional workshops over the same period, reaching 2,468 country officials. Over the last five years, TA projects have emphasized legal and operational advice in relation to the development of financial intelligence units and the development of AML/CFT supervision capacity. The AML/CFT capacity-building activities during this period required 85.19 person years.

3. **The Fund has helped secure positive and tangible results in a broad range of countries that had not previously addressed financial integrity issues in a meaningful way.** For instance, staff have assisted countries and jurisdictions under international scrutiny such as Iran, Myanmar, Turkmenistan, and the West Bank and Gaza. Additional examples of the the following:

> Assistance in drafting AML/CFT legislation resulted in the adoption of new or revised AML/CFT frameworks in many countries and jurisdictions such as Cambodia, Lao PDR, Mongolia, Guinea, Lesotho, The Gambia, China, Syria, Iran, Mauritania, Mauritius, Moldova, the Kyrgyz Republic, Turkmenistan, and the West Bank and Gaza.
>
> Technical assistance to Nigeria and Mauritius contributed to the establishment of financial intelligence units (FIUs) that subsequently obtained membership in the Egmont Group of FIUs.[1] The Kyrgyz Republic, Seychelles, and Bangladesh are currently seeking Egmont Group members[lfo1llow8(g)10 sencip(mont)ent (:)0(F)6(T-9(EA[(.)] TJ

Major bilateral and regional projects in Central America and the Eastern Caribbean region on risk-based approaches to supervision are resulting in harmonized and cost-effective AML/CFT approaches throughout the region.

Technical assistance programs for Albania, Armenia, Kosovo, Georgia, Kyrgyz Republic, Moldova, Macao SAR, and Argentina have helped develop and improve AML/CFT on-site inspection procedures for banks and regulators.

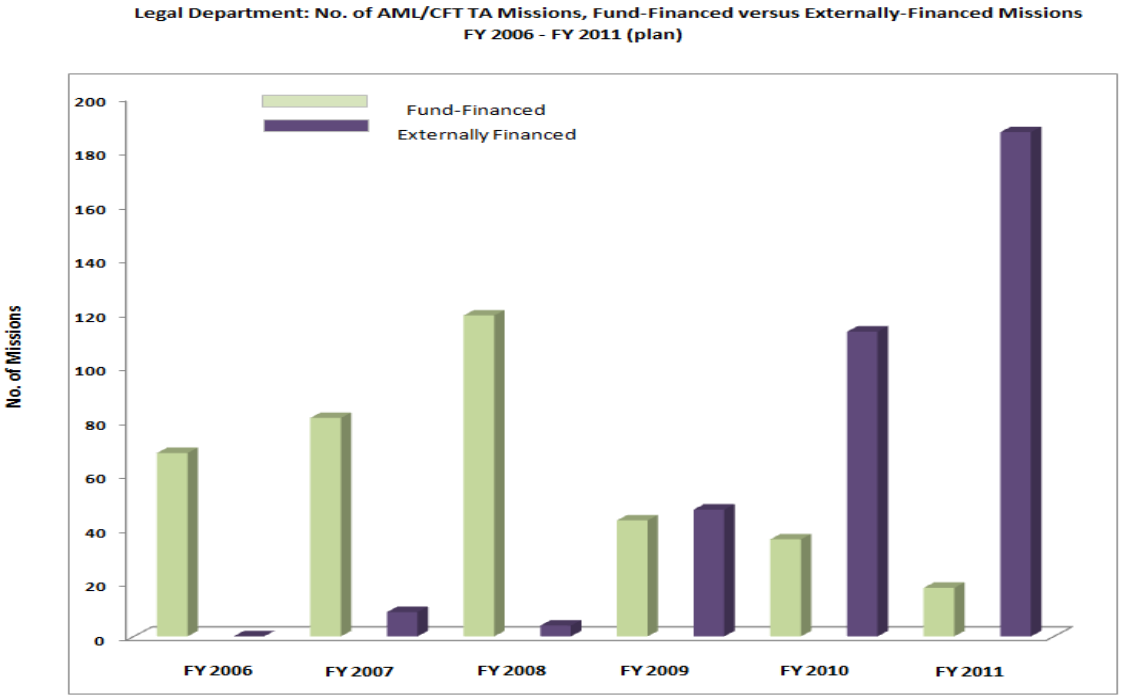
Pre-assessment TA has proven helpful in familiarizing countries with the FATF AML/CFT standard against which they are being assessed and in raising the level of engagement by policy-level officials in such countries as Mexico, China, Djibouti, Vietnam, and Paraguay.

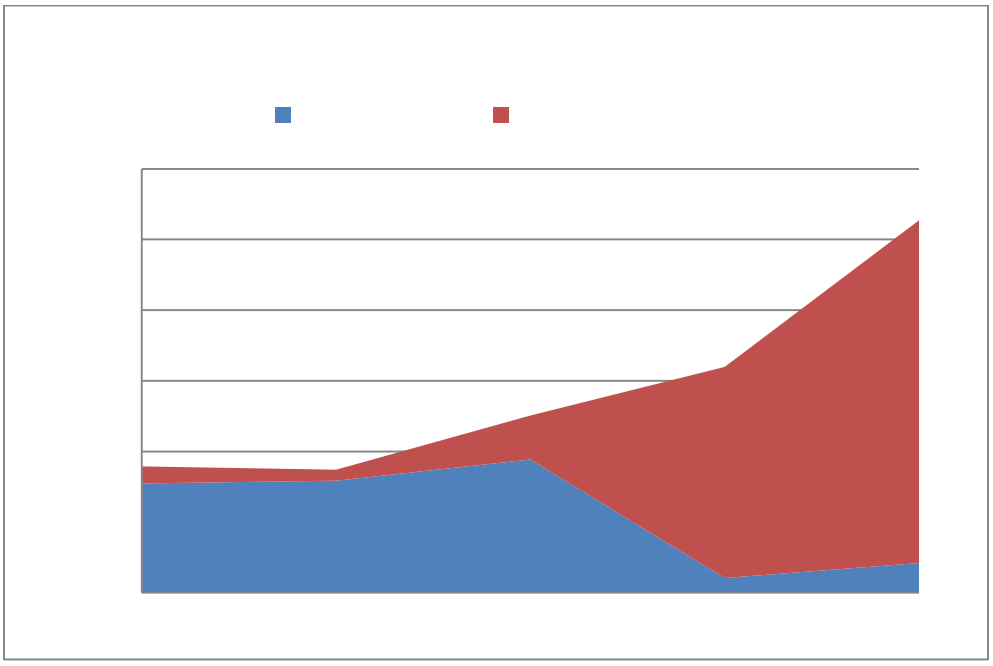
Post-assessment TA has been effective in addressing AML/CFT weaknesses highlighted in the course of assessments in Belarus, Cape Verde, Mauritius, Mexico, Mongolia, Uruguay, and Thailand.

4. **Since 2006, an orientation around stand-alone, mission-based interventions financed mainly by internal resources towards medium-term, results-oriented, externally-financed projects.** This evolution is consistent with international best practices on aid effectiveness, which are increasingly focused on results-based management frameworks that are more focused on sustained impact and concrete results.

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be a centralized unit within a nation or jurisdiction responsible for detecting criminal financial activity and ensuring adherence to laws against financial crimes, including terrorist financing and money laundering.





5. **in favor of bilateral delivery.** In the reported period, staff trained 2,468 country officials across all regions. While workshops are helpful in addressing issues of common concern at a relatively low cost and demand for regional workshops from TA recipients remains strong, it

is often difficult to measure the effectiveness of regional workshops. In part because of these concerns, several external donors are skeptical of the value of regional workshops and have expressed their preference for longer-term bilateral TA. Staff will continue to use the regional workshop modality judiciously, however, especially to address emerging issues of common concern.

6. **The increased reliance on external financing for the AML/CFT TA program has driven these changes in emphasis.** Whereas in FY2007, approximately 10 percent of the AML/CFT TA program was financed through external sources, in FY2011, external AML/CFT TA. This shift took place in the context of the FY2008 institution-wide comprehensive reform and downsizing exercise.

7. **The largest portion of the external resources financing the AML/CFT TA program is channeled through the multi-donor AML/CFT Topical Trust Fund (TTF).** Designed as a multi-donor consolidated TA strategy, the AML/CFT TTF enables cost efficiencies, increases accountability and transparency, improves donor coordination, allows for strategic and prioritized use of resources, and ensures sustainability through a longer-term program. The work program under the AML/CFT TTF is delivered under the strategic guidance of a Steering Committee composed of donor representatives and Fund staff, with participation by other AML/CFT TA providers, as needed. The Steering Committee meets annually to discuss and set policies and priorities, including through the endorsement of annual work and financial plans and the review of progress under the work plan and of performance under the program.

8. **The Fund has continued to rely on other donors to finance projects that do not meet the selection criteria of the TTF.**[2] Since the TTF began operations, Fund staff have continued to deliver AML/CFT TA to countries with financial support from other external sources, su

External Contributions for AML/CFT TA
FY2006-FY2011

Legislative Drafting: This “nuts and bolts” module illustrates one of the Fund’s comparative advantages and	

ANNEX 3. THE FUND STAFF S APPROACH TO CONDUCTING NATIONAL MONEY LAUNDERING OR FINANCING OF TERRORISM RISK ASSESSMENT

A. Introduction

1. **Fund staff is developing a framework on how to assess money laundering (ML) and terrorism financing (TF) risks.** Although the FATF standard recognizes that it is appropriate in many contexts to apply a risk-based approach to AML/CFT, it has proven difficult to apply risk-management concepts to the AML/CFT field in a rigorous way. The undertaking is complicated by the fact that ML and TF processes are many faceted and since they are often intentionally hidden from view inherently difficult to document or quantify. Moreover, different stakeholders in the AML/CFT community see ML and TF risks from different perspectives: financial firms are concerned about legal, operational, and reputational risk posed by their clients, products and services; financial regulators are concerned about the risk that regulated entities will be compromised by dealing (wittingly or unwittingly) with the proceeds of crime; law enforcement and security services are concerned about the risk that criminals and security threats will escape detection and enjoy the fruits of their illicit activity; national policymakers may be concerned about the consequences of any or all of the above.

2. **, the application of traditional risk-management concepts to AML/CFT serves several purposes.** First, it can help staff focus limited resources on countries that pose and/or face the most substantial ML or TF risks. Second, in connection with an assessment of a given country, it can help focus attention on those aspects of financial sector, and legal and institutional framework that constitute particularly significant vulnerabilities. Third, through technical assistance, it can help member countries understand, assess and mitigate the ML and TF risks that they face. Finally, it can help the international community to more effectively articulate and focus on the underlying purposes of AML/CFT regimes, and to assess the effectiveness of AML/CFT controls against these purposes. The enterprise is inherently limited by the issues outlined above as well as difficulties associated with the application of imperfect proxies and the use of estimates that may involve very wide ranges. With these caveats, however, and with the attendant recognition that critiques are welcome and further refinements will need to be made, staff is nevertheless convinced of the benefits of undertaking the work. These benefits relate largely to the focused attention that the attempt of conducting a risk assessment using a disciplined process to make informed judgments can bring to officials responsible for outlining strategies and making decisions concerning allocation of resources.

3. **Fund staff has oriented its ML/TF risk assessment work around the generic objective of minimizing the amount of ML or TF that occurs.** Fund staff believes that the ML that matters most for risk management is typically related to larger-scale criminal activities. The Fund staff s ML or TF risk-management framework, therefore, focuses on substantial ML occurring successfully.

4. **This annex summarizes the main components of the framework that Fund staff is developing for conducting national ML or TF risk assessment (NRA).** The discussion begins by briefly discussing the key features of the ML and TF processes. It then describes key elements of risk management and the Fund staff s preferred approach to applying risk

management to ML and TF and outlines the main components of the framework for assessing ML and TF risk.

B. The ML and TF processes

5. **ML is a process that transforms illegal inputs into supposed legitimate outputs and often involves the abuse of financial institutions as instrumentalities.** ML broadly encompasses a wide range of activities that may be

effectiveness of law enforcement agencies (LEAs) and the criminal justice system (CJS), and other characteristics of the jurisdiction that could facilitate successful ML or TF. In the vulnerability indicators are aggregated and combined with the threat indicators to produce an overall analysis of the likelihood of substantial ML or of TF occurring successfully.[6]

11.
events. Consequences can relate to cost, damage caused, or the significance of outcomes. From one perspective, ML and TF processes generate two types of consequence: first, those associated with laundering itself; and, second, those associated with the use of the assets after they have been successfully laundered. The consequences of laundering proceeds of crime may involve short-term distortion of demand for various products, services, or assets, including those in the financial sector. The consequences of using successfully laundered assets tend to have broader, longer-term social, economic, and political consequences that may apply to citizens, businesses, communities or national or international interests, including by encouraging further criminal activity and thus, further laundering.[7] These

Box 1: 25 Social, Economic, and Political Consequences of Money Laundering

1) Losses to the victims and gains to the perpetrator
2) Distortion of consumption
3) Distortion of investment and savings
4) Artificial increases in prices
5) Unfair competition
6) Changes in imports and exports
7) Effects on growth rates
8) Effects on output, income, and employment
9) Lowers public sector revenues
10) Threatens privatization
11) Changes in demand for money, exchange rates, and interest rates
12) Increases in exchange- and interest-rate volatility
13) Greater availability of credit
14)

13. While the framework is flexible enough to allow for different consequences to be taken in
on the first of the four options described above.

D. Scoring ML and TF risk

14. **Staff has developed**

are only meaningful in relation to other similar scores, across the modules, sectors, factors, regions, products, etc.).

17. **Scores across indicators are aggregated by deriving the geometric mean for all indicators within a nested hierarchy.** The scoring is aggregated upwards to sub-factor, factor, module, and finally overall likelihood level starting at the lowest level of each hierarchy of indicators. This is done using the nth root equation, $\sqrt[n]{A}$ - where, *n* is the number of indicators, factors, or risk events, and *A* is their product.[11] This method of aggregation is preferred for three reasons. First, it maintains the appropriate relationships between the modules and factors set out in Table 3. By combining factor scores using this method, any mary area of impact. Second, the geometric mean produces a more appropriate result than a simple average because it smoothes outlying indicator scores, which is desirable at this stage of development of the framework because many of the indicators still need to be tested for their suitability as proxies for estimating actual ML or TF activity. Finally, this approach always results in a score on the seven-point scale, making results easier to understand.

18. The scores for each analysis module are aggregated to produce a score for the overall likelihood of substantial ML abuse occurring in each jurisdiction. The aggregated likelihood score calculates the geometric mean from each module listed in the first column of Table 3 in the following manner, which follows the outline structure of the key risk events and whereby geometric means within brackets are calculated first: [(A,B1),(C,D,E),(F,G)] ,H [(B2,((I,J,K,L,M),N)),(B3,(O,P,Q1)),R1,R2], [(R3,R4),(R5,Q2,B3)].

19. **As illustrated above in paragraph12, choices must be made among the various consequences of ML and TF in conducting risk management.** (See also Box 1, above.) The framework has, thus, been developed with flexibility to deal with varying objectives. In the first instance, it focuses on a generic objective that is likely common across most AML/CFT regimes to minimize the amount of ML or TF that occurs successfully and which also provides a simple short-term consequence for analysis. More broadly, the framework also enables other consequences to be taken into account.

20. **The proxy indicators for consequence are derived largely from the perceptions of informed officials**, using a structured approach to make informed judgments and involving the use of pre-determined decision-making criteria and measurement scales. The process consists of informing the officials of the results of the likelihood analysis, presenting them with some, often general, information about the potential impact of successful ML or TF abuse,[12] and asking them to choose, using pre-determined decision-making criteria and measurement scales, what they think is the level of ML or TF consequences on each objective that is of interest to the authorities. The approach for

[11] For the modules that analyze indicators broken down by institution types, there is an intermediate step to aggregate the score in proportion to the scale of activity being undertaken within each type.

[12] The general information can be supplemented by specific studies when available (e.g., into the macroeconomic impact of illegal drug markets within an assessed jurisdiction).

organizing and scoring indicators for consequences is similar to the approach taken for indicators of likelihood, as illustrated in Table 7.

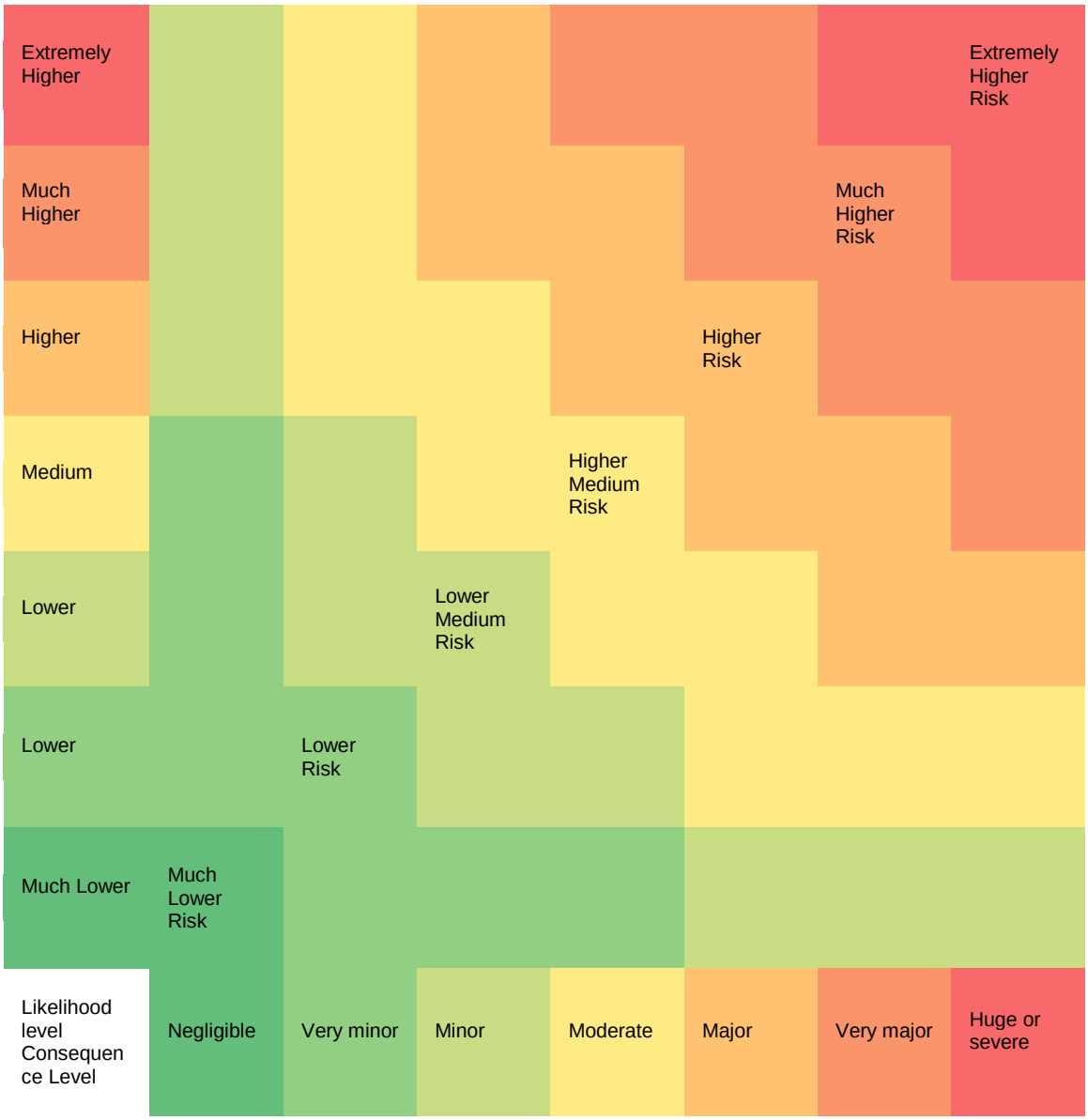
21. **The overall level of national ML or TF risk is derived by combining the** **the result falls within acceptable bounds.** The combination can be done in two ways to aid understanding:

i. First, the two proxy scores can be combined using their geometric mean. This results in a one dimensional score which can be compared against the pre-determined scale in Table 1 to assess whether the overall ML risk fits within acceptable bounds, or whether it indicates that further steps need to be taken to mitigate the risk.

Table 1. Risk level scores

Risk Level Score	Risk Level Descriptor	Risk Mitigation Priority
6-7	Extremely higher risk	Urgent priority
5-6		

Table 2. Level of ML or TF Risk Matrix



22. **The framework also provides for national ML risk to be assessed using different combinations of component parts of likelihood and consequences to facilitate understanding of the nature of ML risk.** Thus, it is possible to present a risk matrix or graph that shows the likelihood score plotted against the score for each of the identified consequences. The opposite approach can also be taken to show the overall consequence score plotted against each of the likelihood analysis module scores. In addition, consequences may vary depending on whether the context is domestic or international. Hence, the framework also allows some consequences to be measured against both absolute scales and against gross domestic product.

E. Conclusion

23. **The Fund staff s framework for conducting national assessments of ML and TF risk is based upon international standards for risk management.** The framework defines ML and TF risk through specific, contextual definitions of threats, vulnerabilities, and consequences. Application of the framework is based upon deconstructing the ML or TF process to focus on key ML or TF risk events, then analyzing the drivers and enablers of those events via indicators of risk analysis modules that produce collectively a proxy of the likelihood of substantial ML or TF occurring successfully. That proxy for likelihood is then combined with a proxy for the consequences of successful ML or TF abuse to produce the national level of ML or TF risk. Implementing the framework involves the collection of objective and subjective data for analysis against pre-determined decision-making criteria to enable scoring within the analysis modules on a seven-point ordinal scale.

24. **The framework will continue to evolve through its application in the context of technical assistance, assessments, and surveillance.** Thus far, the framework has been tested mainly in the context of assisting members to conduct national risk assessments, but it has also been informed by ongoing discussion within the FATF concerning risk-based approaches to AML/CFT controls, and it should prove helpful to staff providing AML/CFT

interested in validating and refining various aspects of the framework, including, in particular, the range of indicators and the decision-making criteria involved in defining their interrelationships. Over time, it is expected that the application of the framework will help member countries to focus their scarce AML/CFT resources on risk-mitigation initiatives where there is the most to gain.

Table 3.[13] ML Risk Analysis Framework: Risk Events and Analysis Modules of Factors

Risk event (that might happen) (1) ML or TF activity will be attempted:

Risk event (that might happen) (2) that, if attempted, the perpetrator(s) of the ML or TF activity will not be caught				
(because of) **contributing risk events**	(due to) **threats (t)** or **vulnerabilities (v)** that increase the likelihood of occurrence		**Area(s) to analyze** (modules of risk factors)	Further broken down by: (factors, and sub-factors)
(2a) if attempted, ML activity not being detected by the authorities	(v) LEAs do not detect ML activity directly.	(v) LEAs only investigate predicate crime	(B2) LEA (specific efforts to identify ML)	Effectiveness focuses on ML, Domestic cooperation
		(v) LEAs not told of foreign enquires or don't treat as ML leads		
	(v) LEAs do not receive [quality] reports on ML activity from the FIU	(v) FIU does not receive sufficient quality reports on ML activity from institutions due to: (v) Insufficient reporting. (v) Poor quality, including over-, reporting.	(I)[O] STR Reporting system	Requirements, Volumes, Quality Sectors, Institution type[(h)]
		(v) Inadequate monitoring of transactions	(J) Transaction & Account Monitoring	Requirements, Effectiveness.[(i)]
		(v) Inadequate information about customers	(K) Customer Identification, profiling, ongoing and enhanced due diligence.	Requirements, Effectiveness
		(v) Institution incapacity	(L) Capacity and competence of institutions	Systems & controls, Resources, Guidance received,
		(v) Inadequate supervision of reporting entities	(M) Supervision	Effectiveness when deficiencies identified.
		(v) Ineffective processing of reports by the FIU	(N) FIU	Effectiveness of analysis, dissemination
(2b) if detected, ML activity not being investigated adequately by the authorities	(v) LEA ineffective at conducting POC/ML investigations		(B3) LEA (specific efforts to suppress ML)	Effectiveness of investigations.
	(v) LEA POC/ML investigators cannot obtain leads or evidence.	(v) Poor access to or records in reporting entities	(O)Record-keeping	Requirements, effectiveness, secrecy.
		(v) Inability to obtain beneficial ownership information	(P) Transparency of ownership	Entity and asset types, Register requirements, powers to obtain information.
		(v) Inability to obtain information and evidence from foreign jurisdictions		

Risk event (that might happen) (3) that, once caught, the perpetrator(s) of ML activity are not sanctioned adequately.				
(because of) **contributing risk events**	(due to) **threats (t)** or **vulnerabilities (v)** that increase the likelihood of occurrence		**Area(s) to analyze** (modules of risk factors)	Further broken down by: (factors, and sub-factors)
(3a) Convicted perpetrator(s) of ML activity not being punished adequately	(v) Inadequate fines being collected	(v) Ineffective systems for collecting fines	(R3)CJS (Sanctioning)	Amount and average of fines collected
		(v) Inadequate fines being imposed	(R4) CJS (Laws, Policy, Jurisprudence, Prosecution & Judiciary)	Powers, Sanctions imposed.[(k)]
	(v) Inadequate prison terms being served	(v) Inadequate prison terms being imposed		
		(v) Ineffective prison system	(R3) CJS (Sanctioning)	Length and average of prison terms served.
(3b) Convicted perpetrator(s) of ML activity not being deprived of their assets	(v) Inadequate confiscation orders being made		(R5) CJS (Asset confiscation)	Powers, Policy, Sanctions imposed, Effectiveness focus on assets confiscated.[(k)]
	(v) Inadequate recovery of assets	(v) Inadequate resources devoted to asset recovery		
		(v) Inability to recover assets from foreign jurisdictions	(Q2) Cross-border cooperation	Effectiveness of administrative cooperation, and MLA to recover assets.
		(v) Ineffective use of provisional measures	(B3) LEA – specific aspects of ML	Assets seized or frozen
(3c) Corruption to facilitate ML occurring	(v) Corruption within the authorities		(H3) Corruption [(f)]	

Notes

(a) The approach advocated is to identify all proceeds generating offenses even if laundering those proceeds is not a domestic criminal offense. It is unlikely that a figure for proceeds entering the jurisdiction can be estimated accurately. However, the size of this threat for any jurisdiction is a function of the world proceeds (which for most countries is a constant omnipresent threat), the jurisdiction"s cross-border vulnerabilities, and the other general issues impacting on domestic ML activity. The actual amount that eventuates, and hence the overall risk, is also a function of the capacity of the jurisdiction to absorb ML activity (i.e., process transactions and store assets that are in the process of being, or that have been, laundered.).

(b) Emphasis on and success for proceeds generating crimes (i.e., powers, resources, and reported crime clearance rates).

(c) All modules that look at AML/CFT agencies look at each agency"s powers, resources, and effectiveness (output and performance). Thus, the rest of the agency entries in this column list only what the effectiveness aspect focuses on.

(d) Cross border products and services may also be of potential use to domestic launderers who wish to export some or all of their proceeds.

(e) This module analyzes and scores factors that differentiate cross-border ML activity from domestic ML activity. General issues relating to the jurisdiction apply to domestic and cross-border ML activity. However, there are some factors that only impact on cross-border ML activity. A higher "score" in this module would reflect a higher chance that the jurisdiction will attract ML activity from other jurisdictions, facilitate the exporting of ML activity from domestic sources, or both, thus increasing the amount of ML activity that occurs in the jurisdiction. The level of actual ML activity that occurs will be constrained by the capacity of the jurisdiction to process and store ML assets. That capacity will also be affected by any actions or limitations on cross-border financial flows. Examples of factors that uniquely facilitate cross-border ML activity include: geographical location, language, trade and cultural ties, ease of currency convertibility, ability of non-residents to operate domestic accounts and residents to operate foreign accounts, treatment of foreign PEPs, whether foreign predicate crimes are recognized as predicates for domestic ML, ability of jurisdiction to carry out international cooperation (e.g., extradition) etc.

(f) The first prototype of this module mainly identifies the existence of higher risk products and services and their use. Subsequent development would broaden the analysis to take account of the potential volume of activity that could be conducted.

(g) Corruption influences all of the ML process, giving launderers the potential to override all controls. It can also be a source of proceeds. For this reason, the existence of corruption is treated as a separate contributing risk event.

(h) All modules that analyze preventative measures imposed on institutions break that analysis down by sector and institution type.

(i) Effectiveness analysis includes in relation to feedback and guidelines from the authorities. Effectiveness would also look at technical issues such as whether the institution can monitor transactions across accounts, across its full network, monitor for unique identifiers, monitor using fuzzy logic for identifiers, monitor for cumulative transactions and other patterns etc.

(j) Mutual Legal Assistance

(k) For ML and predicate crimes. Sanctions may be less critical than the chance of being caught, and incarcerating members of criminal groups without confiscating assets may lead to higher levels of organized crime and corruption (See Eide, 2000, and Buscaglia, 2008).

Table 4. Examples of scoring for indicators of likelihood linked to intrinsic properties or products, services, jurisdiction, etc.

Likelihood descriptor	Measurement scale for economic activity[14]	Provides products, services, assets, or other circumstances that …	Likelihood of an event or activity occurring annually - descriptor	Likelihood of an event or activity occurring annually - as potential probability?	Likelihood of an event or activity occurring annually - as an indicative frequency	Indicator score[15]
Extremely higher likelihood	1t+	Extremely sophisticated range and volume	Almost certain	More than 95% chance	At least once per year	7
Much higher likelihood	100b-1t	Extensive range and volume	Very likely	More than 75% chance	Occurs at least once every two years	6
Higher likelihood	10b-100b	Attractive range and volume	Likely	More than 50% chance	Occurs at least 3 every 4 years	5
Higher medium likelihood	1b-10b	Normal range and volume	Possible	More than 30% chance	Occurs around once every 3 years	4
Lower medium likelihood	100m-1b	Not particularly attractive range or volume	Unlikely	Less than 30% chance	Might occur once every 5 years or so	3
Much lower likelihood	10m-100m	Very limited range or volume	Rare	Less than 10% chance	Might occur once every ten years	2
Very much lower	0-10m	Almost none	Almost incredible			

[14] Bands in U.S. dollars for either proceeds of domestic crime, proceeds of foreign crime, GDP, imports and exports, etc.

[15] All indicators have their own decision-making criteria that map to this scale.

Table 5. Examples of scoring for indicators of likelihood linked to general controls or mitigants

Likelihood descriptor	Mitigant implemented across:

Table 6. Examples of scoring for indicators of likelihood for vulnerabilities linked to weaknesses in AML/CFT controls

Likelihood Descriptor	Reporting entities per AML/CFT supervisory staff member FTE	For perceptions of performance quality and controls	Annual ML prosecutions per $B of POC (if known) OR GDP	Compliance with FATF Recommendations[16]	Indicator Score
Extremely higher	No supervision	Abysmal	None	NC or not scheduled for 2004 methodology assessment	7
Much higher	≥ 100	Very poor	< 0.06	PC + ineffective	6
Higher	≥ 52	Poor	≥ 0.06	PC + effective or scheduled for its first ever assessment.	5
Higher medium	≥ 26	Adequate	≥ 0.12	Scheduled for its first 2004 methodology assessment, and has been assessed previously.	4
Lower medium	≥ 13	Good	≥ 0.24	LC + ineffective	3
Lower	≥ 6	Excellent	≥ 0.48	LC + effective	2
Much lower	6 or less	World Best Practice	≥ 0.96	C	1

[16] In the early development stages of this work, the best available indicator for some vulnerability factors will likely be existing ratings from AML/CFT assessment reports. When these ratings are used, they are mapped to the indicator scores as follows: Compliant = 1; Largely Compliant (and no factor underlying the rating relates to ineffective implementation because this is suggestive of technical rather than substantive deficiencies) = 2; Largely compliant (including because of ineffective implementation) = 3; Has been assessed but not under 2004 methodology, scheduled for 2004 methodology assessment =4; Partially compliant (and no factor underlying the rating relates to ineffective implementation) , or never assessed, but scheduled for 2004 methodology assessment= 5; Partially compliant (including because of ineffective implementation) = 6; Non Compliant, or Not scheduled for a 2004 methodology assessment = 7. A non-applicable rating is ignored as it does not result in the implementation of an AML/CFT control. Instead, it is assumed that the reason(s) for the NA rating will have already been taken into account when assessing the relevant inherent risk issues.

Table 7. Examples of some pre-determined scales for scoring consequences

Consequence - Descriptor	Descriptor - Amount of ML or TF activity	Measurement scale–Estimated ML activity	Measurement Scale–Estimated ML activity as % of GDP	Measurement scale–Estimated TF activity	Descriptor and measurement scale–Geographic Reach	Descriptor and measurement scale–for effect on a "system" or an "objective"	Indicator score
Huge or Severe	Huge value	> $100b	> 20%	> $10m	More than one continent OR Global	Very serious, long-term impairment of system functions (destroys or almost destroys system's functionality) OR achievement of the objective	7
Very Major	High value	> 50b - $100b	10 – 19.99%	> 5m - $10m	Regional countries OR within a continent	Serious medium-term effects that begin to impair system functionality (or which destroy or almost destroy an isolated part of the system OR that begin to impair achievement of the objective)	6
Major	Major value	> $10b - $50b	5 – 9.99%	> $1m - $5m	Bordering countries only	Major, medium-term effects with potential to threaten system functions OR achievement of the objective	5
Moderate	Moderate value	> $1b - $10b	2.5 – 4.99%	> $100k - $1m	National	Moderate, short-term effects not affecting system functions OR on achievement of the objective	4
Minor	Medium value	> $100m - $1b	1.25 - 2.49%	> $10k - $100k	Regional (within a country or some provinces or states)	Minor short-term effects on whole system OR on achievement of the objective	3
Very Minor	Low value	≥ $10m - $100m	0.625 - 1.249%	≥ $1,000 - $10,000	Local (within a city)	Minor short-term effects on isolated part of system OR on achievement of part of the objective	2
Negligible	Negligible value	< $10m	< 0.625%	< $1,000	Negligible OR Within suburb, precinct, or small town	No noticeable harm - business as usual.	1

ANNEX 4. INTEGRATING AML/CFT INTO MODULAR STABILITY ASSESSMENTS AND ARTICLE IV SURVEILLANCE

Introduction

1. **This annex reviews the literature and case studies that underpin the policy proposals set forth in Section III of the paper.** This review supports the argument that money laundering and the financing of terrorism (ML/TF) and the associated predicate crimes can have an impact on financial sector stability and [(k)ris n t3(is)-9bbil.[(M[(m16ne)-7(y4(te)] T

khesr.

awareness of the importance of such issues. The paper proposes a set of considerations that can help make the determination as to whether threats exist. Those considerations are grounded in various channels of transmission between money laundering, terrorist financing and predicate crime and financial sector and macroeconomic outcomes, which are elaborated in this annex. In general, the starting points for this analysis are the perspectives first advanced by Fund staff in 1996, many of which have been subsequently confirmed by the literature and by empirical evidence. In that work, staff found that money laundering could have macroeconomic impacts due to:

> Policy mistakes due to measurement errors in macroeconomic statistics arising from money laundering;
> Changes in the demand for money that seem unrelated to measured changes in fundamentals;
> Volatility in exchange rates and interest rates due to unanticipated cross-border transfers of funds;
> Other country-specific distributional effects or asset price bubbles due to disposition ;
> Development of an unstable liability base and unsound asset structures of individual financial institutions or groups of such institutions, creating risks of systemic crises and, hence, monetary instability;
> Effects on tax collection and public expenditure allocation due to misreporting and underreporting of income;
> Misallocation of resources due to distortions in relative asset and commodity prices arising from money laundering activities; and
> Contamination effects on legal transactions due to the perceived possibility of being associated with crime.[3]

4. These positions were further elaborated in a 2001 staff paper, which found that

performance, can impose welfare losses, and may also have negative cross-border externalities. Such abuse could compromise bank soundness with potentially large fiscal liabilities, lessen the ability to attract foreign investment, and increase the volatility of international capital flows and exchange rates.[4]

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[3]

(WP/96/66).

[4] *Financial System Abuse, Financial Crime and Money Laundering² Background Paper*, prepared by the Monetary and Exchange Affairs and Policy Development and Review Departments in Consultation with Legal and Other Departments, February 12, 2001. In general, the most extensive analysis of transmission channels can

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5. In the past, issues such as exceptionally large criminal markets, the circulation of funds generated by grand corruption, and loss of confidence in the financial systems due to criminal activity were seen as immeasurable, data-poor, and very much uncharted territory. Within the past twenty years, however, research in these areas has accelerated and the field is much less data-poor than it had been. Nevertheless, significant gaps still exist and quantitative analysis, in particular, is constrained by the poor quality and heterogeneity of country data on criminal behaviors and proceeds. The next sections elaborate on the relevant cases and studies in terms of the policy proposals in the main paper, with the understanding that these relationships are still difficult to map and that Staff will continue to work on developing stronger empirical evidence and analytical frameworks.



6. The international community has put a priority on improving global compliance with

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inducing them to reform. AML/CFT-related sanctions and blacklists either at the international level such as the Financial Action Task Force (FATF) Non-Cooperative Countries and Territories (NCCT) process or at the national level such as the United States PATRIOT ACT sanctions can have an impact on financial sector efficiency and attractiveness to investment. When countries or financial institutions are under a sanctions regime, blacklisted, or under the first stages of this AML/CFT scrutiny due to low levels of compliance, the heightened due diligence requirements often demanded by international financial partners impose costs on all relevant transactions. These costs are then transferred to the entire financial sector and to the economy, *inter alia*, through disinvestment or a slow down or reversal of investment growth in both the real and financial sectors.

7. **Research on the economic impact of AML/CFT sanctions is not voluminous,[5] but indicates the potential that such actions have to harm financial sectors and economies, especially in relatively small financial centers.**

> The Liechtenstein financial sector was especially hard hit by being listed by both the FATF and the OECD in 2000. Net income of banks fell from Sw F 549 million to Sw F 251 million between 2000 and 2002, assets under management fell from

[5] Among the issues that hamper such research is that many of the transmission channels are not captured in publicly-available data.

Sw F 112 billion to Sw F 96 billion, and revenues to the government declined from Sw F 64 million to Sw F 27 million.[6]

St. Kitts and Nevis was added to the FATF NCCT list and the OECD tax havens list in 2000, and, as a consequence, experienced a massive decline in the number of IBCs

13,500
revenues from the offshore financial sector.

offshore banks, with a decline in government revenues from that sector of 26 percent.

The experience of the Cook Islands was similar, except that here the loss in revenue exceeded 70 percent.

A study looking at changes in BIS locational banking variables for 46 jurisdictions in the quarters before and after OECD and FATF listing and delisting produced mixed results, with only 14 percent of the regressions being statistically significant. Those, however, did indicate impacts both on the small island OFCs as well as on Egypt, Israel, Lebanon, and Russia.[7]

A series of studies commissioned by Fund staff identified nonbank external deposits as the variable which showed the most sensitivity to listing or delisting events, but the results for 196 jurisdictions lack robustness, in part due to data limitations.[8]

8. **Additionally, there is anecdotal evidence that sanctioned countries were affected economically by the sanctions.** A senior official at an international bank in the Caribbean indicated in 2011 that the small island countries St. Kitts and Nevis, St. Vincent, and

OECD in the 1990s.[9] Liechtenstein officials recalled the period that they were under FATF [10] Finally, the reactions of political leaders in countries under

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6 *is* the bite: International organizations and b *Review of International Political Economy*, 16:4, 2009, pp. 587 590.

7 n *Journal of Money Laundering Control*, Vol. 12, No. 1, 2008, pp. 33-49.

8 the AML/CFT group.

9 Trinidad & Tobago Guardian Online, March 3, 2011.

10 Sharman, op.cit., p. 590.

threat of sanctions, such as the Cayman Islands, the Isle of Man, Mauritius, and Austria indicate that, whatever the economic data may or may not have been able to indicate, the instincts of seasoned politicians were that the potential costs of noncompliance were sufficiently high to warrant taking on the burden of making the policy changes called for by the international community.[11] This evidence, while not quantifiable, adds to the general conclusion that such sanctions are not to be taken lightly and that remaining compliant with international standards is conducive to financial and external stability.



9. **Since at least the mid-1990s, the volatility of international capital flows has been recognized as a potentially destabilizing factor for financial sectors.**[12] There is general agreement that portfolio investment is usually more volatile than foreign direct investment and portfolio investment by nonresidents has been identified as a source of particular instability.[13] Vito Tanzi has underscored how this volatility can be particularly problematic when it originates from money laundering, in that the flows in question are not driven by the economic fundamenta

further points out that the size of international criminal flows could significantly influence variables such as the exchange rates and the interest rates, or even the price of particular assets toward which the money is invested, such as real estate.[14] This linkage was

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[11] Sharman, op.cit., pp. 584-86, 591-93.

[12] For a review of the literature on this topic, see Obstfeld M. and AM Taylor 2003, .G. Williamson (eds), *Globalization in Historical Perspective*, University of Chicago Press: Chicago, 2003, pp. 121 187.

[13] Debelle G. and G. Galati (2005), No. 169; Calvo GA (2000) -of-Payments Crises in Emerging Markets: Large Capital Inflows and), *Currency Crises*, NBER Conference Report, University of Chicago Press, Chicago, pp. 71 104; Lowe P (2009), r 9, as cited in Research Discussion Paper 2009-09, December 2009, International Department, Reserve Bank of Australia, p. 3.

[14] *Policies, Institutions and the Dark Side of Economics,* (Edwin Elgar: Cheltenham, U.K., 2000), pp. 190 193. These points are also raised in relation to later sections of the Annex.

acknowledged by an OECD-sponsored analysis of the Korean economy, which identified the creation of a Financial Intelligence Unit (FIU) as one of the enacted measures that would -term capital inflows from posing a threat to the Korean [15]

10. **Linkages between capital flight and money laundering were extensively explored in an Asian Development Bank study,** which cited Russian, Nigerian, Zambian, and Pakistani examples to establish the connection.[16] In the case of Russia in the 1990s, money laundering techniques such as under-invoicing of export earnings, fake advance import payments, and bank transfers bypassing existing controls, were identified by Fund staff as channels of the flood of flight capital.[17]This case was also the subject of a UN study which ways linked to the problem of [18]



11. **Fraud is one of the most damaging, costly, and long lasting economic events a nation can experience.** An early Fund paper on the impacts of financial crime noted:

> Trust underpins the existence and development of financial markets. The effective functioning of financial markets relies heavily on the expectation that high professional, legal, and ethical standards are observed and enforced. A reputation for integrity soundness, honesty, adherence to standards and codes is one of the most valued assets by investors, financial institutions, and jurisdictions. Various forms of

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[15] and Asian Development Bank, *Asia and Europe, Services Liberalization* (2003).

[16] Bank, Regional TA project No. 5967 (May 2002).

[17] -election strategy, IMF Research Department.

[18] UNODCCP, *Russian Capitalism and Money Laundering*, (UN, 2001), p.15.

reputation, undermine , therefore, weaken the financial system. [19]

12. **Fraud that originates in the financial sector impacts not only financial sector stability but can also affect the real and external sectors.** It can also show up on the fiscal balance sheet through overall growth slowdowns or costly bail-outs and legal processes. Within the last ten years alone, the international community has seen the smooth functioning of the financial system disrupted by the large-scale fraud perpetuated by Madoff ($13 to $ 21 billion), ENRON ($30 billion), Parmalat ($20 billion), WorldCom ($11 billion), Stanford ($8 billion), and the Bank of New York ($7.5 billion). Each of these had international implications.

13. At the country level, the 2010 Kabulbank crisis in Afghanistan may represent another

nascent financial sector. Although at the time of this writing, there have been no criminal findings, if this bank failure is found to have been caused by fraud or insider dealing, then relative to the size of the economy and the formal financial sector, it could be among the largest criminal bank insolvencies in history. The Kabulbank crisis may hinder the

extracting a potentially large fiscal cost all of which strain available resources and endanger ongoing development efforts. Also, in a low income country like Afghanistan, resolution will be complicated by capacity constraints. Asset recovery, for example, which is a complex and difficult process even for the most advanced countries, may prove particularly difficult in this problems and capacity constraints.

14. Similarly, the 2003 financial crisis in the Dominican Republic was prompted by bank -party lending and outright embezzlement of funds using a double accounting system.[20] The total direct cost of the bank bail out to three failed commercial banks in 2003 amounted to 21 percent of GDP. The social and economic costs exceeded the direct cost of the bailouts: a rapid depreciation of the peso by approximately 65 percent (due to a loss of confidence) led to very high inflation (54 percent in 2004) and a serious erosion of real incomes. Approximately 1.5 million Dominicans (about 16 percent of the population) fell below the poverty line in the aftermath of the banking crisis, of which 670,000 fell into extreme poverty. Although

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[19] *Financial System Abuse, Financial Crime and Money Laundering² Background Paper*, prepared by the Monetary and Exchange Affairs and Policy Development and Review Departments in Consultation with Legal and other Departments, February 12, 2001.

[20]UNODC, WB (2007). Crime, Violence, and Development: Trends, Costs, and Policy Options in the Caribbean Report No. 37820.

Dominican GDP growth has rebounded since 2004, the government and central bank continue to struggle to service the resulting higher debt stock.



15. **Tanzi believed, as did the Fund 2001 Staff paper, that global capital markets depend on trust and confidence.**

significantly contaminated by money controlled by criminal elements, this confidence would inevitably be affected [21] In some instances, bankers may try to influence regulators and supervisors with offers of jobs or other emoluments. They can also try to buy influence with politicians who in turn can affect the actions of regulators and supervisors.[22] These phenomena may have a significant impact on the stability of the financial system as

prevent prompt and effective corrective action following a negative shock.[23]

16. In 1995, the Latvian banking system was roiled by a crisis that affected the largest bank in the country as well as a host of smaller institutions. Ultimately, the involved banks represented 40 percent of banking sector assets and 53 percent of household deposits and the crisis led to a 1.6 percent fall in GDP. The crisis was characterized by abuse by insiders in a context of inadequate enforcement of existing prudential regulations. In some cases, owners and managers viewed the bank primarily as a ready-made source of financing for their own business interests, which often took the form of trade activities (often illicit) with parties in Russia. The large majority of the banks that had become insolvent had exceeded limits on lending to owners. Connected lending was also crucial in the collapse of Baltija Bank. The Latvian central bank had often been urged by institutions, including the Fund, to increase the number and skills of supervisors. Part of the failure to take this advice was due to an environment corrupted by the launderers (strong political power of some bank owners or managers, including the support of some parliamentarians and officials for failed large

[21] Tanzi, 2000, op. cit., p. 193.

[22]

Current Developments in Monetary and Financial Law, IMF.

[23] See Claessens, S., Klingebiel, D. and Resolving systemic financial crisis: policies and institutions Policy Research Working Paper Series: 3377. Washington, D.C.: The World Bank.

banks) or organized crime behaviors (outright physical fear when banks had a criminal element). Those same reasons explain why the supervisors focused their efforts on small banks but were more wary of tackling larger banks.[24] Interestingly, similar issues have been noted during the 2008 2009 financial crisis.



17. In general, countries that have experienced terrorist attacks or prolonged conflict with terrorist bodies tend to focus more on the human and political costs than those specifically located in the financial sector or the economy writ large. Nonetheless, intuitively, there would be both direct and indirect costs associated with terrorist acts which would logically be proportional to the size of the attack or the insurgency. A 2002 OECD working paper

at $28.4 billion, with a significant near-term, albeit temporary, loss in consumer confidence both in the US and elsewhere in the developed world. Shocks to financial markets, illustrated

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implied volatility were also noticeable, but transient.[25] -

[24] Fleming, A., &
Paper 1590. Washington, D.C.: World Bank.; Hallagan, W. (2003). *The Development of Banking in Transitional Economies*. Working paper. Washington State University. Hallagan, W. (1997). Speed and Sequencing of Market Reforms: The Case of Banking in Latvia. *Contemporary Economic Policy*, Vol. 15(2), 24
r & M. Skreb (Eds.), *Financial Sector Transformation, Lessons from Economies in Transition* (195 236). Cambridge, U.K.: Cambridge University Press; International Monetary Fund (1995). *Latvia±Recent Economic Developments*. IMF Staff Country Report No. 95/125 (December); Rawlinson, P. (2001). *Russian Organized Crime and the Baltic States: Assessing the Threat.* Working Paper 38/01. ESRC

[25] Lenain, P., Bonturi, M., Koen, V., 2002. The economic consequences of terrorism. OECD Working Paper 334, Organization for Economic Cooperation and Development, Paris, pp. 6 11. Largely on this basis, Johnston
ng the
The Impact of Terrorism on Financial Markets, IMF Working Paper (January 2005). The OECD paper, however, engages in several speculative projections of impacts from *potential* terrorist acts which would be significantly more disruptive than what has been experienced to date.

the attacks, the multiplier effects of the direct effects and the type of policies adopted in response to the attacks. [26]

18. The most comprehensive investigation of the macroeconomic consequences of

he Penn World Table data set, thereby covering 177 countries over 33 years. The study found that:

> ...on average, the incidence of terrorism may have an economically significant negative effect on growth, albeit one that is considerably smaller and less persistent than that associated with either external wars or internal conflict. As well, terrorism is associated with a redirection of economic activity away from investment spending and towards government spending [27]

19. Differentiating between advanced and developing economies indicated that developed nations are more frequent targets of terrorist acts than developing countries, but that the economic impacts of the less frequent events in the developing world appear to be significantly greater.



20. Governments have to raise revenues to fund services and public goods. Tax evasion represents a fundamental challenge to this core state function, leading to higher fiscal deficits, underinvestment in public goods, inadequate social safety nets, and substandard

education, infrastructure, and institutions. This diversion of resources slows or prevents

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[26] Bruck, T. and B- *European Journal of Political Economy*, Vol. 20 (2004) 293 300.

[27] *Journal of Monetary Economics*, 51 (2004), pp. 1007 1032.

growth and development, has a direct impact on human security, and the development of social capital.

21. **Large scale tax fraud is estimated to be the most prevalent and significant of all proceeds-generating crimes.**[28] Tax offenses generate large sums of money that need to be laundered to be integrated into the financial system and thereby used by tax offenders. The economic literature on tax evasion, while extensive, tends to focus on the incentives for utility-maximizing individual taxpayers and the effects on fiscal balances, leaving the connection between fiscal imbalance and macroeconomic performance implicit.[29] Fund country studies, however, are much more explicit in their linkage of poor fiscal performance due to low tax compliance and sub-optimal macroeconomic outcomes. A 2003 study of Guya

indicates that, absent evasion through the informal sectors, Guyana could have collected an additional 7 percent of GDP per year over the 30-year period from 1970 2000.[30] Sizable fiscal gaps are not limited to developing countries, although the impact may be higher there; VAT gaps in the EU countries have been estimated to be as high as 34.5 percent of hypothetical revenue (Italy), with Spain, Greece, and Belgium all in the 19 22 percent

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[28] Although the FATF Recommendations do not presently include tax crimes as a predicate offense, the subject is actively under discussion, the recommendations are considered a minimum standard, and many countries already have extended their domestic AML regimes to encompass tax evasion and put in place mechanisms to enable cooperation between and among authorities charged with tax collection and enforcement and AML/CFT. Fund staff work on AML/CFT assessments and on helping country officials conduct national risk assessments consistently indicate that tax fraud is among the largest source of criminal proceeds. See e.g., Legal
-Money Laundering and Combating the
-30 (Washington: International Monetary Fund); Legal Department, 2010, *Technical note on the Anti-Money Laundering/Combating the Financing of Terrorism Regime*, Financial Sector Assessment Program United States of America, p. 6, footnote 8 (Washington: International Monetary
Netherlands: Detailed Assessment Report on Anti-Money Laundering and Combating the Financing of
25 (Washington: International Monetary Fund).

[29] The seminal work in this field is widely considered to be Allingham, Michael A. and Agnar Sandmo. *Journal of Public Economics*, 1:323-338 (1972). A key later work

National Tax Journal, Vol. 38, No. 3 (September 1985), marries the traditional perspective with thoughts about tax code design. Among the few works that even implicitly looks at the macroeconomic impacts of tax evasion is Roubini, N. and Xavier Sala-i- *Journal of Monetary Economics*, 35:275 301, 1995, which looks at the negative economic impact of probable governmental responses to high tax evasion. See also Dabla-
Journal of Policy Reform, Vol. 8, No. 2 (June, 2005), which models, *inter alia*, the growth impacts of movements into the informal sector.

[30]
Working Paper, 2003 (WP/03/7).

range.[31] Tax gaps for other taxes, such as the U.S. individual income tax, have been estimated at 13.7 percent of hypothetical revenue, or close to $290 billion.[32]

22. A recent compelling case study relates to the Greek financial crisis, in which tax evasion is playing a determinant role. As indicated by staff from the outset of the stand-by arrangement, fiscal consolidation is at the heart of the adjustment strategy and is dependent the wide tax evasion and corruption in tax administration. [33]Selected data helps to understand the magnitude of the problem. In 2006, the VAT Gap was 30 percent in Greece to compare to 12 percent on average in the EU-25 while in 2007 the number of verifications to taxpayers was 0.2 percent in Greece to compare to 4.1 percent on average for OECD countries. In a country where tax crimes are predicate offenses to money laundering, as most are now in Greece, AML legal and institutional tools can be used to detect and investigate the laundering of the proceeds of tax evasion, prosecute tax offenders and recover the proceeds of tax evasion, including when they are hidden abroad.

23. **Finally, tax fraud poses a particular and growing risk to the financial sectors of those countries that are the recipients of deposits from nonresident tax evaders.** As the international community has become less tolerant of cross-border tax evasion,[34] countries whose financial sectors may be dependent on such nonresident deposits can find themselves not only the targets of sanctions, as noted above, but also can experience sudden, destabilizing withdrawals of deposits if intensified enforcement actions or tax amnesty programs significantly change the incentives for nonresident depositors. Financial systems that have been overly dependent on such flows may find that such a business model is problematic or perhaps unsustainable.

24. **As noted in the paper, there are instances where money laundering, terrorist financing, and their associated predicate crimes can have effects on external stability that may not necessarily be transmitted through the channels of the financial system.** The following sections elaborate on some of the studies and cases that illustrate such instances.

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Working Paper (2007) (WP/07/31).

32 *Journal of Economic Perspectives*, Vol. 21, No. 1 (Winter, 2007). 2001 data. Similar calculations for Sweden show a tax gap of between 8 9 percent, which is the range that the United Kingdom reports as well.

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34 The G-20 Toronto Summit Declaration (June 26 27, 2010).

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exchange rates.[41] Exchange rate effects were further noted in the case of Nigeria, where:

> purchasers of foreign exchange were willing to pay to falsify import documents so that they could evade customs duties, or to make transfers that were otherwise restricted (e.g., capital flight) or illicit (e.g., money
> .[42]

Distortion of demand for money: ytical contribution was directly focused on this effect. He calculated that each 10 percent increase in crime results in a 6 percent reduction in broad money demand and a 10 percent reduction in allel financial

[43]



26. percent increase in the money laundering associated with crime resulted in an estimated 0.1 percent reduction in annual GDP growth rates.[44] While his work did not identify specific criminal activity or transmission channels, the literature does suggest the following two specific predicate crimes which are both significant sources of proceeds and potential agents of financial sector or macroeconomic destabilization.

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[41] Tanzi, 2000, op. cit., p. 192, *Financial System Abuse,* p. 9.

[42] 22, (IMF Country Report No. 01/131).

[43] Quirk, 1996, p. 13.

[44] Quirk, 1996, p. 20.

Corruption by government officials is significant relative to the size of the economy or the government budget[45]

27. There is a large and growing body of evidence proving the negative impact that corruption has on economic growth. The costs of corruption have an impact on many elements of the economic system from the fiscal balance sheet to the balance of payments to the financial system. Even when governance and rule of law issues are left aside, in diverting resources from basic needs and perverting efficient and equitable allocation in the economy, corruption and grand corruption are detrimental to the formulation and implementation of sound economic, and especially fiscal policy.

28. As far as financial sector-specific impact is concerned, a 2005 IMF working paper found a strong association between corruption and a shallower and less efficient financial system[46]
average length of time an African banking system spent in crisis increased with the level of [47] More generally, corruption has been associated with sub-optimal monetary policies in developing countries,[48] with disruptive capital flight during Asian currency crises,[49] and with difficulties in attracting FDI.[50] Finally, the negative impact of

[45] It is worth noting that corruption by government officials is partially addressed in existing Fund policy on

GN on governance.

[46] Tressel, T., Detragiache, E.and Gupta, P. (2005). *Finance in Lower Income Countries: An Empirical Exploration*. IMF Working Paper 05/167. Washington: International Monetary Fund.

[47] Kane, E. and Rice, T. (2000). *Bank Runs and Banking Policies: Lessons for African Policymakers* National Bureau of Economic Research, NBER Working Papers: 8003.

[48] Huang, H. & Wei, S.-J. (2006). Monetary Policies for Developing Countries: The Role of Institutional Quality. *Journal of International Economics*, September 2006, v. 70, issue 1, pp. 239 252.

[49] Moghadam, M. R., Samavati, H., & Dilts, D. A. (2003). An Examination of Capital Flight from East Asian Emerging Economies: Paradise Lost. *Journal of Asia-Pacific Business*, v. 5, iss. 1, 33 49.

[50] Samanta, S. (2006). Foreign Direct Investment Flows and Corruptions in Developing Countries: An Analysis. *Global Journal of Finance and Economics*, April 2006, v. 3, iss. 1, 87 98.; Kose, A., Praasad, E., Rogoff K., and Wei J-S. (2006). Financial Globalization: A Reappraisal. IMF Working Paper 06/189. Washington: International Monetary Fund. Kyobe, A. and Danninger, S. (2005). *Revenue Forecasting² How is it done? Results from a Survey of Low-Income Countries*. IMF Working Papers: 05/24. Washington: International Monetary Fund; Wei, S.-J. (2006). Connecting Two Views on Financial Globalization: Can We Make Further Progress? NBER Working Paper, forthcoming; Gelos, G. and Wei S.-J. (2005). Transparency and International Portfolio Holdings. *Journal of Finance*, Vol. 60, No. 6, 2987 3020; and Wei, S.-J., (2000b). How Taxing is Corruption on International Investors? *Review of Economics and Statistics*, Vol. 82, No. 1, 1 11.

corruption on public finance was the subject of an FAD-edited volume, *Governance, Corruption, and Economic Performance,* published in 2002.[51]

Transactions in illegal markets (usually drug production and trafficking) are large (official) GDP

29. **There are several countries where illicit sectors form a significant portion of GDP.**
economy is Afghanistan, where the potential export value of 2010 opium production was US$1.4 billion, equivalent to roughly 11
from 34 percent and 26 percent in 2008 and 2009, respectively.[52] This large illicit sector is a driver of growth both through consumption and agriculture. It is the source of funds for both infrastructure and services and, combined with the level of corruption, recently measured at 20 percent of GDP, its value chain likely penetrates the co
financial sector. Discounting this sector from overall analysis reduces the complexity of the actual situation in the country, which does not bode well for future policymaking and advising. Monetary and fiscal policy is particularly impacted, as are government forecasts and assessments of trade.[53]

30. In other countries, large illicit productive sectors contribute to GDP, although not as substantially as in the case of Afghanistan. Official data in Andean Countries suggest that the coca and cocaine sector represents only a modest share of total GDP**.**
national statistics do not include an estimate for the impact of coca and cocaine production in GDP. Staff has, nevertheless, estimated that the share of production of coca and cocaine represents 0.9 percent of total GDP in 2009. Bolivia reports that the cultivation of coca leaf represents some 1/8 1 1/4 percent of total GDP, and UNODC sources suggest that illicit coca production formed where illicit coca production formed 21 percent and 14 percent of

[51] *Governance, Corruption, and Economic Performance,* 2002.

[52] See: UNODC and Government of Afghanistan Opium Survey, 2010, page 7. Afghanistan is also an example of how AML/CFT-related issues, both in the drug sector and in the area of financial fraud, can be well integrated into country and financial sector work.

[53]

Development Working Paper No. 18, December 2004) for a comprehensive review of the macroeconomic benefits and costs that Afghanistan receives from its participation in the drug economy, generally concluding

boosts to aggregate demand and the balance of payments. For the purposes of inclusion in the Article IV, however, it is sufficient to demonstrate criticality, not downside threat. See also, Ward, Christopher, Mansfield, David, Oldham, Peter, and Byrd, William, 2008, *Afghanistan: Economic Incentives and Development Initiatives to Reduce Opium Production* (World Bank/Department for International Development). Martin, Edouard, and

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ug Industry: Structure, Functioning, Dynamics, and Implications for Counter-Narcotics Policy,ed. by Buddenberg and Byrd (World Bank/UNODC).

agricultural output in 2008 and 2009, respectively,[54] Colombian statistics indicate that the share of production of coca and cocaine has ranged between ¾ 3¾ percent of total GDP from 2000 to 2008, declining toward the end of the period as a result of the coca eradication efforts. In Asia, Myanmar and Laos are similarly impacted.[55]

31. **In Andean Countries these illicit sectors do not generate economic activity exclusively in the informal sector, nor do one hundred percent of the funds they generate immediately leave the country in the hands of organized crime.** [56] The impact and the transmission channels are complex, but given what is now a comparatively large data set on production and value in these sectors, as well as a growing understanding of how the markets themselves work, Fund staff now have a good basis upon which to estimate impact on GDP and trade for countries where this empirical information is particularly robust. There is also scope for further work on understanding the flow of funds in the financial sector. In particular, staff have developed an analysis of the impact of shocks from the cocaine economy on Peruvian GDP that provides robust econometric support for the existence of such transmission channels, as well as a methodological basis for evaluating their significance in various countries. This material is the basis for Box 7 in the body of the text.[57]

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[54] UNODC and Estado Plurinacional de Bolivia, *Monitoreo de Cultivos de Coca 2009,* 2010. Bolivia reports that the cultivation of coca leaf represents between 3.6 8¼ percent of total Agriculture GDP from 1990 2008.

[55] UNODC, The Central Committee for Drug Abuse Control and The Lao National Commission for Drug Control and Supervision, *South-East Asia Opium Survey 2010, Lao PDR, Myanmar,* 2010.

[56] Pedroni
Working Paper (forthcoming).
the Illicit Drug Sector in Bolivia and Peru: Current P *Journal of Interamerican Studies and World Affairs,* Vol. 37, No.3 (Autumn), pp. 125 149 (Miami: University of Miami); De Franco, Mario, and Godoy,

Journal of Latin American Studies, Vol. 24, No. 2 (May), pp. 375 406
(Cambridge: Cambridge Univers Realizing the Potential of Crop Substitution: An

Kennedy, Michael, Reuter, Peter, and Riley, Kevin Jack, 1994, *A Simple Economic Model of Cocaine Production* (Santa Monica: RAND Corporation); Mejia, Daniel, and Esteban Pasada, Carlos, 2008, *Cocaine Production and Trafficking: What Do We Know?* World Bank Policy Research Working Paper No. 4618 (Washington: World Bank); Steiner *World Development,* Vol. 26, No. 6, pp. 1013
Annals of the American Academy of Political and Social Science, 582

The Journal of Drug Issues, Vol. 0022-0426 (January), pp. 185 200.

[57] Coca and cocaine production could have several types of effects in the economy**.** For example, it is reasonable to think that resources devoted to the cultivation and trafficking of coca products are being drained from other productive opportunities in the economy. In this scenario, economic activity associated with illicit coca and cocaine sector is expected to crowd out economic activity in other sectors of the economy and create social and political unrest that could be alsosec4(n)6(d)-5( )-2(cr)-5(ea)-3(te)] TJothern



32. **Spillover effects associated with ML/FT and their predicate crimes can fall into a number of categories,** some of which are associated with the issue of destabilizing inflows and outflows addressed earlier.

33. In general, w
for criminals from other countries to successfully launder the proceeds of their domestic crimes. In some cases, financial products and services in one country may have special features that facilitate the concealment of beneficial ownership. In others, lax enforcement of customer due diligence in relation to foreign politically-exposed persons can allow the proceeds of corruption to be transferred illicitly from a developing country to a developed one. Money raised in one jurisdiction can be used to finance terrorist acts carried out in another. One special case would be the problem of cross-border tax evasion, especially in circumstances where the predicate crime is defined differently in different jurisdictions.

34. Criminal activity in one node of the global financial system can have negative impacts on other countries with which it has financial ties. As noted above, the Madoff, ENRON, Parmalat, WorldCom, Stanford, and BoNY scandals all had cross-border impacts. In this regard, criminal proceeds that could be not macro-relevant in a large developed economy can have significantly greater destabilizing effects if they are exported to an economy that is smaller. For example, the small island economy of Antigua and Barbuda was overwhelmed by the consequences of fraud perpetrated in the United States by the Stanford Financial Group in a scenario that implicated senior Antiguan regulators and caused a significant economic downturn prompting a request for an IMF program.[58] Similarly, as cited above, the proceeds of Russian crime became a destabilizing factor in neighboring Latvia in the 1990s.

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there are economic spillover effects from the illicit coca sector that could lead to increases in economic activity in other sectors of the formal and informal economy. The two mechanisms operate in opposite directions and may create opposing effects. Pedroni and Verdugo, *op.cit.*

[58] and Request for Stand-By Arrangement
IMF Country Report No. 10/279, September 2010.