

Anti-Money Laundering Overkill?

*It's time to ask how well
the system is working.*

BY PETER REUTER AND EDWIN M. TRUMAN

Over the past twenty years, but with a huge increase in prominence since September 11, 2001, the United States and the other wealthy nations of the world have constructed an ever more embracing set of anti-money laundering (AML) controls. Their aim is to make it more difficult to finance terrorism, to traffic in drugs, or for corrupt kleptocratic officials in developing countries to rip off their citizens. An associated objective is to make it easier to catch those who commit these crimes. How well is the system doing? Should it be altered and expanded?

LAUNDERING

A starting point for a policy assessment is a good description of the problem. There are no systematic estimates of the scale of money laundering, though large numbers are frequently thrown around without serious support, most prominently the 2–5 percent of global GDP (\$800 billion to \$2 trillion in 2004 dollars) suggested by International Monetary Fund Managing Director Camdessus in 1998. The oft-

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cited figure from the United Nations that the illegal drug trade, at the international level, generates \$400–\$500 billion annually (8 percent of total trade flows) also implies that the amounts laundered are massive. However, that latter figure is a vastly inflated estimate. Total drug sales at the retail level probably total only \$200 billion, and the international trade component may be only \$10–\$20 billion; most revenues from cocaine and heroin go to the millions of domestic distributors at the bottom of the system whose earnings are far too small to require laundering. Terrorist finance, the component of money laundering that generates the greatest social damage, is a pittance by contemporary standards; the operations of supporting dedicated operatives require a few million rather than billions of dollars in donations and revenues. It is fair to assume that money laundering is in the hundreds of billions of dollars annually but probably only several, and it is unlikely to be a trillion.

However, even if money laundering is not extensive enough to be an important international financial flow, it is socially important because money laundering facilitates behaviors that society cares about a great deal. Indeed, anti-money laundering tools provide the means to achieve multiple objectives. The success of the system should be

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judged not by how much it reduces money laundering but by how much it reduces the criminal activities that generate the laundering, namely drug trafficking, corruption, terrorism, etc. A regime that forces terrorists to avoid using banks and forces them to carry money in suitcases across international borders would only get high marks if it

The Spectrum of Money Laundering Schemes

DRUG TRAFFICKER

“Rick” launched his own drug trafficking operation using the funds of the cartel he once served.

Cash shipments arrived by boat or plane and were promptly divided and placed into a range of bank accounts. An agent then moved the funds to the personal accounts of overseas intermediaries. Each intermediary arranged to transfer the funds back to accounts at the national central bank, which granted authorization.

At this point, Rick would call the intermediary to cancel the transfer. The funds were then withdrawn in cash from the intermediary’s account and wired back to other accounts, using the authorization from the national central bank to explain the funds’ origin. Without knowing it, the central bank was providing legitimacy to drug monies.

EMBEZZLEMENT AND (SELF-) MONEY LAUNDERING

Several officers of the Washington, D.C., Teachers’ Union (WTU), including president Barbara A. Bullock, were implicated in a scandal involving the theft of \$4.6 million.

One element of the operation involved Bullock’s chauffeur Leroy Holmes, who laundered more than \$1.2 million. Many of the 200-plus checks Holmes cashed were made out to creditors such as the local phone company or the D.C. Treasurer, with the original payee’s name crossed out and replaced with his own. He often left Independence Federal Savings Bank with his pants pockets stuffed with as much as \$20,000 worth of bills. The bank itself never filed the required CTRs or SARs.

In addition, the WTU made several payments totaling \$450,000 for the “consulting services” of a phony company called Expressions Unlimited. One of the company’s partners, Michael Martin, was Bullock’s hairdresser.

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meant that the actual flows of funds to support terrorists were much reduced.

Laundering the proceeds of crime can be as simple as driving cash south over the U.S.-Mexican border to put it into less tightly supervised financial institutions there. It can be as complex as the special purpose vehicles set up in the Caribbean by Enron officials. It can involve institutions as humble as hawalahs and other “informal value transfer systems” that function primarily to provide low-cost money transfer systems for low-income immigrants or as lofty as JP MorganChase. See the accompanying box for two examples.

Different activities generate different money laundering needs. Drug dealers have the problem of large quantities of cash arriving on a regular basis. Robert Maxwell’s needs were very different indeed when he used his newly acquired *New York Daily News* as a vehicle for washing money that he had taken from the London pension funds of Maxwell Group Newspaper PLC in 1991. A regime focused on catching laundering related to drug smuggling will require considerable adaptation to catch these other kinds of schemes.

THE AML REGIME

The United States has been the leader in the effort to create a money laundering control regime, from an initial focus on banks in the early 1970s and an expanded concern with drugs in the mid-1980s to the more recent focus on international terrorist finance. For many reasons the United States has seen anti-money laundering as an international matter. Through the leadership of the 33-member Financial Action Task Force (FATF) established in 1989 and based in Paris, a set of international AML standards has been developed along with loose mechanisms to mon-

itor compliance with them. The system is designed to make it comparably difficult to launder money in New York, London, Singapore, or the Cayman Islands.

Nations differ in how they go about implementing this regime. The United States is enforcement-minded, with relatively weak regulations, vast numbers of reports containing little information, but the threat of heavy penalties for anyone who actually gets caught. The Swiss, often tarred as the bad guys on this issue, take an opposite approach. They emphasize co-operation between financial institutions and the authorities. A small number of reports is generated, and the government acts promptly on those reports to freeze assets, rather than to incarcerate offenders.

In 2000 and 2001, the FATF reviewed forty-six jurisdictions, both nations and territories such as the Cayman Islands, where there were questions as to the adequacy of AML controls. Exactly half of them initially were put on a list of candidates for possible sanctions if they did not shape up; within four years all but six had put in place systems that, at least on paper, met international standards. The cost to reputation of being placed on the “name and shame” list was apparently enough to generate substantial corrective responses.

Since 2002, the World Bank and the International Monetary Fund have been drawn, reluctantly, into monitoring compliance with the global AML standards. They are universal organizations, compared to the self-appointed FATF club, with well-earned reputations for competence and integrity. Though uncomfortable with responsibilities linked to law enforcement, the Bank and Fund have produced a number of comprehensive reports that promise to contribute to further improvements in AML systems throughout the world.

ENFORCEMENT

Most of the FATF and the Bank/Fund attention has been directed at the creation of a system of laws, regulations, and institutions—the prevention pillar of the AML regime. Less attention has been given to how well the system

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Each year the federal government, which has the principal U.S. enforcement responsibility in this area, convicts approximately 2,000 people for violations of various money laundering statutes. That suggests either a small money laundering industry or, more plausibly, that most launderers face a low risk of getting caught in the course of a year. We estimate that risk at less than 5 percent compared with closer to 25 percent for cocaine sellers. Indeed, the risk in the United States may be very much less than 5 percent. Nevertheless, it is higher than in Europe. In the United Kingdom in the 1990s, barely 30 convictions for money laundering were recorded each year, and in Germany just a handful annually. If there is a lot of money laundering going on in Europe, and there is little basis for suggesting that there is substantially less than in the United States, those performing the service face minimal risk of getting caught and going to prison. Nor are the financial penalties imposed on the money laundering system impressive; the U.S. government seizes less than \$1 billion annually and the UK government barely 20 million pounds in recent years. If the estimates of several hundreds of billions of dollars in annual money laundering are correct, this is a minimal tax.

The AML system has worthy goals but it also imposes real costs. The obvious ones—government expenditures on operating the Currency Transactions Reports (CTRs) and Suspicious Activity Reports (SARs) programs—are a small part. Firms subject to the reporting requirements have to invest in systems to identify cus-

tomers and transactions and to deliver reports. They in turn subject customers to costs and inconvenience by requiring additional information and time for verification. Our very rough estimate of the total financial cost of the current system in the United States is about \$7 billion annually, including costs borne by the government, financial and non-financial private sector institutions, and the general public. Moreover there are the much more subtle costs in the form of errors, individuals and businesses that are tarred incorrectly with the money laundering brush as well as denied prompt access to their funds.

The FATF now has recommended the expansion of the prevention pillar of the AML regime to a broad array of financial and non-financial businesses and to certain professions. One current frontier of regulation in the United States is real estate agents, but the AML regime may well move beyond them to any person or business dealing in large purchases, as is already the case in Britain. Dealers in antiques, rare postage stamps, or jewelry would be required to file reports when any customer uses more than \$10,000 in currency for a purchase or when there is something “suspicious” (a notoriously vague and variably interpreted term) about an actual or potential transaction.

WHAT HAS BEEN ACCOMPLISHED?

A fair question then is whether the current AML system has accomplished much. Unfortunately, there is no information on the outcomes of ultimate concern, namely how much money laundering controls have helped reduce the extent of drug dealing and other criminal activities or even how much it has helped in catching those who deal in drugs, finance terrorists, or bribe kleptocrats.

One useful intermediate measure would be whether money laundering services have become more expensive and/or difficult to find. Criminal justice agencies are astonishingly uninterested in prices, so that information is episodic. Back in the 1980s, when the U.S. government ran a successful sting operation laundering money for the Medellin cartel of Colombian cocaine dealers, a competitive price for large quantities was reported to be about 5 percent of the gross amount laundered, with very speedy delivery guaranteed. More recent reports include prices as high as 10 percent, but too little is known about the quality and quantity of the services provided to judge whether there has been an actual increase in prices.

For some of the targeted activities, it is simply implausible that an effective money laundering system would make much of a difference. High-level drug dealers, the only ones who need money laundering services, account for no more than 25 percent of the retail price of cocaine and heroin. Raising the cost of money laundering from, say, 5 percent to 10 percent, a massive achieve-

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ment, would raise the retail price of the drugs by only about 1.25 percent. That is not to say the AML controls are not worth having, but their accomplishments are likely to be very difficult to detect.

A subsidiary objective of the global AML regime has been to protect the integrity of the core financial system. Banks in particular are quasi-public utilities, and the public does not want them to be directly involved in handling dirty money. This objective appears to have been largely achieved. Scandals such as that involving Washington, D.C.'s Riggs National Bank, a medium-sized regional institution, serve as reminders that even now the system works imperfectly. However, as far as one can tell from reports on individual cases, the large banks in the principal financial centers are now rarely the port of first call for cleaning money. It is also noteworthy that one consequence of substantial success in achieving the modest objective of reducing the direct involvement of large banks in the major financial centers in money laundering activities has been to divert it to other, less-regulated channels and institutions.

THE WAY FORWARD

Articulation of global AML standards under the leadership of the FATF has been impressive, and many countries have substantially improved the laws and regulations on their books. However, the international regime would be strengthened further if money laundering could be investigated and prosecuted in any jurisdiction in connection with major underlying criminal offenses in other jurisdictions, for example terrorism and corruption. Tax evasion should be included in the list of such major crimes. The United States does not regard tax evasion in the United States or in any other jurisdiction as the basis for a U.S. money-laundering investigation or prosecution. This reflects the long-term lack of U.S. enthusiasm for the high taxes anywhere. But the United States is not alone among industrial countries in this regard. On the other hand, tax evasion is a major concern in many emerging market countries. Therefore, international cooperation and solidarity on anti-money laundering objectives such as terrorism would be

enhanced if the global AML regime applied to tax evasion in any country.

The global AML regime is largely the construction and concern of the wealthy nations. Combating money laundering is low on the list of priorities for most developing nations. In particular in the poorest countries, a strong AML regime is an expensive luxury good. It follows that the rich nations should not only set global AML standards and provide technical assistance in their dissemination and establishment in countries around the world, but they also should provide financial assistance to the poorest countries to strengthen their regimes, and thus improve the international regime about which wealthy countries care so much.

As money laundering is found to involve a widening array of institutions and activities, pressure builds to bring more businesses and professions under the net of the AML regime. Lawyers and various financial professionals, such as accountants, may serve as money laundering principals and as such are already subject to prosecution for doing so. On the other hand, the latest FATF recommendations adds these professions to the list of those required to conduct customer due diligence to discourage and detect those who might be laundering money. Both in Europe and North America lawyers and accountants are well organized and politically potent. We think it very unlikely, absent a string of scandals that they could have prevented, that lawyers in the United States, who are subject to minimal federal or even state oversight, will be forced to comply with onerous money laundering control requirements. Accountants and auditors in the European Union as well as in the United States also seem to be waging a successful campaign against their coverage by the prevention pillar of the regime.

More generally, it is time that governments pushing the expansion of the AML regime through the FATF process demonstrate that the existing controls have generated benefits comparable to the direct and indirect costs that it imposes on many parties. Critics argue that the regime has done little more than force money launderers to change their methods. Felons' lives are more complicated and a few more are caught, but there is little change in the extent and character of either money laundering or of the underlying crimes. The critics may well be right. There is little in the record of convictions for money laundering to suggest that the elaborate global AML regime that has been constructed over the past decade and a half has proven useful in more than an opportunistic fashion in combating either money laundering or the underlying crimes of concern. In an era where performance assessment is a routine demand imposed on government agencies around the world, a careful assessment of the achievements of the existing regime should be required before it is expanded further. ◆