

# Encouraging Public-Private Partnerships to Fight Financial Crime



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# Global Banking and Security: Financial Institutions as Agents of Government Policy Working Group

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# Foreword

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Preserving the vitality and integrity of the global financial system is essential to prosperity, economic growth, and global stability, and is therefore a core concern to the Atlantic Council and Thomson Reuters. Over the last two years we have collaborated on important initiatives, including a push for transatlantic regulatory convergence on financial reform, and bringing together senior policymakers and business leaders to share lessons learned and best practices in response to the crisis.

This year we are engaging another vital challenge for global finance: ensuring the rules and regulations governing the fight against financial crime—including money laundering, terrorist financing, and use of the financial system by sanctioned individuals or regimes—are effective and efficient. Over the past two decades, and particularly since 9/11, governments have increasingly relied on the private sector to gather information in order to identify potential terrorists and prevent criminal activity. While these activities are crucial to protecting national security, they have significant costs for firms.

As they seek to comply with new regulations and compete for new business in a global market, financial firms face a difficult balancing act between knowing their customers, managing risk, and ensuring they remain profitable. Governments and the financial industry should therefore work together to take stock of these compliance costs and ensure that new rules and policies follow a clear strategy.

In an optimal scenario, the interests and goals of government and financial institutions should align to create a seamless partnership in safeguarding global prosperity and security. This requires a clear and open dialogue.

The Atlantic Council and Thomson Reuters are committed to fostering just these sorts of public-private partnerships to solve global challenges. We have convened a high-level

working group of senior regulators and compliance officers to strategically examine the direction of new financial regulations, address the issues facing firms in their role as implementers, as well as analyze new trends in policy development. The group's primary goal was to define what can be done to improve the effectiveness of these new regulations while also lowering costs and limiting challenges for the private sector. Time and time again the group emphasized a need for a deeper conversation to determine what works best and the need to work together to quickly implement those strategies.

We would like to thank the members of the distinguished working group for their efforts—this report has benefited greatly from their experience and input. We offer special thanks to former deputy national security advisor for combating terrorism Juan Carlos Zarate for chairing this working group, to HSBC chief legal officer Stuart Levey for his intellectual guidance throughout the project, and to Justin Antonipillai of Arnold & Porter for hosting the initial working group session in Washington. Finally, we'd like to thank Alexei Monsarrat, director of the Atlantic Council's Global Business and Economics Program and his team for skillfully weaving a complex set of thoughts and ideas into the text of this report.

We hope both policymakers and financial industry leaders will find our suggestions thought-provoking, insightful, and ultimately useful when crafting and implementing financial crime policy in the days ahead.



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# Executive Summary

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**M**ore than five years into the crisis, a host of challenges continue to plague the integrity and health of the financial system. High among these is the ongoing fight to prevent criminals—money launderers, terrorist financiers, and organizations and individuals sanctioned by the international community—from utilizing the system. This fight is chiefly directed by governments and requires a set of rules and enforcement tools for the private sector; but the goals of government and financial institutions should align to create a seamless partnership in safeguarding global prosperity and security.

The Atlantic Council and Thomson Reuters convened two expert working group sessions that examined how governments and financial institutions can improve their cooperative efforts to prevent financial crime and safeguard the financial system.

The project’s goal is to spark debate about the strategic direction of the fight against financial crime, and assess whether current regulations and rules, and the process by which they are made, effectively meet desired policy ends. This reports sets the groundwork for that debate, and takes place within a larger debate about the re-regulation of the financial industry after the 2008 crisis, and the best way for government and the private sector to partner in ensuring that the financial system can serve its intended purpose: to generate liquidity for the real economy in a stable and safe manner.

The following are the key challenges and recommendations highlighted in the report.

- The interests of government and financial institutions must align if they are to fight financial crime effectively.
- Governments have long relied on private financial institutions to help in the fight against financial crime, and more recently, in national security.

- Both the private and public sectors benefit from a safe and transparent financial system free of bad actors.

The threat of increasing compliance costs risks corroding proactive engagement and enforcement efforts of financial institutions, turning compliance practices into defensive “box-checking” exercises. Compliance comes with costs and over the past decade the regulatory burden on financial institutions has accelerated dramatically.

Three broad challenges are driving the system towards a tipping point, beyond which additional regulations and new government efforts to use the financial system as a policy implementer reduce enforcement effectiveness.

- 1. The “multiple target” problem:** Over the years, governments have shifted the emphasis of their enforcement priorities (e.g., from drug traffickers to terrorists to tax evaders). New priorities go in tandem with new regulations, and as priorities accumulate over time, so do financial institutions’ compliance requirements. To solve this problem:
  - Governments and financial institutions should together move towards a broader risk management approach and away from an event-driven system.
  - Governments must expand on and deepen their partnership with a variety of different “gatekeepers”—private sector groups that assist in financial transactions and the movement of money—to police risks in the financial system.
  - The international regulatory regime should emphasize containing global systemic risk over any one particular type of financial crime e.g., terrorism.

**2. Jurisdictional inconsistencies:** The complexity of complying with national regulations while meeting international standards can cause confusion and drive up compliance costs. Ideally, regulations and responsibilities would be coordinated at the international level to help ensure companies have a single standard to follow.

- An international approach to risk must seek to universalize compliance and level the playing field as much as possible, by better standardizing rules.
- Policymakers need to find the appropriate balance between public and private-sector responsibility in both information-gathering and analysis activities.
- Multinational financial institutions would greatly benefit from a comprehensive international framework that provided a single standard for collecting and sharing financial information with governments.
- In an ideal and efficient compliance system, global institutions should be allowed to share data internationally and internally as long as jurisdictions are equivalently regulated.
- Taking a systemic approach to risk would help standardize data collection across jurisdictions and develop a global minimum standard.
- Standardization of data collection requirements should work through existing organizations, and should focus on harmonizing the differences between larger jurisdictions.
- There is a need to level the playing field if enforcement regimes are to be effective, especially in jurisdictions that lack the capacity.
- Governments should address the overlapping state of global sanctions, specifically standardizing the formatting of sanction lists to simplify the screening process involved.

- Private institutions should be included in any discussion on revising data models, given that they are the gate-keepers of financial transactions.
- On sanctions, key UN states should create a forum for dialogue composed of member states' sanctioning bodies and the UNSC committee representatives.

**3. Data and privacy conflicts:** There are problems of data volume and emerging privacy laws that either reduce effectiveness, raise costs, or both. Financial institutions often face conflicting and/or redundant requirements as they operate across multiple jurisdictions.

- Policymakers on both sides of the Atlantic should work to strengthen and streamline their approach to financial intelligence gathering. By adopting a common, strong, standard, financial institutions will face lower compliance costs.
- Governments could relax and/or streamline the requirements for reporting suspicious activities, alleviating some of the reporting costs banks currently pay and limiting the amount of information flooding government agencies.
- Financial institutions and governments could better screen customers and transactions and analyze financial information with more robust data management programs.
- US and European leaders should collaborate to promote common transatlantic standards in data protection, to avoid a disparate set of regulations that harms private actors and allows third nations to essentially lead the debate.

Better partnership is the solution to these problems. Governments and financial institutions need to consult more frequently, more substantively, and with greater candor to lower regulatory costs and improve crime fighting effectiveness. Ultimately both actors share the responsibility of improving the public-private partnership.

### ■ Tasks for Government

- Communicating to banks to make the intent of policy actions clear, and about what policy tools are working and what are not in order to refine and improve regulatory requirements.
- Partnering with banks at the design stage of legislation and regulation.
- Recognizing the incentives that regulations can have in a complex global marketplace.
- Strengthening the role of compliance officers.

### ■ Tasks for the Private Sector

- Creating an institutional “culture of compliance” that emphasizes the crucial role banks play in the stability of the international system and in national security.
- Quantifying the costs of compliance and communicating them to governments.

Governments and financial institutions do not have to reinvent the wheel when it comes to public-private partnerships. There are existing examples that can serve as models for future collaboration, including recent outreach efforts by the US Treasury, and groups like the UK Joint Money Laundering Steering Group. Governments and financial institutions can build upon the progress made by existing partnerships and should look to industry-led models of self-regulation.





# The Case for Change

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***The current framework for fighting financial crime has weaknesses that the private sector and government must address.***

## **The Importance of Interest Alignment**

Governments have long relied on private financial institutions<sup>1</sup> to help fight financial crime, and increasingly to help protect national security. Although US anti-money laundering (AML) laws date back to the Bank Secrecy Act of 1970, the global effort began with the 1988 Vienna Convention<sup>2</sup> as countries looked for ways to stop drug trafficking. The formation of the Financial Action Task Force (FATF) in 1990 accelerated this work, as did the post-September 11 advent of counter terror financing (CTF) efforts. Over this same time period, financial sanctions evolved to prevent nuclear proliferation and human rights abuses.<sup>3</sup>

Ideally, banks and governments will attack financial crime with equal energy and intent. Governments can pass legislation and regulation to make money laundering, terror financing, and sanctions-breaking illegal; and there have been great strides over the last thirty years in globalizing the norms and legal structures that countries need to fight financial crime. But without the energetic and active partnership of financial institutions, law enforcement will have limited impact.

The assumption that the interests of governments and financial institutions align is crucial to the effective implementation of AML, CTF, and sanctions. The rationale governments have long used to enlist banks' help in

implementing policy is that financial crime is bad for business, and bad for the overall stability of the financial system. Better and clearer rules that promote good practices will help fight crime and improve the system. Increased transparency through "know your customer" rules helped banks ensure their customer base was legitimate, and monitoring requirements improved banks' ability to strengthen their internal control mechanisms.

September 11 added important emphasis to the alignment argument. The attacks highlighted the degree to which governments and financial institutions had shared interests in the fight against terror finance, and would gain from increased cooperation. Under the USA PATRIOT Act, government officials began receiving much more information from banks on their customers and transactions, which aided in the CTF effort. The net effect was to help track and prevent terror finance flows while making a more transparent and stable operating environment for financial institutions.

Looking back at the evolution of measures to fight financial crime, there is a sense of 'mission creep'. Financial institutions were originally conscripted into a fight to combat illegal activities which impacted the health and propriety of the financial system but are now required to expend limited resources on efforts to advance the foreign or fiscal policy of particular states and which have increasingly little to do with the markets themselves. Among these are identifying citizens avoiding the payment of tax and the imposition of sanctions against rogue actors. Although the extension of anti-financial crime regimes into these areas may be reasonable, it appears that it has been done with no deliberate agreement to do so.

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<sup>1</sup> This report principally addresses the role of banks, and not other financial institutions, such as insurance companies, and designated non-financial businesses and professions.

<sup>2</sup> Officially the "United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances"

<sup>3</sup> We focus here on the recent activity (e.g., against Iran, Iraq, Syria, and Libya), acknowledging that sanctions have long been a tool for the international coercion, including against South Africa and Cuba.

### The Threat of Increasing Costs

Compliance comes with costs, and twenty-five years after the Vienna Convention and eleven years after 9/11, these cumulative costs are beginning to undermine interest alignment. The intense CTF campaign waged in the early 2000s sharply accelerated the regulatory burden and political pressure on financial institutions. The categories of costs for financial institutions include:

- **Compliance:** Collecting data, performing extensive background checks, monitoring transactions, and the host of other requirements banks comply with have real financial costs. There are forty FATF recommendations in its International Standards on Combating Money Laundering and the Finance of Terrorism and Proliferation.<sup>4</sup> Nearly all (31 out of 40) of these have direct requirements for financial institutions.
- **Loss of business:** Banks have an incentive to turn away suspicious business, which may or may not turn out to have been criminal activity. Regulators are increasingly telling banks that they should not be doing business with certain higher risk entities. We will address whether banks decline business as much as they should, but there is no question that there is a chilling effect on accepting legitimate prospective customers. This can also include instances where regulators threaten to revoke bank licenses in certain jurisdictions.
- **Reputation:** Banks bear substantial reputation risk if found to be out of compliance, or even rumored to be under investigation, whether or not there have been actual dealings with criminal elements. There is also an assumption of guilt when a bank is reported to have dealt with an entity that a regulator feels is too high a risk.

The costs associated with anti-financial crime laws compete with other requirements imposed by state authorities, including financial reform measures intended to prevent another financial crisis. Moreover, these costs are imposed during a protracted period of contraction for the financial

sector. Better coordination and prioritization among state authorities may help avoid a situation in which neither priority is executed well.

Many of these costs are of course intentional and provide important incentives for banks to enforce government policies. No bank would ever say their dedication to rooting out financial crime is waning, but governments need to better understand and account for the cumulative impacts

of their policy directives. At the same time, banks should do more to quantify their regulatory costs to governments. Together, the two sides need to discuss openly and collaboratively how to practically and most efficiently meet their common objectives.

Increasing costs risks corroding proactive engagement and enforcement efforts of financial institutions. As compliance costs have increased along with the number of executive orders financial institutions have to enforce, banks have increasingly—and often understandably—run their compliance systems in a defensive mode. Their main concern is increasingly evolving from proactively aiding the fight against financial crime to preventing penalties and costs. This is not to suggest that the sole reasons banks misbehave results from regulatory over-burdening; but there is no question that an increasing regulatory burden drives banks to focus more on meeting the letter of their obligations rather than the spirit of the law.

We risk a “tipping point” where additional regulation and new efforts by governments to use the financial industry as an implementer reduce enforcement effectiveness. While there is not yet a crisis, inaction could have important consequences, including:

- **More crime will go undetected and unpunished:** The current system has had important successes. But for banks and governments to maintain (and hopefully improve) the system, it needs reform that will streamline rules, lower costs, and engage the ingenuity and creativity that dedicated private sector compliance officers can bring to the fight.
- **The financial system will be less stable and safe:** Lawmakers and regulators are currently working to reform and strengthen the financial system after its worst crisis in 80 years. The stability that a strong

We risk a “tipping point” where additional regulation and new efforts by governments to use the financial industry as an implementer reduce enforcement effectiveness.

<sup>4</sup> The FATF recommendations are the internationally agreed guidelines for identifying and preventing financial crime.

anti-financial crime framework lends to the system is important to this effort. Backtracking would send a powerful signal to criminals that governments and financial institutions are no longer serious about fighting crime.

■ **Firms and governments will waste resources:**

Both financial institutions and governments will waste increasing amounts of precious resources. Given tight corporate margins and government budgets, managers and political leaders will look for ways to cut ineffective efforts. The political impetus driving CTF will not last forever.

■ **The real economy will suffer:** As it currently stands, the financial ecosystem is fragile and faces strong headwinds from

the financial crisis and a broader set of political dynamics that inhibit economic and financial growth. The role

of the financial sector should be to provide liquidity to the real economy, and it cannot do so under too many regulatory burdens.

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Over the years, government policy objectives have evolved and increased, but compliance regimes have not kept pace.

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There are qualitative differences between AML and CTF enforcement, and these differences have implications for the nature of compliance

The following discussion outlines these issues, followed by proposed solutions. The majority of these remedies require better partnership and communication between government agencies and the private sector, as well as better inter-government coordination at the national and international levels.

### 1. The multiple target problem

Over the years, government policy objectives have evolved and increased, but compliance regimes have not kept pace. In the EU, money laundering has been a powerful and persistent theme throughout the last decade, and motivated much of the financial regulation. In the United States, by contrast, fighting the financing of terrorism has been the core driver of financial regulation during the same period.

regimes. As noted above, and documented by FATF in its own recommendations, the targets of financial crime fighting has evolved and expanded over the years: from preventing money laundering by drug cartels, to cutting off funding for terrorists with a concurrent effort to isolate regimes bent on acquiring nuclear weapons. As new targets have evolved, old ones have remained, often with new requirements added that fit poorly with existing implementation processes. This means that a host of requirements with differing implementation tools have accumulated over time, driving up compliance and monitoring costs for governments and firms.

Appendix A offers a case study of the Foreign Account Tax Compliance Act (FATCA) that illustrates some of these costs in the real world. In the next section, we outline a set of problems and potential solutions that can help advance a reform effort and provide some fundamental principles, as well as specific recommendations on steps that government and financial institutions can take.

### The Major Challenges

There are three broad challenges driving the system toward a tipping point:

1. The “multiple target problem” as governments add new policy goals and targets to their financial crime efforts.
2. Jurisdictional inconsistencies along several important fault lines.
3. Conflicting regulatory mandates, particularly emerging privacy rules.

While money laundering and terror finance both undermine the stability and security of financial markets, there are clear qualitative differences between them. A system based on CTF will be prescriptive, underwritten by a government-issued list of names which must be isolated and cauterized from the financial system. In contrast, a system based on AML is in principle less prescriptive in nature and less susceptible to being mechanized as it simply lays out a set of activities that are deemed illicit.

Moreover, the economic dynamics of money laundering and terror finance are fundamentally different, and these differences will have implications for compliance regimes. Money laundering is predicated upon the proceeds of crime, whereas terror finance is often sourced from voluntary donations to licit organizations.

Additionally, the scale of finance involved in terror finance is quite small on a per case basis in comparison with the revenues traditionally associated with long term money laundering operations. For example, the 2007 London car bombings were reported to have been financed by less than \$15,000, which flowed through UK- based financial institutions; this contrasts against the \$1.3 billion that the Abacha family laundered through UK-based financial institutions in the 1980s. Therefore it is extremely challenging to identify low-level terror finance participants at this scale of monetary transfers as compared with money laundering offenders.

These operational differences result in differences in enforcement of financial regimes. For example, AML rules afford greater enforcement discretion for banks, but this also carries greater risk of unintentional noncompliance. Given that it is unreasonable to expect that a firm would decide not to do business in an entire region because of a high risk of money laundering, there is usually an element of forgiveness for occasional lapses, so long as the institution appears to be making a good faith effort to comply. Similarly, the punishments for money laundering will rarely threaten the license of the financial institution in question; this is in contrast to terror finance which is a license-threatening activity for a financial institution to conduct. In general, financial institutions may decide to take a risk on money laundering regulations, whereas they will be exceedingly careful, perhaps excessively so, not to break terror finance laws.

Government officials have not clearly communicated their intent to financial institutions, especially those responsible for enforcement. The addition of new targets is often driven by events, and heavily influenced by political pressures. As drug cartels and the drug trade grew increasingly out of control in the 1980s, a strong public demand went up for a solution. The terrorist attacks of September 11 ignited an immediate and intensive hunt for terrorists, and stopping their money flow was a crucial part of that response. Sanctions have tended to move at a slower pace, but are especially subject to evolving policy objectives as countries jockey for leverage and seek new ways to apply pressure. Box 1 traces the evolution of sanctions policy as an example of this “shifting target” problem.

Governments and financial institutions should together move away from an event-driven system prone to shifting targets and cumulative enforcement requirements, to a broader risk management approach. Just as money laundering has faded

from the political spotlight, so too will the threat of terrorism. Whatever new threat arises will require yet new tools and adjustments to compliance and enforcement, potentially adding a new layer of requirements and costs for banks.

This broader focus on risk management will require governments to broaden and deepen their partnership with a variety of different “gatekeepers”—private sector groups that

assist in financial transactions and the movement of money—to police risks in the financial system. A broader framework in which to think about financial crime will lead to new thinking about how to mitigate risk, and help provide a more consistent set of rules that are less prone

to change and/or accumulation over time. This would also be in line with the broader financial regulatory reform efforts at the G20 and within countries, which focus on the broad stability of the financial system.

While FATF recognizes a small number of designated non-financial businesses and professions, the full list should include accountants, auditors, lawyers, insurance companies, and company service providers. At the same time, if these efforts are to work, governments must make sure they are not overburdening any one particular gatekeeper. Therefore intensive engagement and coordination with these numerous gatekeepers is key, making sure risks and responsibilities are distributed appropriately.

### **2. Jurisdictional inconsistencies**

Financial institutions clearly have a lead role to play in preventing terror finance, implementing sanctions, and promoting the overall legitimacy of the financial sector. While there are some distinct issues that each of these categories present, the challenge for banks across all of them is navigating the web of regulations at the national and international levels, which can cause confusion, increase compliance costs, and potentially create gaps through which criminals can escape. Ideally, regulations and responsibilities would be coordinated as much as possible at the international level to help ensure companies have clear and consistent standards to follow when determining what information to keep and what to watch for.

Risk measurement is ripe for reform. How risk is defined will determine the kinds of tools needed to manage it. There are host of efforts to formulate guidance on risk through existing fora (e.g., FATF, which has just updated its guidance on risk, and the Wolfsberg Group), and the effort to define risk will

**Government officials have not clearly communicated their intent to financial institutions, especially those responsible for enforcement.**

**BOX 1: The Evolution of Sanctions**

**Financial sanctions were initially developed to root out illicit financial activity.** The initially conduct-based system of sanctions was driven by a desire to excise criminal or illicit activity from the financial system. Because it was politically easier to build a consensus around issues of transparency and financial integrity than issues such as terrorism and security, sanctions proponents made the argument that such illegal activity was bad for the financial system, in addition to politically undesirable. As a result, these sanctions were likely to be targeted—focused on specific activities or entities—and had relative success making it through the UN Security Council (UNSC).

**The scope of sanctions has expanded as financial integrity rationale gave way to pure geopolitics.** Conduct-based sanctions were appropriate to address illicit financial activity; however as diplomatic and political drivers have grown in prominence, the “maximalist” approach to sanctions—those targeting the entire financial system and institutions of a target nation—has also grown. “Minimalist” or “targeted” sanctions, by contrast, address only specific actors suspected of illicit activity.

The international sanctions posed against Iran are a good example of how the maximalist approach has developed over time. Initially Iran was subjected to targeted sanctions which were gradually ratcheted up until they addressed the entire Iranian financial system. Recent sanctions such as UNSC Resolution 1737 (2006), 1747 (2008) and 1929 (2009) address the very fundamentals of Iran’s financial system, as does US’s Iran Sanctions Act (2006) and Iran’s exclusion from the use of SWIFT.

**The threat of military action has driven this change, especially by the United States since 2001.** Sanctions serve to fill a dearth in the foreign policy space between diplomatic censure and military action, acting as a “no

boots on the ground” option. This has increasingly been the case since 2001. For example, Israel’s threat of military action against Iran motivated Europe’s support for sanctions against Iran in UNSC Resolution 1737 (2006); similarly, members of the Security Council voting in favor of UNSC Resolution 1970 (2011) against Libya did not all elect to intervene militarily. Sanctions provided a means for a nation to coerce another nation without directly bearing the costs, which were shifted onto private financial institutions. This shifted cost burden has meant sanctions are a more politically feasible way in which to assert foreign policy.

**Financial institutions face cost and communication challenges as the scope of sanctions expands.** As the targets and number of sanctions continue to grow, so do the reasons behind them. This prevents financial institutions from divining any predictable pattern other than “more sanctions,” which makes it difficult to develop cost-effective implementation strategies.

**The nature of sanctions is such that ambiguity is often intentional.** Governments may want to leave sanctions language vague for two reasons. First, it may expand compliance: facing opaque requirements, firms may err on the safe side and sever all ties to a given country. Second, vagueness may also be part of the political strategy behind the sanctions.

Regardless of the motivation, if financial institutions do not understand the goal they are meant to achieve, they cannot design cost-effective and mission-effective compliance systems. For example, in 2012 EU regulators banned the “indirect financing” of the Iranian regime, as well as listing the ‘Iranian Revolutionary Guard’ as a sanctioned entity. The vagueness of this language makes it virtually impossible for firms to comply with these clauses.

always have to strike a balance between giving banks and jurisdictions flexibility in implementing the recommendations, and providing clear and proscriptive rules. There is currently a strong bias toward the “risk-based approach” which, by definition, leaves discretion of specific risk measurements and tools to individual jurisdictions and financial institutions. As the FATF guidance notes:

The risk-based approach allows countries, within the framework of the FATF requirements, to adopt a more flexible set of measures, in order to target their resources more effectively and apply

preventive measures that are commensurate to the nature of risks, in order to focus their efforts in the most effective way.

While this flexibility provides some great advantages—mainly that it lets firms respond sensibly to their own circumstance—it comes with some serious challenges, particularly in the following categories:

- a. Regulatory arbitrage
- b. Data collection
- c. Regional and national capacity
- d. Sanctions

## Encouraging Public-Private Partnerships to Fight Financial Crime

It is worth noting up front that there are two mitigating factors to these challenges—FATF country assessments and the level of the home government’s commitment and engagement on fighting financial crime. FATF requires that countries use risk based analysis “to ensure that measures to prevent or mitigate money laundering and terrorist financing are commensurate with the risks identified.” The group then evaluates countries on their performance. Listing by FATF as a “high risk and non-cooperative jurisdiction” carries strong stigma and may act to deter investment. Governments with a greater moral commitment to reducing financial crime will be more sensitive to this stigma and increase enforcement and regulation on their home firms.<sup>5</sup>

Notwithstanding these measures, there remain serious jurisdictional issues for AML, CTF, and sanctions enforcement.

### *a. Regulatory arbitrage*

The FATF recommendations allow countries and firms to define whether they are “high risk” or “low risk,” saying simply that “where there are higher risks, countries should require financial institutions and designated non-financial businesses and professions to take enhanced measures to manage and mitigate those risks; and that, correspondingly, where the risks are lower, simplified measures may be permitted.” Depending on that self assessment, firms will have to conduct greater or lesser customer due diligence and other measures. Since customer due diligence has costs, there is an incentive to under-estimate risk to provide a competitive advantage.

Companies also fear their competitors may seek out more lightly regulated jurisdictions to avoid costs. This can drive down compliance to its lowest common denominator as firms try to ensure they stay competitive. This makes a compelling case for better cooperation among banks (see below on creating a culture of compliance), but it also makes a credible case for governments to intervene to equalize approaches to risk across jurisdictions, since no single firm could credibly commit to doing so. If a firm were to act unilaterally they would risk losing business and in doing so being driven out of the market.

Reform to the risk based analysis must seek to universalize compliance and level the playing field as much as possible, by better standardizing risk rules.

### *b. Data collection*

Policymakers need to find the appropriate balance between public and private-sector responsibility in both information-gathering and analysis. There is currently a disconnect between those that set the rules for customer due diligence and know your customer, and those that bear implementation costs, which results in inefficiencies. As regulatory and information-gathering requirements rise for

the financial sector, governments need to be increasingly sensitive to the high compliance costs. Governments should also ensure that the public services it

provides reduce the burden on financial institutions wherever possible. For example, regulators allow banks to rely on some government-provided company registries to perform know your customer, but these are of uneven content and quality.

International standards for collecting and sharing financial information would be very helpful for multinational financial institutions, but negotiating such a framework will be challenging. There are currently two main competing information collection and sharing models: the American model, which focuses on collecting large volumes of information while reviewing less of it; and the Continental European model, which collects less information, but examines it more closely. This means multinational financial institutions’ information collecting and sharing activities must be tailored to multiple and disparate jurisdictions. Multinational financial institutions would greatly benefit from coordinated international rules that provide a single framework for collecting and sharing financial information with governments. While history shows that this will be extremely difficult to negotiate,<sup>6</sup> it remains a worthwhile policy objective.

Disparate formats and methods of collecting data currently mandated by different jurisdictions should be standardized. The definition of risk will in many cases determine the type and amount of data banks will need—and that

**Policymakers need to find the appropriate balance between public and private-sector responsibility in both information-gathering and analysis.**

<sup>5</sup> At the same time, however, the FATF listing is a function of commitment and progress, rather than the quality of the system. Therefore a country with weak controls that is progressing may stay off the list, whilst a country with stronger controls that is not cooperating would be on the list. This makes risk assessment even more difficult for banks.

<sup>6</sup> The EU continues to have serious reservations about sharing financial information on their citizens to the United States, citing data and personal privacy concerns. In fact the EU appears to be moving in the opposite direction with its proposed EU Data Protection Directive, which would certainly make US-EU cross border information sharing more difficult.

governments will require—in order to effectively prevent crime. The desperately needed standardization of data collection, therefore, would be greatly facilitated by a systemic approach to risk across jurisdictions. In an ideal and efficient compliance system, global institutions would be allowed to share data internationally as long as jurisdictions are equivalently regulated. This would avoid needless costs associated with overlapping compliance regimes. However, because controls in a given jurisdiction are determined by the risks facing the institution in that jurisdiction, if jurisdictions have different perceptions of risk, they will necessarily have different collection requirements. Taking a systemic approach to risk would help standardize data collection across jurisdictions and develop a global minimum standard.

Standardizing the collection of data across jurisdictions should focus on aligning differences between larger jurisdictions. The most effective way to bring both of these categories into a global minimum standard is through aligning the larger jurisdictions as a first step. For example, some Asian countries ask financial institutions to demonstrate 10 percent of beneficial ownership for every account opening; moreover they require that banks start accounts as high risk subject to subsequent review. These more stringent assessments may be at odds with the desired global standard; however, appealing to a smaller group of the largest jurisdictions may be the most effective way to proceed towards a global standard. Focusing on the low-hanging-fruit and aligning these jurisdictions first would subsequently encourage the smaller jurisdictions to comply. Likewise for smaller jurisdictions with very lax requirements, focusing on aligning the larger jurisdictions will incentivize a race to abide by the commonly agreed to standard, or else face economic consequences for being out of step with larger jurisdictions.

Standardization of data collection requirements should work through existing organizations. The Joint Money Laundering Steering Group (JMLSG) in the UK, the Wolfsberg Group, and the Financial Action Task Force (FATF) should help disseminate the message that a global minimum standard would mitigate systemic risk to financial institutions, as well as discuss what financial institutions are willing to do in exchange for a recognized standard.

### *c. Regional and national capacity*

Differing enforcement capacity can create an unlevel playing field. States and financial institutions are not prepared equally to comply with financial crime regulations. If a regulator within a given jurisdiction lacks the capacity (in technical ability or resources) to enforce the rules, then its banks will minimally comply with the rules and therefore face

lower compliance costs. There is thus a need to level the playing field by increasing capacity, as firms not facing the costs of compliance will hold a competitive cost advantage over compliant firms.

Deficits in compliance could result from the lack of legislative framework in a country, the lack of capacity, the lack of understanding, or the lack of political will. These weaknesses are particularly important from the perspective of sanctions, as they not only inhibit the effectiveness of sanctions but also damage the credibility of the Security Council. Reforms should seek to facilitate enforcement in these deficit nations to level the playing field of sanction compliance.

### *d. Sanctions*

Sanctions enforcement presents some specific jurisdictional challenges. These derive principally from the fact that states will implement sanctions bilaterally (or in other configurations that may not include all UN nations). Even in cases of broad international support, some nations may “gold plate” their efforts, which will mean tighter restrictions within that jurisdiction.

This challenge is set against the backdrop of an increasing use of sanctions on both sides of the Atlantic. While the EU has historically been more reluctant to use sanctions, this has shifted in recent years. This is due in part to the fact that the EU has the capacity to act collectively on sanctions under the Lisbon Treaty. The use of sanctions has increasingly become a way for the EU to unify the international relations of its member states.

There is a need to address the overlapping state of global sanctions. While there is political scope and capacity to address this problem, any solution would have to overcome the temptation of states to use sanctions individually as instruments of influence. However, there are areas ripe for reform that would be relatively straightforward.

One such reform would be to standardize the formatting of sanction lists to simplify the screening process involved. For example, the current patch-work system increases the likelihood of ‘false-positive’ identification: this increases the costs of manual sifting as well as wrongfully denies access to individuals to their inconvenience and possible violation of their rights. A standardized data model for sanctions lists would address this issue, and would also likely be a relatively popular proposal if introduced at the UN Security Council.

Private institutions should help determine the sanctions data model, given that they are the gate-keepers of financial transactions. This could take the form of a forum for dialogue composed of member states’ sanctioning bodies

and UNSC committee representatives. This forum could work to facilitate collaboration between sanction-enforcing bodies at the national level to simplify the compliance of firms operating across jurisdictions. Such a forum could also include representatives of financial institutions to facilitate compliance, as well as to address best practice sharing, information sharing, and provide guidance on compliance. This proposal could potentially address another facet of the overlapping problem, namely that certain individuals' names are on several lists issued by the same organization. Such a positive and proactive engagement of financial institutions would establish common norms and perceptions of sanctions, thereby improving their effectiveness.

Each sanction tool is unique, which raises the cost of compliance for financial institutions; partnerships should seek to standardize the nature of sanctions. It is often impossible for countries to reach agreement on the scope of sanctions—both in targeted entities and in penalties. As a result, different countries will develop different sanctions regimes.

The consultation process between financial institutions and regulators should build an operational template for sanctions. It is both possible and desirable to reach consensus on what the consequences of being sanctioned should be. A system of sanctions with a clearly specified template for what sanctions should consist of would be more cost effective for firms to implement. Instead of responding to each set of sanction instruments separately, a predetermined sanctions implementation regime would enable firms to simply plug in target lists and configure the degree to which targets are to be controlled.

The ad hoc nature of sanctions implementation necessitates a flexible and swift consultation process if sanctions are to be effective. In contrast to AML regimes, which keep the identity of criminals confidential throughout deliberation and implementation, sanctions are by definition public knowledge. This implies targets possess information regarding their status.

Libya provides a good example of the need for haste when implementing sanctions. The US was quick to implement sanctions on Libya just days after the initial decision had been taken. If too much time passes between the decision to impose sanctions and their implementation, the target will

be able to mitigate the impact of the sanctions by removing assets from given jurisdictions. Regulators should seek a form of partnership with financial institutions that includes an emergency working group to address ad hoc concerns of sanctions implementation and the need for rapid response.

### 3. Data and privacy conflicts

Fighting financial crime is, at its root, about data: collecting data on suspected or identified bad actors, and ensuring that the right people in government and the private sector

have and act on data in a timely and effective way. In addition to the jurisdictional and collection issues discussed above, there are problems of data volume and emerging privacy laws that either reduce effectiveness, raise costs, or both.

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**The ad hoc nature of sanctions implementation necessitates a flexible and swift consultation process if sanctions are to be effective.**

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#### a. Data volume

New regulations may result in information overload for both banks and regulatory agencies. In the post-9/11 environment, governments have developed a voracious and increasing appetite for financial information in response to security concerns. Unfortunately, the ever-growing amount of information has overwhelmed the ability of either banks or regulators to adequately analyze it.

Put simply, it is neither cost-effective for firms to over-report and swamp regulators with information they cannot or will not use, nor desirable for regulators to have to sift through heaps of data. Policymakers on both sides of the Atlantic should work to strengthen and streamline their approach to financial intelligence gathering. By adopting a common, strong, standard, financial institutions will face lower compliance costs as their requirements are standardized across jurisdictions. This would also allow for easier data sharing across international borders.

Governments could relax and/or streamline the requirements for reporting suspicious activities, alleviating some of the reporting costs banks currently bear and limiting the amount of information flooding government agencies. Analysts could better manage a smaller stream of incoming information and use it more strategically. This would ultimately lead to better quality regulations and programs.



Technological breakthroughs provide another way of improving financial information management and analysis. Financial institutions and governments could better screen customers and transactions and analyze financial information with more robust data management programs.

*b. Privacy*

The requirements of regulatory compliance often conflict with laws governing the use of data. While it may be true that “data is borderless”, unfortunately the laws governing data are

The requirements of regulatory compliance often conflict with laws governing the use of data.

not. As noted above, data protection laws, privacy laws, and bank secrecy procedures differ greatly between jurisdictions, and can work against compliance requirements. The emerging EU data privacy directive (see Box 2) stands out in this area but other laws present challenges as well.

There are legal obstacles to data sharing across jurisdictions and even within international affiliates of the same financial institution. This means banks have to duplicate customer due diligence in many countries, raising costs. They also cannot effectively centralize their AML and CTF functions. Most compliance

**BOX 2: Privacy and Security in the United States and Europe**

***The US and EU have long diverged on their treatment of privacy issues, and are moving away from each other at an accelerating rate.*** Europeans have been skeptical and critical of the United States’ handling of data, especially in the post-9/11 world. For example, European authorities have been particularly troubled by the dramatically expanded rights afforded to law enforcement agencies through the USA PATRIOT Act. While harmonizing views on data protection across the Atlantic would dramatically ameliorate these problems, this seems very unlikely given the extension of many parts of the USA PATRIOT Act and the newly-proposed EU Data Protection Directive.

***Different data privacy standards complicate information sharing efforts between the United States and Europe.*** The EU has been critical of the US approach to handling data, claiming that national security unnecessarily trumps personal privacy rights. Current EU data privacy regulations set out common rules for public and private entities within the EU that hold or transmit personal data, and prohibit the transfer of that data to countries where legal protections are not deemed “adequate.” Some EU officials, concentrated mainly in the European Parliament, continue to have concerns over the United States’ ability to guarantee a sufficient level of protection for EU citizens’ personal data. The United States and EU are currently negotiating a framework agreement to protect personal information that has been exchanged in a law enforcement context. The US government hopes for mutual recognition of each side’s data protection systems, even though there are differences between the US and EU regimes. The United States hopes that the EU will accept its data protection standards as adequate.

***The inherent discord between competing national security and personal privacy concerns is especially pronounced in the financial sector, and the newly-proposed EU Data Protection Directive’s “right to be forgotten” calls international data sharing capabilities into serious question—with potentially huge security consequences.*** The proposed EU Data Protection Directive puts time limits on how long and for what purposes companies are allowed to store data on their customers. The draft law clearly states: “a controller [an individual that manages or collects personal data] should not retain personal data for the unique purpose of being able to react to potential [government] requests.” Governments rely heavily on information stored on past financial transactions and customer data in their investigations. In London for example, banks are required to store client and transaction data for five to seven years, and similar rules are in place in the United States and other European countries.

The EU Data Protection Directive also limits the situations in which US law enforcement agencies are able to obtain customer and transaction information in the first place. For example, the EU would no longer recognize the validity of US national security letters (NSLs). NSLs are used to pull information on transactions and customers and do not require a judge’s approval. They can be issued to companies even if there has been no crime committed, and they contain a “gagging order” that prevents banks from telling their customers that their personal information has been disclosed to US authorities.

## Encouraging Public-Private Partnerships to Fight Financial Crime

regimes are predicated on some reliance on “equivalent jurisdictions”—countries deemed to have sufficiently similar (and high) standards, allowing reduced customer due diligence and other requirements between them—at least when it comes to taking on new business. If a customer has satisfied due diligence in an equivalent jurisdiction, then the assumption is that this customer will satisfy due diligence in the home jurisdiction.

Even in jurisdictions commonly considered to be equivalent, however, there are substantial differences in the laws governing data use. For example, there have historically been fundamental differences between the US and the UK with respect to determining beneficial ownership. The US is gradually tilting towards a beneficial ownership model that is more similar to the UK’s, but this will take time.

Ideally, global institutions would be allowed to share data internationally as long as jurisdictions are deemed to be equivalently regulated. If regulators were to publish an agreed list of equivalent jurisdictions, this could overcome the problem of equivalence without directly acting to

reduce the inequality between jurisdictions. Before the risk based approach to AML was introduced certain regulators would publish a list of equivalent jurisdictions; because a risk based approach accentuates inequalities between jurisdictions, perhaps it is again time for regulators to publish lists of equivalent jurisdictions.

US and European leaders should collaborate to promote common standards in data protection to avoid a disparate

**US and European leaders should collaborate to promote common standards in data protection to avoid a disparate set of regulations that harms private actors.**

set of regulations that harms private actors. A transatlantic convergence of regulatory standards would help avoid duplicity of information gathering and prevent legal conflicts where certain states require information to be collected that other jurisdictions prevent banks from either accessing or sharing.

A simplified and standardized set of rules would dramatically lower compliance burdens, allowing financial institutions to focus on their clients. The potential impact on job creation and economic growth is considerable. The United States and Europe can either lead the agenda or allow ourselves to be led towards the regulatory bottom by third countries with less at stake in preserving the financial system as it currently exists.



# Partnership as the Solution

***Private and public sector actors need to define an intentional and strategic policy framework. This requires more frequent, substantive, and candid consultations in order to lower regulatory costs and improve crime fighting effectiveness. Creating positive feedback loops between regulators and financial institutions will help sharpen enforcement and improve compliance.***

While there are a range of groups that work to coordinate elements of government-private sector engagement (see Box 3), there is no formal mechanism through which government and the private sector come together to strategically address the effectiveness of current policy or the aggregate impact of regulation on the industry. Without this kind of high level guidance, the system risks unintentionally drifting, and haphazardly accumulating new rules that may not fit well with existing compliance processes.

Some government and private sector officials have criticized existing institutions for failing to engage in real dialogue. Instead, the different groups too often engage in bureaucratic box checking of their own, defending jurisdictional turf at the expense of raising real issues. Once this happens, conversations devolve into position statements with no actual exchange of ideas, challenges, or problem solving.

If the global authorities want to fight financial crime, then financial institutions necessarily will be on the front line. Government should therefore work with banks as partners in the fight, and the same is true in return. A new form of exchange will require action and open mindedness on both sides. Governments will need to better understand—and care about—the high costs the financial sector bears in their role as implementers. The private sector has real work to do on improving its culture of compliance, and in better quantifying the costs and challenges it faces.

## **BOX 3: Tackling Money Laundering Together: JMLSG, MLAC, and HM Treasury**

The UK's anti-money laundering framework is a prime example of constructive collaboration between the public and private sectors.

The Joint Money Laundering Steering Group (JMLSG), a group of 18 UK Trade Associations from the financial services industry (including the British Bankers' Association and the Association of British Insurers), offers industry-led guidance to UK financial institutions on how to interpret and implement the country's money laundering regulations.

The JMLSG guidance is then reviewed by representatives from the UK government, law enforcement, financial services industry, and regulators, who meet as the Money Laundering Advisory Committee (MLAC). This committee of public and private sector actors then advises the minister of HM Treasury on whether to approve the industry guidance. MLAC also serves as a forum for these different stakeholders to discuss AML regulations and the best approaches to money laundering prevention.

The JMLSG guidance is not mandatory nor does it have regulatory authority in and of itself, but following it amounts to de facto AML compliance. For example, if a bank is suspected of money laundering, UK courts must take into account whether the actions being investigated occurred while following approved JMLSG guidance.

## **The Tasks for Government**

Government officials tend to see compliance with crime fighting regimes as the duty of the financial sector. Few financial institutions would disagree. But there are ways the

## Encouraging Public-Private Partnerships to Fight Financial Crime

government can make important adjustments to its approach that will increase cooperation and compliance by banks, and engage them as proactive agents in the effort to stop financial crimes. These include:

1. Communicating and providing better feedback to banks on what works and what does not;
2. Partnering with banks at the design stage of legislation and regulation;
3. Recognizing the incentives that regulations can have in a complex global marketplace;
4. Strengthening the role of compliance officers.

Some of these issues must also be addressed jointly by financial institutions, and we are not suggesting these talks fall to government alone.

**Financial regulatory regimes should be designed in coordination with the private sector during both the legislative process and implementation phase.**

### 1. Communicating better

Better communication would be a core attribute of better partnership. There are a number of changes to how government communicates with compliance departments that would improve effectiveness and help motivate better compliance. For example, the suspicious activity reports (SARs), which financial institutions spend considerable time and money to file, are one of the main tools of compliance regimes. However, regulators rarely provide feedback to banks on how they use these reports, or whether the information is useful (e.g., is the type of information they need or whether any SARs result in actual cases). This

frustrates and de-motivates compliance officers, leaving them with the sense that they are merely there to check boxes.

Lack of feedback also contributes to a sense among compliance officers that their best bet is to report as many SARs as possible so that they do not unintentionally run afoul of the law, and so that they do not stand out versus their competitors. This further adds to the sense that they are reporting only for the sake of reporting, and creates a flood of potentially useless, and certainly overwhelming, data volume.

Regulators thus need to provide more comprehensive feedback on how they use the information compliance officers provide. This will enable financial institutions to

customize and target their reporting efforts.

This feedback could be provided in the form of regular consultations between regulators and financial institutions at the jurisdictional level. Box 4 details recent efforts by

the US Treasury to implement this kind of discussion on new customer due diligence procedures.

### 2. Partnering on design

Financial regulatory regimes should be designed in coordination with the private sector during both the legislative process and implementation phase. By engaging businesses during the development of new regulations, governments can be sure that financial institutions understand the intent of the regulations—be it national security concerns, risk diffusion, or otherwise. Companies and compliance officers that

#### BOX 4: US Treasury Private Sector Outreach

In March 2012, the US Treasury concluded over two years of discussion on customer due diligence (focused on beneficial ownership) within the US government, and with private sector and international counterparts. It then launched an aggressive outreach campaign. In an effort to engage stakeholders—including banks, broker-dealers, futures commission merchants, and mutual funds—and in order to cultivate broad understanding and support for a comprehensive and well-informed rulemaking process, the Treasury held an extended comment period on the proposed new rule with the stated goal of creating effective policy with minimal burden to industry.

Additionally, since the end of the comment period, Treasury has implemented a comprehensive outreach strategy intended to engage industry stakeholders on increasingly detailed issues. This included a public hearing with nearly 100 persons in attendance, including representatives from various financial services industries and non-governmental organizations, and members of the law enforcement, regulatory, and legislative communities. Treasury will use this information, along with further comments received through regional outreach events in Chicago, New York, and Los Angeles to inform the new rule.

understand the role they are being asked to play are far better equipped to engage actively in implementing the rules, and far more likely to provide governments with the information they need to fight terrorism or prevent funds from reaching sanctioned officials.

A key solution would be to set up a forum where the private sector can clearly quantify the costs involved and the governments can spell out the goals of their new regulations. By acting in consultation, the public and private sector can determine a prudent path forward which produces actionable financial intelligence instead of information overload, at a reasonable cost. This would also provide an opportunity to discuss with industry how it selects clients. For example, the insurance industry underwrites clients based on their risk of loss. Since criminals are not a desired client set, there should be a way to align underwriting criteria and processes with the financial crime fighting efforts.

### 3. Understanding incentives

Competitive market forces encourage a race-to-the-bottom amongst financial institutions. Firms that decide to loosely enforce regulations (or, as noted above, are in districts designated uncooperative or are under weaker regimes and therefore under less customer due diligence burden) have a competitive advantage over “good performers.” This is a serious incentive misalignment. Regulators can help by forming regional groups that bring together FIUs and financial institutions to share knowledge of money laundering risks and compliance procedures. A partnership forum would seek to increase the awareness that money laundering and terror finance are a detriment to the regional group of banks and link the region through common AML procedures. This will help overcome “collective inaction” —or a race to the bottom—as result of competitive forces.

For example, the US Treasury and regional banks participated in the US-Middle East North Africa Private Sector Dialogue from 2006 to 2007. This was an initiative of the US Treasury Department that aimed to facilitate dialogue between US financial institutions and their counterparts in the MENA region on AML/CFT issues. There is a similar effort in Latin America. Such partnerships should be re-energized, and expanded to other regions, serving to act in similar fashion to the JMLSG.

### 4. Strengthening compliance officers

Governments can help strengthen a culture of compliance and control within financial institutions. As detailed below, financial institutions have work to do in getting incentives

right for their employees to enforce AML, CTF, and sanctions rules rather than skirt them in the hopes of making money. But government has a role to play as well.

The emphasis of compliance regimes in financial institutions has swung too far towards data collection and penalty avoidance at the expense of proactively pursuing the spirit of the law—namely, encouraging financial institutions to make sound and responsible decisions when it comes to taking on new business. Under the current system, firms put their efforts into ensuring that they are in compliance with the many rules that apply to their business, rather than spending time and resources to decide whether or not to enter into business with a given customer.

There is therefore a need to introduce basic normative structures that underpin financial institution compliance regimes. Regulators can support this by strengthening the position of compliance professionals within financial organizations. For example, guaranteeing criminal immunity to compliance officers within financial institutions in the event of non-compliance is one way of strengthening their position and their focus on norms. In the EU, officers who report money laundering face criminal liability, whereas their US counterparts have criminal immunity. A reporting officer with criminal immunity who is adequately monitored is more likely to prioritize sound decision-making over ‘box-checking’ compliance.

Regulators in the EU and the US should also seek to encourage firms to strengthen the hand of compliance professionals, offering them veto power over new customers and a direct line to senior management. Bank managers should not structure incentives and their organizational hierarchies such that employees will prioritize profit over compliance and control. If individuals within an organization are to be in a position to reject business and potential profit sources, they must know that in doing so they are acting consistently with the culture of the organization. However, if the board or senior directors of a financial institutions make it clear that they want business at all costs regardless of the risks associated with a new customer, then no number of compliance professionals will compensate. Therefore, it is crucial the compliance professionals have direct access to the senior leadership that makes these decisions.

Legislators should relieve some of the public pressure on compliance professionals in the event of non-compliance. When firms are found to be non-compliant with regulation, firing the compliance officer may be politically expedient, but the action does little to resolve the underlying issues. It is unfair to single out the compliance officers when a firm is found to be non compliant as it ignores the underlying

cultural challenges within the organization. Focusing the pressure on compliance professionals encourages boards to distance themselves from the compliance process, which is fundamentally the wrong approach for regulators.

### Tasks for the Private Sector

Financial institutions are ultimately responsible for carrying out their role as good stewards of the financial system, which means stopping financial crime and, increasingly, protecting national security. The benefit of a risk based approach is that firms have discretion in how they design compliance, but this comes with the requirement that companies take real steps to comply. Crucial areas for private sector reform are creating an institutional “culture of compliance” and quantifying the costs of compliance.

Private actors need to better create a “culture of compliance” that emphasizes their crucial role in the stability of the international system and in national security. Regulators and the public hold the view that financial institutions have not made a full effort to comply with existing regulation. While governments can help provide incentives, it is the responsibility of financial institutions to create risk management and customer due diligence systems that really work; not ones that merely adhere to the letter of the law. The specific issues undermining compliance have not always been technical. Rather, they have often been issues of management, incentives, organizational culture, and differences in compliance across jurisdictions.

There are several examples in recent years of such issues undermining compliance. These cases show that banks had the technical capacity to be in compliance with money laundering and terror finance regulations, but the culture within the organization and focus on commercial concerns led the organization to circumvent their ethical and legal obligations to comply.

While easily stated, changing the culture is not a small task. As noted above, regulators and governments can play an important role in helping compliance officers, improving feedback to make compliance about more than checking boxes, and better structuring risk to remove incentives for banks to race to the bottom of compliance standards. But changing culture is ultimately a management responsibility and has to come from the top; foremost with a commitment by financial institutions that they will not engage in a competitive race to the bottom.

Financial Institutions need to do a better job of quantifying the costs associated with compliance, and governments need to make their intentions clear to financial institutions. Governments currently have a poor understanding of (and may be unconcerned with) the costs associated with compliance. This restricts the dialogue between regulators and financial institutions.

If sanctions reform is to be effective and comprehensive, financial institutions have a responsibility to report back to regulators the difficulties associated with implementing the proposed reforms. Without this, regulators will struggle to design requirements that are appropriate to the associated costs and risks. Proposals to reduce the cost of compliance,

such as cost-pooling within the industry and common data collection standards, are impossible to evaluate if the costs firms currently face are not quantified. The argument for cost reducing measures requires a better understanding of current

costs, and therefore firms must do a better job of reporting the costs of compliance.

This feedback has to be two-way in that governments have a responsibility to set out clear objectives to financial institutions about what it is that they wish to achieve and what motivates their actions. This should be done in a confidential manner between regulators and financial institutions as a continuing dialogue.

### Positive Examples of Cooperation

Information sharing between governments, within governments, between companies, and within companies should be streamlined and strengthened. The idea that governments and financial institutions should work together is not new, and we are not suggesting that anyone reinvent the wheel. But there are ways to improve on existing efforts and, in some place, as we have noted, create new ways to work together. Companies and governments still lack legal, structural, and technological capabilities to share data quickly and efficiently. Government agencies still fight turf wars too frequently and fail to communicate internally. These problems tend to be more pronounced at the global level.

There are, however, some existing examples of public-private partnership that serve as models for future collaboration. Successful partnership models between regulators and financial institutions must work to effectively communicate the intent of regulations in a transparent

Private actors need to better create a “culture of compliance” that emphasizes their crucial role in the stability of the international system and in national security.

manner. An ideal partnership model would seek to work through the progress made by existing partnership models and look to industry-led models of self-regulation.

The Joint Money Laundering Steering Group (JMLSG) in the UK is a good example of such industry-led implementation of AML. The JMLSG is unique to the UK, and is in part a residual of a period in the UK in which the financial services industry was self regulating. The group brings together money laundering specialists from a consortium of financial institutions and associations. These specialists translate the requirements of the regulators into practicable guidelines for the financial industry.

The JMLSG example is also a model case for partnership as the revision of JMLSG guidance is done in consultation with UK legislators and regulators. In this way, compliance with JMLSG guidance is tantamount to compliance with FSA and HM Treasury rules. Moreover, approval of JMLSG rules by HM Treasury's Money Laundering Advisory Committee (MLAC) provides the statutory link between the regulator and the consortium, and is taken into account in future legal proceedings. The organization represents a good example of intra-agency cooperation on regulatory compliance with working groups specialized on issue specific concerns. Further detail on the JMLSG as well as several other coordination mechanisms, appears in Box 3.



# Conclusion

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**T**his discussion yielded a host of challenging but achievable ideas to improve cooperation between financial institutions and governments in the effort to eradicate financial crime. The need to act is urgent. The range of costs facing the financial industry, many of which have accrued over the years without a comprehensive review of the net impact, threaten to weaken the global financial system, as well as global prosperity.

The challenge is, ironically, worst for those who best comply. It is the jurisdictions and institutions who take crime fighting seriously that spend the most resources doing so. While this should in no way excuse banks from energetically

engaging with governments as partners, it is incumbent on policymakers to ensure that rules are as efficient and effective as possible.

The global financial crisis has magnified this challenge, and raised the stakes. The transatlantic economies—long the global standard setters for fighting crime—have been economically weakened, and consumed with politically divisive decisions about our economic resources. This puts at risk our ability to influence the shape and future of the global financial system, and making it all the more crucial to solve the problems we know we have, and deepen the partnership between government and the private sector.



## APPENDIX A

### The Foreign Account Tax Compliance Act (FATCA)<sup>7</sup>: A Case Study

***A massive new US tax compliance project, aimed at ensuring that Americans with foreign financial accounts pay US tax, begins to be phased in in 2013, creating a true test of whether global cooperation among governments and the private sector can actually work.***

FATCA was enacted in the United States in 2010 and threatens to impose 30 percent US withholding tax on most US-source payments to foreign financial institutions (FFIs) unless those firms agree to a contract with the Internal Revenue Service to report on, and potentially withhold taxes on, Americans holding overseas financial accounts. While US regulatory authorities have conducted extensive communication on FATCA<sup>8</sup>, serious implementation issues remain. These reflect aspects of the discussion on AML, CTF, and sanctions:

1. It will be costly and complicated to implement; and
2. There will be cross-jurisdictional challenges, including conflicts with privacy and other local laws and problems with data collection.

We provide this analysis to demonstrate that these issues are current and relevant, and can have serious impacts for governments and the private sector unless they can work cooperatively, and are given ample time to do so.

#### 1. Implementation costs

FATCA applies across a broad universe of financial institutions. The FATCA statute and legislative history reflects a focus by US policymakers on banks and bank accounts, but the law applies much more broadly—to insurance companies, fund businesses, asset managers, hedge funds, and most other types of financial institutions. Financial institutions globally are incentivized to comply with FATCA as otherwise, US source payments they receive will be subject to 30 percent withholding. The withholding tax penalty is the “stick” that the US Congress used to gain compliance by FFIs that would otherwise be outside the scope of US tax law. However, the cross-border flow of funds is immensely complex and, unless the rules for implementing FATCA are

written in a manner that takes into consideration the various types of financial transactions that occur every day, the application of such withholding taxes could seriously disrupt global financial markets.

Key elements of FATCA, including precisely determining the types of financial institutions and accounts it applies to, were left to the US Treasury to determine in regulations. However, unless the Treasury works cooperatively with the private sector and with tax authorities globally, FATCA will become a compliance, and potentially a financial, nightmare.

The threshold for identifying US customers with foreign bank accounts is difficult and costly. The law requires that banks identify 100 percent of US account holders who maintain an account balance of at least \$50,000. Different banking standards across the globe make doing so prohibitively difficult and costly. The resources needed to comb through millions of accounts are enormous, and two factors will make the process an especially large operational challenge:

- Some accounts predate the push for more uniform and more extensive identification standards, making identification of US account holders more difficult.
- The reporting requirements on US customers are very strict. Banks fear they will be required to conduct examinations and reexaminations of millions of accounts due to the scope of the reporting requirements and hefty penalties associated with noncompliance.

In the end, even if foreign financial institutions (FFIs) go through all of the legwork and costs of trying to achieve full FATCA compliance, failure to do so still risks high costs (including a 30 percent withholding tax).

#### 2. Jurisdictional issues

The increased burden of information sharing across multiple jurisdictions and intra-organizational coordination will be costly. Global banks will have to report information on their US customers to the IRS, but different data privacy laws in non-US legal jurisdictions will make this a very complicated process. The US Treasury should be applauded for quickly realizing that addressing these conflict of law issues has to be accomplished through inter-governmental cooperation. It is in the process of beginning to negotiate IGAs that

<sup>7</sup> As defined by the US Internal Revenue Service: “. . . FATCA will require foreign financial institutions to report directly to the IRS information about financial accounts held by US taxpayers, or held by foreign entities in which US taxpayers hold a substantial ownership interest.” However, the United State has now engaged other governments to agree to act as a “go between” in certain circumstances, particularly in jurisdictions where legal conflicts effectively prevent the communication of customer data to third parties.

<sup>8</sup> Consultations have included the release of the, three sets of preliminary notices, proposed regulations, model inter-governmental agreements (IGAs), and most recently, a signed agreement between the United States and Great Britain.

## Encouraging Public-Private Partnerships to Fight Financial Crime

will facilitate the ability to make FATCA work despite contradictory data privacy statutes around the world. To a certain extent the IGAs build on a network of bilateral tax treaties and information sharing agreements, but such agreements are not currently in place with many countries. Moreover, despite Treasury's best efforts, it may take years for a fully comprehensive network of such IGAs to be put in place, along with local domestic legislation that may still have to be enacted for the IGAs to work. International cooperation is thus absolutely essential, and FATCA will truly test whether such cooperation on an international scale is feasible. Many foreign governments also want to cooperate because they too would like to collect taxes on their citizens with undeclared income and they want to assess the effectiveness of the Anti Money Laundering regime.

FATCA implementation touches on virtually every practice area within a financial institution, from the IT department to the bank's legal team. As financial institutions prepare themselves for FATCA, they will have to develop heightened cooperation among often disparate parts of the organization that traditionally have little interaction with one another. This will by nature be very slow and costly. Unfortunately, the final FATCA regulations begin to be phased in quite soon—on January 1, 2013.

FATCA raises broader information gathering and privacy issues. Under FATCA, the IRS has a new role in financial information sharing on the international stage, which will be a major challenge in ensuring that this information is used and managed properly. There are questions about the IRS' capacity to handle the massive amounts of information they will soon receive from banks around the world, and FATCA's long reach could further inflame the EU debate over data privacy. As the US government tries to force European financial institutions to hand over more data, it could lead to the EU accelerating efforts to make cross-border data sharing much more difficult. Policymakers in the United States and Europe must come to a common understanding and framework of privacy rights in order to move forward with better cooperation, but they seem to be moving in opposite directions.

Even with intergovernmental agreements, FATCA compliance will be extraordinarily difficult for FFIs.

FATCA requirements do not only apply to financial institutions within compliant jurisdictions, but to all financial institutions within a bank's expanded affiliate group. In territories where FATCA compliance is possible then FFIs can choose to comply.

However for FFIs in jurisdictions where compliance is not possible, the current regulations create a special classification for these types of cases, the "limited affiliate status," which lasts through 2015. This still may not be enough time for FFIs to resolve all of the jurisdictional conflicts that arise to enable compliance.

This is a major issue for FFIs—even though they are trying to comply with FATCA, even the FFIs who have complied in their own jurisdiction would become non-compliant when the limited affiliate status expires for the expanded affiliate group. In this case, FATCA is an even more onerous burden—an FFI group may have invested large amounts of capital in changing its operation and reporting systems in order to be FATCA compliant, but then must suffer withholding penalties not only for its noncompliant entities but, by contamination of the expanded affiliate group, also on those entities that have tried to comply.

The IGAs attempt to address this contamination issue by the inclusion of a "related entity" term which unlike "limited affiliate", does not expire. However these related entities will still suffer withholding and so the problem of the compliant FFI in a non IGA territory in the expanded affiliate group remains. Such an entity would lose its compliant status by contamination when limited affiliate status disappears and would at best only be regarded as a related entity of an FFI in an IGA territory thus preventing contamination of the IGA FFI.

Therefore, absent a change in the Final Regulations or IGAs to address this, even territories whose FFIs can comply with FATCA may need to seek IGAs to protect their FFIs from contamination from other parts of the expanded affiliate group. Consequently there is a clear need for a longer phase-in of the FATCA rules to provide more time to resolve these issues and set up a comprehensive framework of IGAs globally.

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